Testimony of James S. Chanos

Chanos & Co.

Systemic Risk: The Chinese Communist Party's Threat to U.S. Financial Stability

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House Select Committee on the Chinese Communist Party

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Good morning. My name is James Chanos. I would like to take this opportunity to thank the House Select Committee on the Chinese Communist Party for allowing me to share my perspective on China's economic model and the risks it poses to the United States.

I am the President of Chanos & Co., a New York private investment management company that I founded in 1985. Chanos & Co. specializes in short-selling, an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price. Chanos & Co. is among the longest continually running short investment funds in the world.

Prior to founding Chanos & Co., previously called Kynikos Associates, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating with a B.A. in Economics and Political Science.

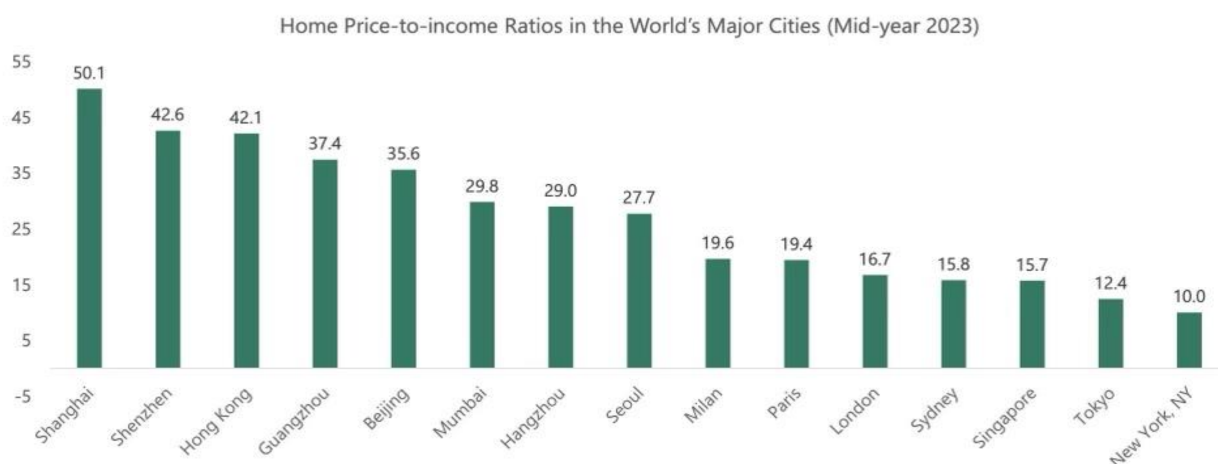
On behalf of our clients, Chanos & Co. manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it holds fall in value. Chanos &

Co. selects portfolio securities by conducting a rigorous financial analysis focused on securities and industries that may be overstating profitability, facing macroeconomic headwinds, showing signs of fraud, or a combination thereof.

My interest in the Chinese economic model first arose during a research meeting in the Fall of 2009. Our real estate analyst was giving a presentation and noted that China had 5.6 billion square meters of real estate under development, half residential and half commercial. At first, I thought the analyst had made a mistake or misspoke and meant 5.6 billion square *feet*. No, he assured me, it was 5.6 billion square meters. That translates to over 60 billion square feet. It was a 'light bulb turning on' moment for me, as I realized that the 30 billion square feet of office space under development represented a 5x5 square foot cubicle for every man, woman, and child in China!

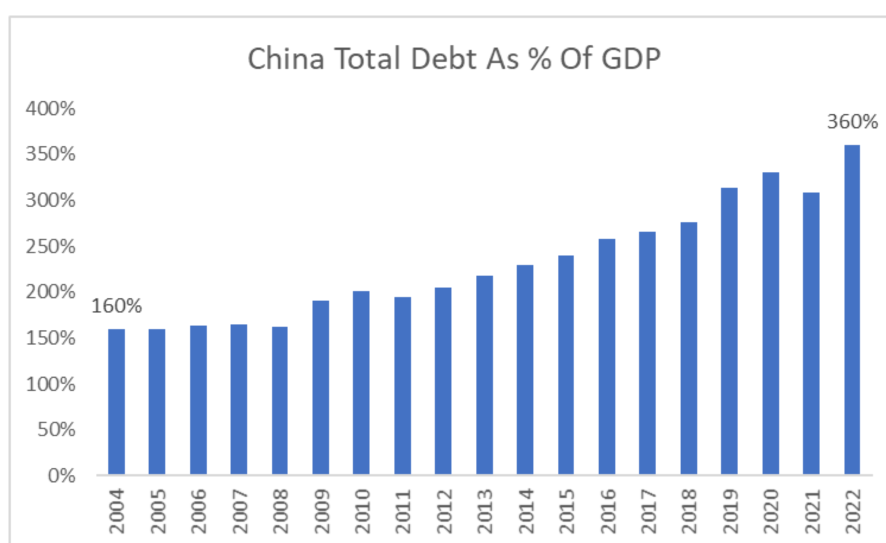
That meeting took place during the late innings of the Global Financial Crisis. At that time, the strength of the commodities market during a global recession seemed curious, if not odd. The underlying strength, it turns out, was due to the rise of the Chinese real estate market and associated construction boom.

We soon learned that much of that construction was for high-end condos. Home prices in some Tier 1 cities are as high as 35-50x average annual income levels. It became apparent that the Chinese real estate boom was equal parts engine for economic growth and tool for speculation.



Source: Various

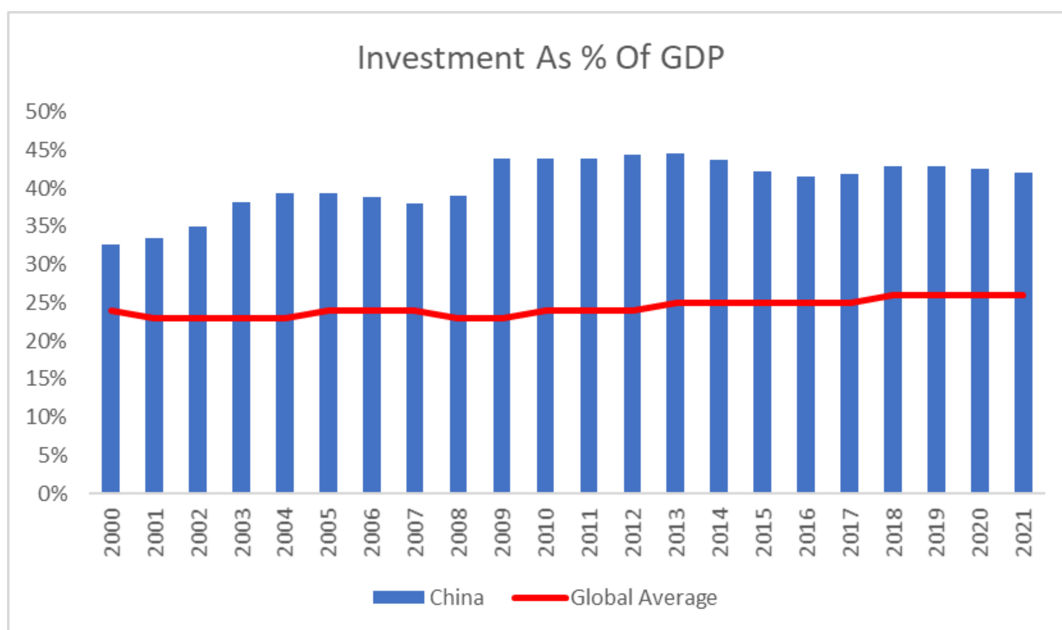
Our research into the Chinese real estate market and broader economy revealed some ugly truths and deep flaws regarding their financial system. We began warning clients about China shortly thereafter. In the subsequent years, nothing has fundamentally changed about the Chinese economic model, except the problems have only gotten worse.



Source: Chanos & Co.

China's economic model is not difficult to understand. Quite simply, it is all about growing GDP at almost any cost. Total debt now represents 360% of China's GDP, up from 160%

in 2004. The easiest way to grow your GDP is using the investment-driven model. China has seen over 40% of its GDP come from investment throughout the 21st Century, compared to the global average of 25%.



Source: Chanos & Co.

Financial history lessons from other countries in the 20th century have taught us that investment-driven economies do not fare well over the long-run. The Soviet Union, 1980s Japan, and the 1990s 'Asian Tigers' offer historical parallels. Those countries are still dealing with the fallout of their economic policy mistakes today, several decades later.

China has frequently pointed to a shift towards a service economy, but those promises have failed to materialize because that kind of pivot is extremely difficult to execute without a recessionary reset. A fundamental macroeconomic accounting identity states that investment equals savings. Therefore, a decrease in savings (i.e. increase in consumption) translates to a decrease in investment, thus immediately threatening final demand. Every $1 of spending on Project XYZ translates to $1 of GDP. As a result, GDP can be dialed to whatever number China

wants over the short-term. I have often said that China is the only country in the developed world that knows its GDP on January 1 of that year. However, as GDP grows, so does the required amount of additional investment needed to grow in the future, much of which is debt-funded. We call this China's "treadmill to hell".

Increasing the amount spent on investment projects that don't generate revenues or income does not make sense to a rational observer. The more money borrowed to service the existing debt on uneconomic projects doesn't ultimately add to national wealth. It just delays the inevitable write-offs of bad investments. How China will wean itself from its addition to debt is unknown. Two decades of oftentimes illogical spending will inevitably come home to roost.

There are numerous real world examples of the folly of China's economic model. The overbuilding from the construction boom has been rampant. Vacant metropolises, or 'ghost cities', began popping up a decade ago. It didn't matter that few people lived in these freshly built cities, because the construction contributed to GDP growth. But after two decades of unfettered growth, the real estate boom is showing signs of going bust.

A recent report from Goldman Sachs published on August 8, 2023 shows that property sales and construction starts are in a severe state of decline. Meanwhile, property developer debt accounts for 16% of China's GDP, having peaked at 20% pre-pandemic and up from 6% in 2006. But a recent drop in housing prices that started in late 2021 has demonstrated that China's real estate market has developed serious cracks in its foundation. The impact of a crashing Chinese real estate market carries enormous consequences for China's financial system, its domestic economy and the rest of the world.

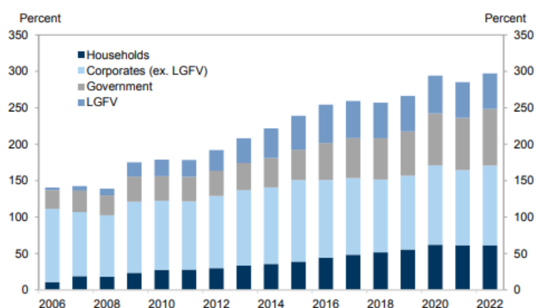
Exhibit 1: Sales and especially new starts have plunged since 2020

Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 2: Home prices have declined even in top-tier cities

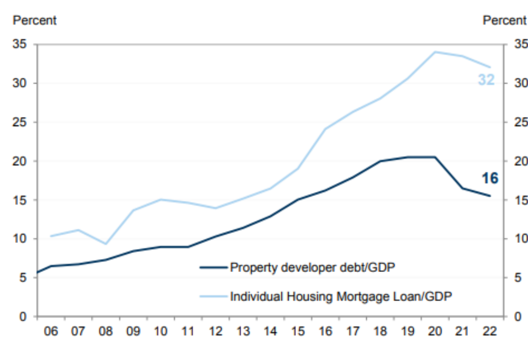
Source: NBS, CREIS, Centaline, Beike, Wind, Goldman Sachs Global Investment Research

Exhibit 3: Overall debt has continued to rise in recent years



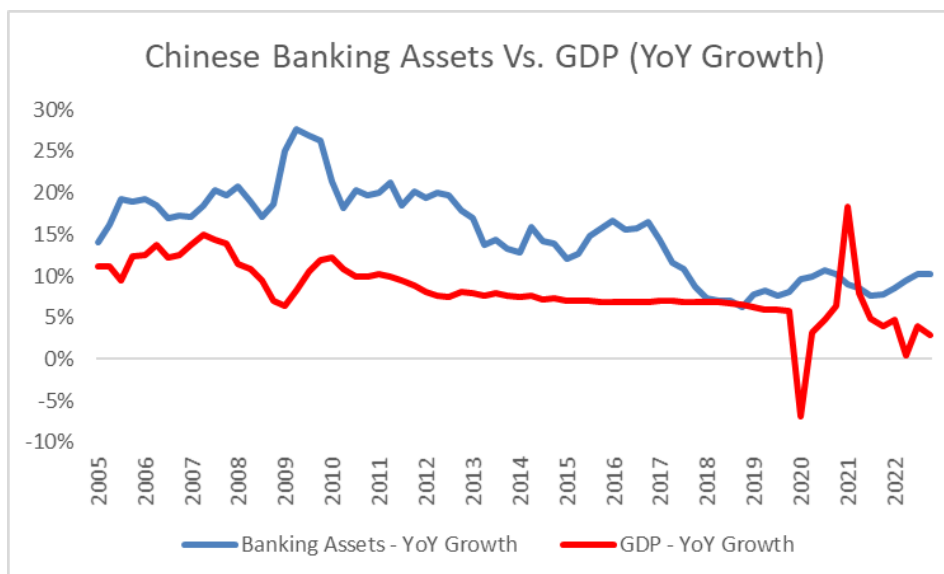
Source: BIS, WIND, Goldman Sachs Global Investment Research

Exhibit 4: Property sector deleveraging began in 2021



Source: Bloomberg, Wind, PBOC, China Trustee Association, Asset Management Association of China, Goldman Sachs Global Investment Research

China's real estate market, however, is only one part of their economic model, albeit a significant one. The true nexus of their financial system is the banking sector.



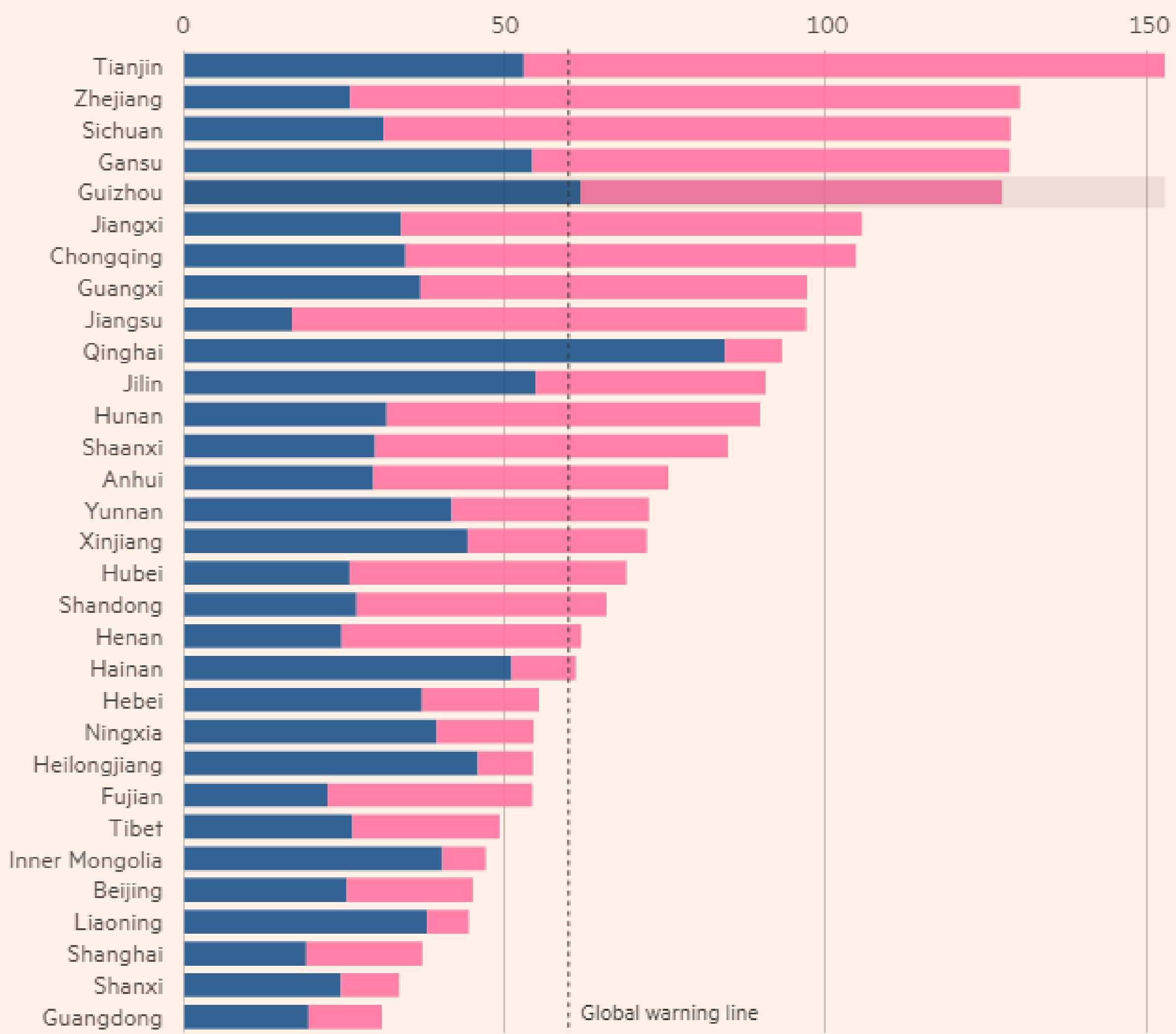
Source: Chanos & Co.

Chinese banks have seen their assets grow at a faster rate than GDP growth, often twice as high. The increasingly unproductive nature of Chinese credit is a telltale sign of a financial bubble. The enormous debt burden built up extends to all sorts of different financing entities, many of which are showing deep signs of strain.

One type of vehicle used is the LGFV – or Local Government Financing Vehicle. The first one was set up in 1998 to fund highway construction. It has become quite popular with local governments since then. Total local government debt has ballooned to RMB 94 trillion, or $13 trillion dollars at the end of 2022 – according to Goldman Sachs. That is equivalent to 72% of China's GDP. The majority of that, an estimated RMB 53 trillion ($7 trillion), sits with LGFVs.

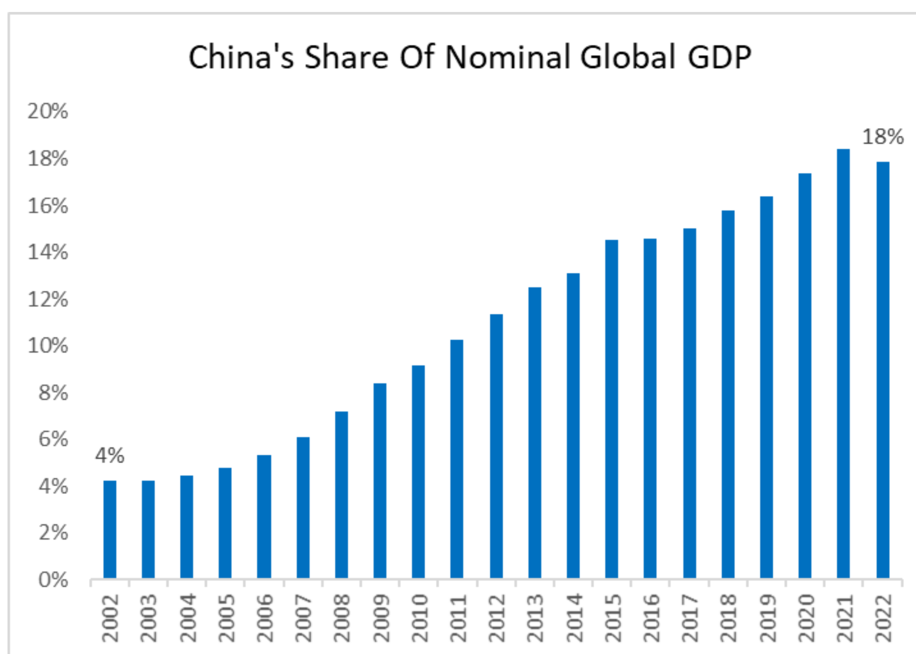
LGFVs are unique to China and represent a unique part of their debt structure. Beijing has only recently started to send its central bankers to provinces with exceptionally high debt levels to tackle their debt problems. Two-thirds of Chinese local governments carry debt levels about the global warning benchmark line. The LGFVs are implicitly backed by Chinese banks –

raising questions on which entities ultimately will have to handle the bad debt write-offs. Will it be the banks or the local governments themselves? But LGFVs aren't the only vehicles being used within the Chinese financial sector as part of their economic engine.



Other non-bank lenders, wealth management products, investment trusts, and asset management companies also play key roles in China's financial sector. Together, they create a tangled web of financial relationships that can be difficult to decipher.

What is clear is that China needs to make structural changes to the sources of its economic output. If China is unable to pivot its economic model, either due to reluctance or inability, it poses global risk. The question is whether China can ever wean itself from its debt-funded real estate investment while simultaneously keeping their economy afloat. We do not know the answer to that yet.



Source: Chanos & Co.

What we do know is China's enormous appetite for commodities combined with heavy imports and exports make them an indispensable trade partner to the world. China accounts for 15% of global imports and 12% of global exports. They rank as a top trading partner for almost every major economy around the globe. A failure of the Chinese economic model will

surely translate to global financial strain. Said differently, China's economy and the global economy are inextricably linked.

China Trade Flows By Country (2020, US$ B)

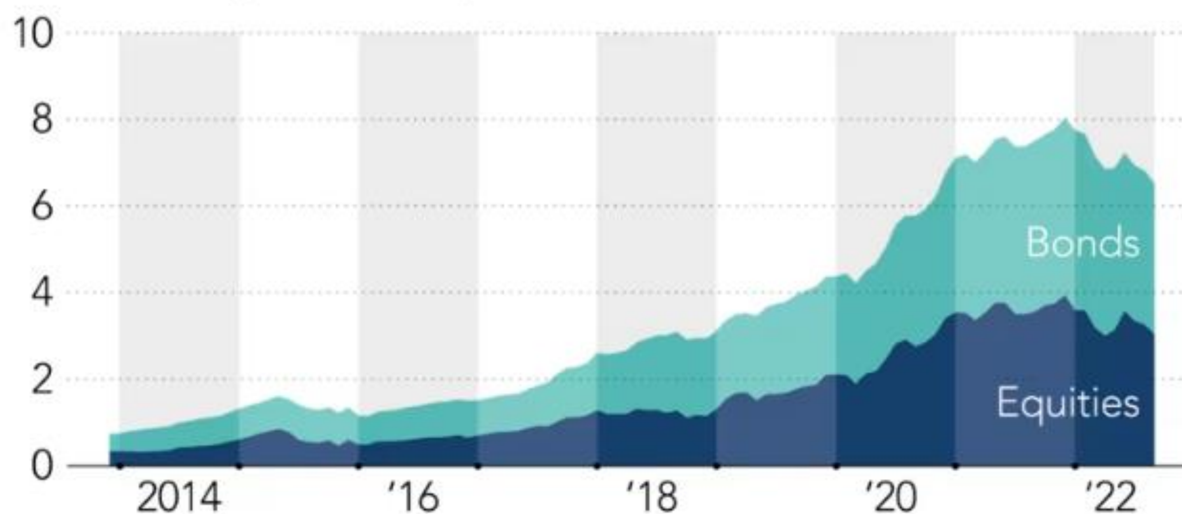
	Exports To China	% of Exports	Partner Rank	Imports From China	% of Imports	Partner Rank
Australia	114.8	46.9%	1	43.5	20.5%	1
Brazil	84.0	40.2%	1	34.9	21.0%	1
Chile	28.7	39.0%	1	15.3	25.8%	1
Germany	86.3	6.2%	3	105.3	9.0%	1
Indonesia	41.0	25.1%	1	37.1	26.2%	1
Japan	142.6	22.2%	2	174.2	27.4%	1
Malaysia	56.4	24.1%	2	74.3	39.2%	1
Netherlands	12.7	2.3%	9	79.0	16.3%	3
Pakistan	2.1	9.5%	3	15.5	33.8%	1
Peru	14.1	36.3%	1	8.8	24.4%	1
Rep. of Korea	172.7	33.7%	1	112.5	24.1%	1
Russia	50.6	15.0%	2	57.2	24.7%	1
South Africa	15.2	17.8%	1	20.5	29.8%	1
United Kingdom	19.7	5.0%	6	72.6	11.4%	2
USA	135.9	9.5%	3	452.5	18.8%	1
Global	**2,590.6**	**15.3%**	**2**	**2,055.6**	**12.0%**	**1**

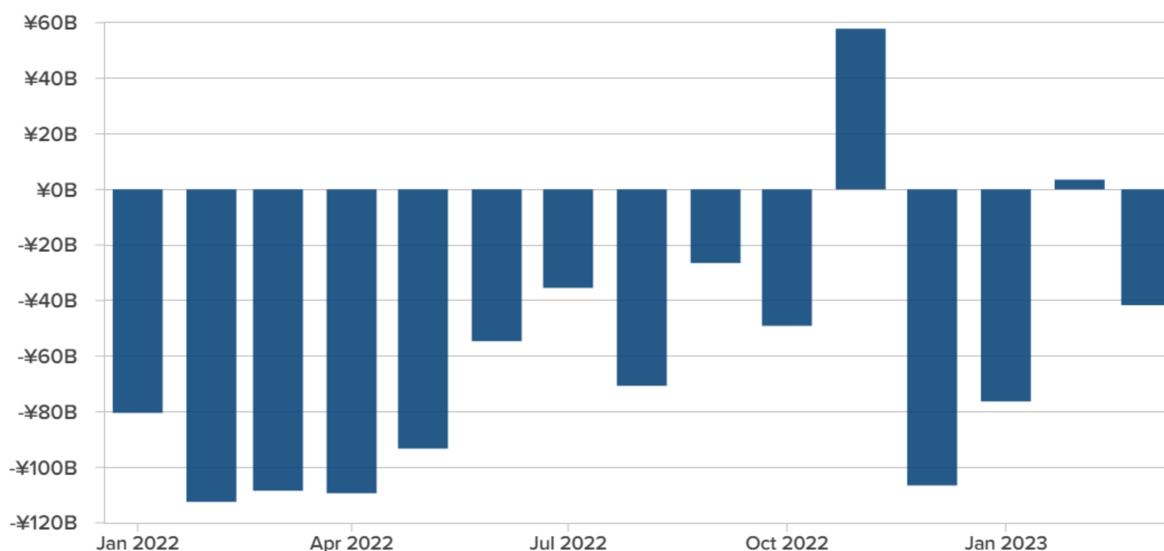
Source: Chanos & Co.

This is particularly true for commodities. China has been consuming 50% of global iron ore exports, 40% of copper exports, is 50% of global steel demand, and uses enormous quantities of just about everything else. Note the high usage of base metals for construction. Their share of global incremental oil demand growth over the last decade has hit 50%. And China currently accounts for 77% of global battery manufacturing capacity.

Thus far, we've illustrated how the Chinese economic model works and the systemic risk it carries for the global economy. But how do the underlying problems of the Chinese economic model ultimately impact the West financially?

China's investment-based model has an insatiable appetite for capital. Western investors have been a willing source, albeit there has been increased skepticism building recently due to Chinese property weakness. Foreign holdings of Chinese securities has ranged between RMB 6-8 trillion ($1 trillion) recently, up from RMB 1 trillion in 2014. Since the start of 2022, there have only been two months where foreign ownership of Chinese bonds increased during a given month. There is a flip side to that coin, too. Overseas investment by China fell (18%) in 2022 to $147 billion dollars. China currently holds some $1.9 trillion of US stocks and bonds.

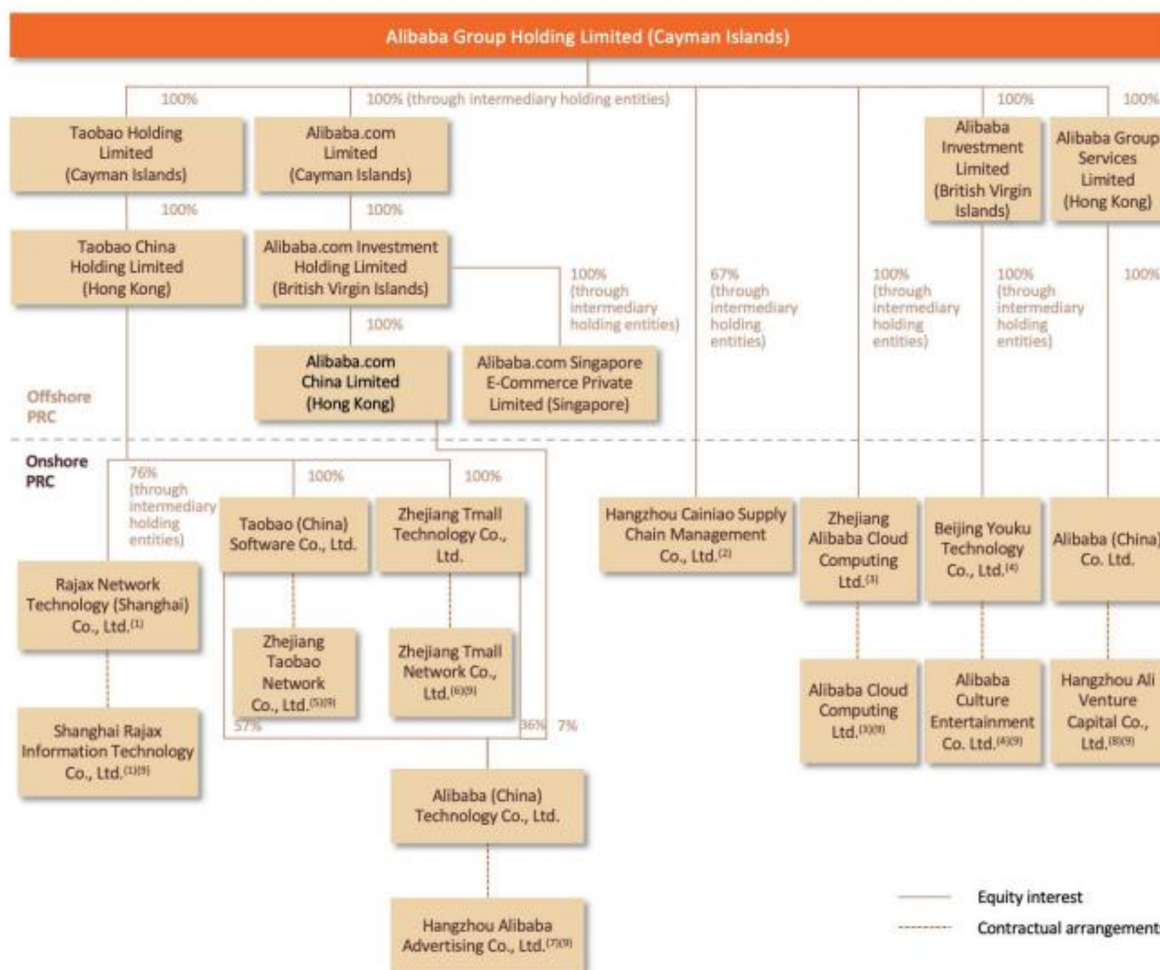




Western holdings of Chinese securities could be heavily at risk, and in more ways than you might think. One such way is through Variable Interest Entities, or VIEs. The VIE structure was designed to attract foreign investment into Chinese stocks, but there are major risks that are often ignored. For example, Western investors in VIEs often do not realize that they do not have legal ownership rights to the underlying assets in the PRC. Instead, investors actually own a piece of paper in an offshore entity that was set up for overseas listing purposes. That piece of paper has a contractual agreement with the operating business in China, which was designed to skirt Chinese rules restricting foreign investment in sensitive industries like technology and telecommunications. However, VIE structures are inherently opaque and carry enormous governance risk. There is also the small issue of VIEs being technically illegal in China.

For an example of how the VIE structure works, let's look at Alibaba, listed on the New York Stock Exchange under the ticker "BABA". When you buy BABA stock, you don't technically

have a claim on the underlying assets in China, but rather ownership in an offshore shell company that has a claim to its profits. If China ever did crack down on VIEs, many Western investors could be left holding the proverbial bag.



Source: BABA 20-F Filing

One real instance of the VIE structure coming back to haunt Western investors relates to the collapse of Archegos Capital in 2021. Archegos had loaded up on numerous US-listed Chinese stocks. Archegos rapidly collapsed amid a flurry of margin calls, many related to those same Chinese stocks. It now serves as a stark reminder of the systemic issues inherent in questionable Chinese issuers.

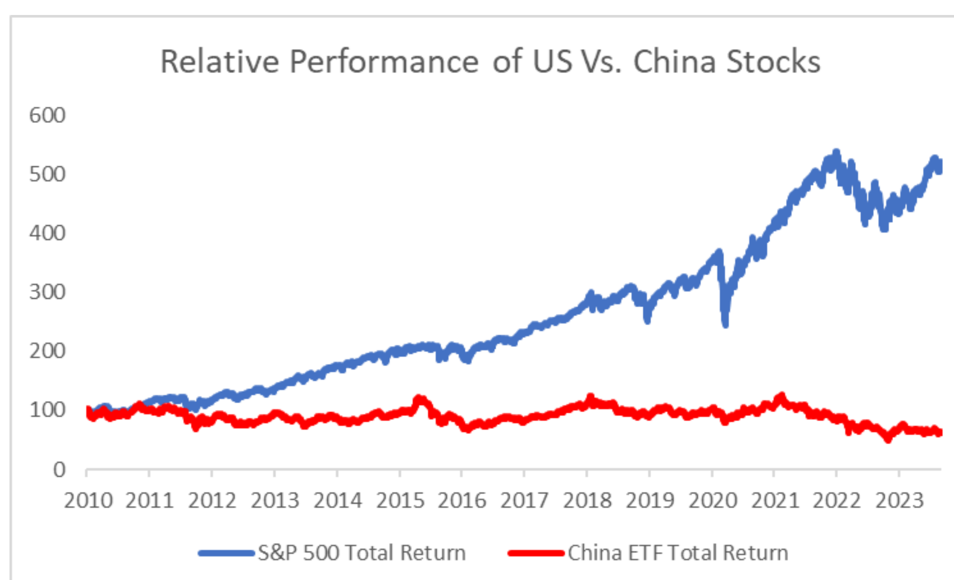
Governance issues also pose risk to Western investors in China. The Chinese Communist Party is run by an autocrat who has the ability to crack down on entire industries unilaterally and without warning. We saw this in the 2021 collapse of the Chinese online education sector. The posterchild of this industry, GSX Techedu, was one of the key positions of US-listed Chinese stocks held by Archegos. Other key governance/reporting issues apply to Chinese data more broadly. There is a long and storied history of data coming out of China being falsified at every level of government reporting.

China's credit problems are not confined to its borders. Through their One Belt, One Road initiative, China has lent over $1 trillion dollars to emerging market countries around the world, particularly in Africa and southern Asia. Countries on the receiving end, including Pakistan and Sri Lanka, have recently struggled to repay these loans. The loans serve multiple purposes for the Chinese model. First, it helps with their GDP growth because the loans often require vendor financing with Chinese construction firms. Second, it also strengthens political and trade connections between China and emerging market economies, making it easier to secure trade flows between the lender and the borrower.

Global systemically important banks are not immune to risk either. Banks, including HSBC and Standard Chartered, have loan exposure north of 50% related to the Greater China region. Though major US banks do not have that kind of outsized direct exposure to China loans, the Chinese banking system still poses risk to the global financial system. The 'Big 4' US banks (JPMorgan, Citigroup, Bank of America, and Morgan Stanley) had combined China exposure of $48B in 2022, down (16%) from 2021 levels. That represents just 1% of their combined global loan portfolio, but almost 6% of their combined equity.

While Western banks may be somewhat insulated from direct exposure to Chinese bad debt, we cannot say the same for Western equity investors, many of whom represent US pension funds and retail investors. We estimate that offshore-traded Chinese equities, subject to many of the risks we have discussed here, represent $3 trillion in market capitalization as of mid-2023. Total Chinese equity market capitalization represents 14% of total global equity market capitalization.

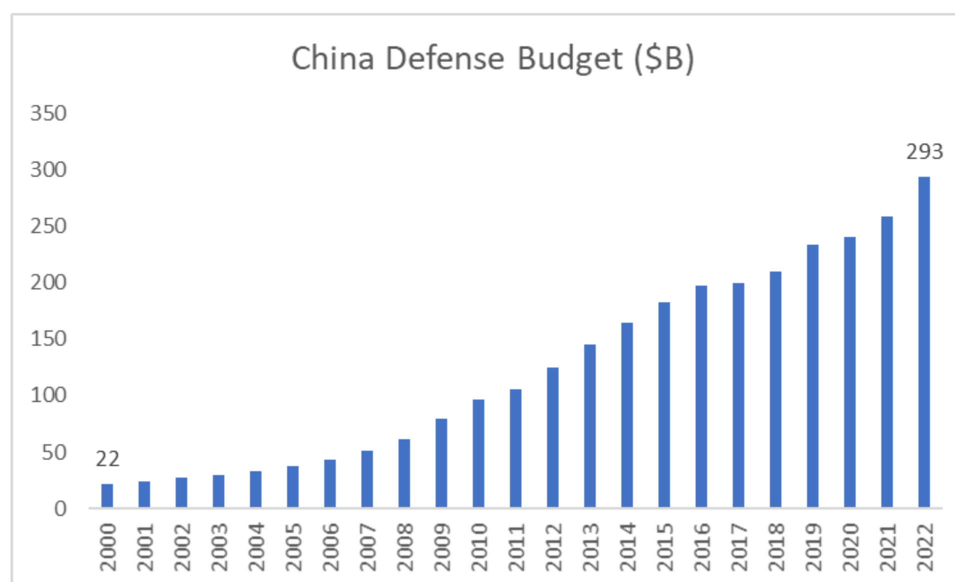
Taking the risks outlined into account, it is no surprise that Chinese stocks have significantly underperformed relative to US stocks. Since 2010, the S&P 500 Total Return index has outperformed a China stock ETF by a factor of 8x on a relative basis. On an absolute basis, the China ETF has nearly been cut in half vs. the S&P 500 Total Return increasing over 5x.



Source: Chanos & Co.

As we think about a possible shift in spending within China, one possible solution that would allow China to keep its investment-driven model intact would be to shift spending away from real estate and towards defense. China currently has the second highest defense budget

in the world at $293 billion, a 13-fold increase since they spent $22 billion in 2000. Of course, increased defense spending by China presents new questions on the security paradigm in the Pacific theater. President Xi Jinping's increasingly bellicose rhetoric, particularly around China's interest in the South China Sea and Taiwan, may undermine US military interests in the region.



Source: Chanos & Co.

Finally, I would like to remind you that my original observations have been frequently critiqued by Western investors bullish on China. I was regularly accused of 'not understanding' China, and portrayed as a pessimistic naysayer. While short sellers like myself may never be popular among the chorus of bulls on Wall Street, we are often the ones wearing the white hats when it comes to identifying economic shortfalls and outright fraud. I continue to believe that the Chinese economic model poses grave financial and geopolitical threats to the US and its interests, more so today than ever before.

Thank you very much for this opportunity to share my perspective.

James S. Chanos

Michael Chanos

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