STATEMENT OF CONGRESSMAN TIM RYAN (OH-17) -- JUNE 22, 2006

Thank you for calling the hearing on the growing military power of the People's Republic of China. Much of this hearing will discuss the military platforms China is buying to augment its military capacity, and the implications this has on U.S. interests and allied interests in the region.

Secretary Rumsfeld has expressed concern regarding China's military expansion during a visit to Asia last year, and I think its appropriate for the committee to consider how China is burnishing its armed forces. Today, China has $875 billion in currency reserves, increasing a staggering $200 billion a year. Recently, they surged ahead of Japan as the largest single-holder of foreign reserves. They gathered this stockpile as a result of the predatory monetary policy they implemented in 1994. That year, China devalued its currency by 50 percent, pegging the yuan at 8.28 per U.S. dollar and maintaining this rate until last year. In July of 2005, under significant pressure by members of this body, China made a token gesture and allowed a 2.1% appreciation, moving the peg to 8.01 per dollar, a paltry 0.3%. Due to China's surging productivity resulting from a transition from state-owned industries, distinguished economists like Peter Morici of the University of Maryland and Nick Lardy of the Institute for International Economics think the problem is getting worse, not better. Virtually all analysts believe the currency is substantially undervalued, potentially 40 percent or higher.

Last April, Mr. Chairman, we both appeared on CNN's Lou Dobbs show to discuss our legislation, H.R. 1498, which clarifies that exchange rate manipulation is an illegal export subsidy and requires the International Trade Commission to determine whether "market disruption" from China is occurring as a result of exchange-rate manipulation . It also recognizes the critical damage that currency manipulation does to our defense industrial base, requiring the Defense Secretary to prohibit defense procurement from a country that undervalues its currency for products that compete with a U.S. producer.

The Department of Defense itself implies China's currency policy provides it with a comparative advantage that will affect future weapons programs for the U.S. In an article featured in Manufacturing and Technology News, a trade publication, a recent DoD report asserts: China is adding capacity and the production capacity will soon find its way onto the world markets. "Given China's competitive advantages (specifically, favorable exchange rates and low labor costs), and also the fact that analysts expect that the prices for steel will continue to decrease the next five years, U.S. steel suppliers may be facing a challenging future," says the Pentagon's Industrial Policy shop in an assessment of the impact China is having on steel, aluminum and titanium prices and availability. The article goes on to claim: "If lead times continue to increase, DOD weapons programs may be forced to start long lead parts procurements earlier than the current span of 12 months prior to start of final assembly," says the Industrial Policy office. "Increasing long lead span times could force the Department to adjust program funding across the Department -- reducing weapons system deliveries, stretching-out programs and impacting logistics support."

Last May, we issued a letter to our colleagues calling currency manipulation a national security threat. In that letter, we quoted a 1999 book called "Unrestricted Warfare" by two People's Liberation Army (PLA) Colonels, published by the PLA. The colonels argued that in order to attack another country's economy, the aggressor:

"must adjust its own financial strategy, use currency revaluation or devaluation as primary, and combine means such as getting the upper hand in public opinion and changing the rules sufficiently to make financial turbulence and economic crisis appear in the targeted country or area, weakening its overall power, including its military strength."

Therefore, experts like William Hawkins of the U.S. Business & Industry Council argue that China's currency policy created the Asian *economic* flu of 1997 and intended the flu to spread to the United States defense industrial base, which it has. Since 2000, the U.S. has lost over 3 million manufacturing jobs. In tradable manufacturing industries, the import penetration rate increased from 22.6% in 1997 to 31.2% in 2004, much of that from China. In 2005, the bilateral deficit with China was over $200 billion. China's trading partners estimate China has a global trade surplus of $376 billion. Of the goods the Chinese cannot produce, they openly push the U.S. government to approve more "high-tech" exports, which are really military-useful technology that will only reduce the trade deficit by 0.6%.

Mr. Chairman, nobody makes the case better than you do. On Lou Dobbs Tonight last May, you said the Chinese are using the hard dollars to buy Sovremenny-class Missile Destroyers from the Russians, designed to kill American aircraft carriers. As another example, you also mentioned they are buying MiG 27's and MiG 30's. You said in the old days they couldn't afford them because the Russians would not take IOU's. You summed up your statement to a national audience, saying Russia is arming China "and the sad thing is they're arming in a way that will offset the American fleet. And they are doing it with American dollars."

There are two things we can do to stop these terrifying developments. First, on the supply-side, we should stop issuing US government debt, which is fuel to create more private debt from a massive trade deficit. The second thing this Congress should do address the demand-side, reducing the incentive for any trading partner to accumulate foreign currency for trade advantage. Even if the U.S. stopped selling Treasury securities, foreign authorities can still acquire numerous private debt instruments.

The best vehicle to address currency manipulation is our bill, H.R. 1498. Congress should pass H.R. 1498, which has 170 bi-partisan co-sponsors. It has 32/62 Members of this committee as co-sponsors -- that is a majority. As you know Mr. Chairman, we took great pains to ensure that this bill is WTO compliant, and believe this legislation will provide the clarity, and give the administration the tools necessary to get this issue under control.

Mr. Chairman, We should be alarmed at how China is accumulating their currency reserves, and how they spend the reserves on military procurement. It is my hope, Mr. Chairman, that we can continue to move forward on this very important area of concern, specifically having a hearing on our bill in the near future and address this very real threat to our national security. Thank you for your leadership.

China: Crisis and Implications

By George Friedman

The Chinese government is continuing efforts to cope with its runaway economy. The People's Bank of China has raised interest rates. Banks have been told to curb lending. The government has said that it will implement procedures to rein in foreign acquisitions at low prices -- or, in other words, to block fire-sales of Chinese companies. As a recent headline in the Japan Times put it, "China's Monetary Surge Dooms Its Boom."

A lot of things have gone into dooming China's boom, and the money surge is one of the more immediate problems. However, as we have argued (and this article should be read in the context of past analyses), the end of the Chinese boom was inevitable. The issue now is how all of this will play out in China and in the world.

What must be understood is that China now is moving from an economic problem to a socio-political one. The financial problem is a symptom; the fundamental problem is that tremendous irrationality has been built into the Chinese economy. Enterprises that are not economically viable continue to function through infusions of cash. Some of the cash comes from borrowing, some by exporting at economically unsustainable prices. The result is a squandering of resources. The reasons that this continues have nothing to do with economic rationalism and everything to do with political and social reality.

If interest rates were to rise and lending were to become disciplined, many of China's enterprises would fail. This would bring several consequences.

First, and most important, it would result in a massive increase in unemployment. At this point, the irrationality has been going on for years. It is not only state-owned enterprises that are economically unsustainable; many newer enterprises, including those in which Western companies have invested, are not succeeding. When we look at the figures for nonperforming and troubled loans, they amount to nearly half of China's gross domestic product. That represents a lot of irrationality, a lot of financial failures and a lot of unemployment. And unemployment is a political and social problem. The question is whether China politically can afford the economic solution.

Second, lending has become a system for maintaining the political solidarity of China's elite. Loans have been made not only to avoid the problem of unemployment; they also were made as part of political arrangements that allowed the Chinese Communist Party and regional party organizations to avoid conflict and divisions. As long as the pie was growing, everyone could have a piece. But if the pie starts contracting, there will be losers and winners. The question of who will go bankrupt and who will not will become a highly divisive and potentially destabilizing political crisis. Again, the economic solution -- austerity -- and political reality may run counter to each other.

Obviously, China has massive cash reserves. These may not be massive enough to cover the financial crisis, but they are sufficient to allow the government to put off addressing the problem for a while. China also has the ability to promulgate rules and regulations that allow bankrupt entities to continue functioning. However, it always must be remembered that on the other side of a bad loan is a damaged creditor. A loan that can be deferred by fiat is an asset that can no longer be used. When you avoid economic disaster for the debtor, you transfer the pain -- and potentially the disaster -- to the creditor. And since the creditor is normally the economically healthier entity, you postpone the death of the weak by weakening the strong. The more you do this, the worse it becomes. Thus, whether the Chinese use cash reserves to postpone the problem or use regulation to do so, the net result will be buying time at the cost of increased pain.

China's Likely Path

Asia has been here before. Japan encountered this problem around 1990, and East and Southeast Asia encountered it in 1997. Roughly three models for dealing with the problem exist:

- **Japan model:** Use reserves and formal and informal measures to avoid actions that would trigger massive bankruptcies and unemployment. Accept economic stagnation for the better part of a generation.

- **South Korea model:** Move rapidly to restructure the economy, using economic and political means. Control social unrest with security measures. Move out of the problem in a matter of years.

- **Indonesia model:** Lacking resources to manage the crisis, suffer both financial dysfunction and political strife among the elite and between regions.

Japan was able to do what it did because it is a highly disciplined, cohesive society, in which shared pain is viewed as preferable to social dislocation. South Korea was able to do what it did because the magnitude of its crisis was relatively less than Japan's, and because the state had the means for suppressing unhappiness. Indonesia failed to do what it needed to do because it lacked resources and political power.

Other countries have fallen somewhere along this continuum. China will make its own path. However, it should be pointed out that China is not socially similar to either Japan or South Korea. Like Indonesia, China is a diverse and divided nation. The Communist Party lost its moral standing in the 1970s. As with Suharto's government, its legitimacy now derives from the fact that it has created prosperity. When prosperity slows down or stops, the Party cannot fall back on inherent legitimacy, as was the case with the system in Japan. And the wildly diverse levels of economic development make a single, integrated solution, as was used in South Korea, unlikely. The most likely direction for China, therefore, is massive social and political instability.

Now, the Communist Party may lack moral authority, but it does wield tremendous power. The People's Liberation Army and the various security forces are an enormous presence in China. Indeed, the government already is using its security forces aggressively, cracking down on dissent and against at least some business leaders, in anticipation of coming troubles. The ability to suppress unrest is not trivial. Therefore, the most likely path for China in a post-boom environment is to increase suppression and reimpose systematic dictatorship.

This is not an absolute given. There are many in the Party who now are arguing that China has abandoned its Communist principles and its social base. In other words, they want to reach out to the peasants in the interior, who have benefited little from the boom and who resent the prosperity of the coastal regions. The idea is to use these peasants in a process of renationalization -- or, at least, a process in which the free market is dramatically limited and at least some of the wealth is redistributed.

This goal makes little economic sense, but what China needs economically is unsupportable socially and politically. Imposing a crushing austerity for five to ten years would solve the economic problem, but it is unlikely that the political center could hold. Indeed, if the Chinese were to follow this course, they could do it only with massive political suppression at the same time.

The Party's Tangled Web

Therefore, one likely path is the reimposition of dictatorship, followed by whatever economic solutions the leadership might want to make. But there is a problem here: The interests of Party and People's Liberation Army leaders in Shanghai diverge from those of the central government. These leaders are deeply involved in the financial process of the coastal area, in bringing in foreign investment, in taking advantage of the nonmarket access to capital. They have no inclination to stop. Indeed, their wish is to see the irrational boom continue as long as possible.

There are splits in the interests of regional Party leaders, as well as a split between the regions and Beijing. The interests of coastal leaders lie not with Beijing so much as with Tokyo, New York and London. They have integrated themselves in the international financial system, and they are busy making plans for sustaining their regional enterprises in the event of a crisis. Meanwhile, Party leaders from the interior are demanding that these actions be stopped and that investment flow to their regions instead. Beijing is riding two horses that are running in very different directions.

Beijing well might fall off the horses. China has a history of cycling between a dictatorial system that closes it off from the world (a poor, but equal and stable China) and a system in which China is open to the world but torn apart from the inside out. Consider: Mao marched into the interior, raised a peasant army, came back and liquidated the internationalist bourgeoisie in 1948. He closed off the country and united it, throwing out the foreigners. Under the other model, preceding Mao, the country was open to foreigners, who tore it apart in regional conflicts while the interior starved.

The end result of China's economic crisis, therefore, will be a deep-seated political crisis. Only ever-increasing amounts of money have allowed China to maintain the current political alignment. Without that, it has two options. The first is a return to some sort of dictatorship from Beijing, under which economic problems would be dealt with inefficiently but unambiguously. The other is to accept a split between the coastal regions and the interior, the weakening of Beijing's authority and a period of instability and intense regionalism. It all depends on the political moves Beijing is making now, but our bet would be on the latter course. The instruments of power that Beijing has are too complicit in the financial crisis, and have too many diverging interests, to make the first option likely.

Geopolitics and Ripple Effects

Two possible geopolitical models emerge from this. Under one -- in its extreme form -- China returns to some sort of geopolitical Maoism. It encloses itself from the world, becomes increasingly bellicose but is limited by its own geography in what it can do. Under the other model, China slowly fragments and becomes a cockpit for the ambitions of foreign economic interests -- backed up by political and military power, with regional Chinese officials collaborating with foreigners to continue economic development. Oddly, the latter model would be more destabilizing to the world than the former, inasmuch as everyone will want to maintain their investments in China and expand them. In this scenario, China would again be a magnet for problems.

Mind you, these are not absolutes, but represent extremes on a continuum. There is surely a model under which Beijing would muddle through, as have the Japanese or Indonesians. No coherent strategy would emerge; it would all be tactical. It is difficult for us to see how this would not lead to regional destabilization, but then, China might be able to live with that. How it handles the unemployment and displaced peasant issue, however, is yet another question. This is a possible mid-point on the spectrum, but not in itself likely, it would seem.

As for the effects on the international economy, there has been a great deal of discussion about China's ownership of U.S. Treasury instruments and the consequences if that money were withdrawn in a crisis. In fact, this is the last thing that is going to happen. If China has a massive financial crisis, no one -- including the Chinese government -- is going to shift money from a safe haven into an uncertain cauldron. In crisis, the tendency would be a flight to safety. That means that rather than being pulled out, money would surge into the U.S. market -- legally and illegally, from the Chinese standpoint.

It is interesting to correlate the massive U.S. market surges that began in 1991, after the recession, and intensified dramatically in 1997 and 1998, with trends in Asia. In both cases, these surges followed major economic crises in rapidly expanding Asian economies. The events were, in our opinion, linked. The crisis in Japan in 1990 and 1991 led to major capital flight and helped to fuel the U.S. market rise. Similarly, the impending and expected East Asian meltdown in 1997 produced massive capital flight from Taiwan, South Korea and elsewhere to safer havens. A massive withdrawal from the U.S. market is the last thing to be expected.

What are in danger, of course, are foreign investments in China. There is the obvious financial issue: Many of these investments were not economically viable to begin with. But there is a political problem as well. The Party is going to have to blame someone for China's troubles, and it will not be the leadership. The obvious culprits will be corrupt officials and their paymasters in the international banking system. The truth or falsehood of the charge will matter little; corrupt officials and bankers already are being arrested, in the early stages of the crisis. As the situation intensifies, we would not be surprised to see foreigners investigated for corrupt practices as well.

But the bottom line is this: China has a history of nationalization and expropriation, and the party that enacted those measures is still in power. No one would have believed that the Party of Mao possibly could have become what it is today, but one should not assume that the evolution of the Chinese Communist Party is complete. Leaders could find that they have reason to re-enact some of Mao's own economic policies. We would be surprised to see a complete return to Maoism. We would not, however, be surprised to see the Party deliberately reverse some transactions that are no longer in its interests or (as and if things get more intense) take even more radical steps. It is still a Communist Party, it might be useful to recall.

Ultimately, the choice that China is now making is how quickly it will allow the consequences of its economic irrationality to unfold. The economic answer to the problem is to let shaky enterprises fall -- but the political cost of doing so will be too great, and a solution has already been long delayed. The longer an economic solution is delayed, the less one becomes possible and the more intense becomes Beijing's need to address the problem with political and security solutions. The more dependent the Chinese become on such measures, the more catastrophic will be the consequences if these solutions don't work.

China is long past the point of being able to solve the problem easily. The question is simply whether to buy time and pay in intensity, or force the crisis now. At some point, there no longer will be a choice. But the single most important thing to understand is that China does not really have an economic crisis any longer. The time for that has come and gone. There is now a political crisis at hand.

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