

Chanos Crash: Timing China's Financial Meltdown

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At an October seminar of the Chicago Council on Global Affairs (CCGA), carnival economist Niall Ferguson promoted his new book, [*Civilization: The West and the Rest*](#). He revealed the blindingly obvious as if it were a divine revelation: the U.S. has serious problems. He preached that the U.S. corrupted its six Ferguson-defined “killer apps”: competition, science, rule of law, medicine, the consumer society, and a strong work ethic.

Ferguson claims India and China have downloaded these killer apps and compares the West with a virus infected PC and the East with a fast Mac. Never mind that competition, science, medicine, trade, and industrious workers have been in evidence in India and China for centuries. The West didn't invent these ideas, so perhaps there's more to the story than Ferguson's pat explanation. As for rule of law, that killer app seems as corrupted in the East as it is in the West. Ferguson's crowd-pleasing presentation didn't mention other “killer” apps that are prevalent in China: fraud, high debt levels, and privatizing gains while socializing risks and losses.

Ferguson claims that in 1978 citizens of the U.S. were on average 20 times richer than the citizens of China. Today, U.S. citizens are only five times richer. He apparently defines wealth as acquisition of material goods. That is important, to be sure, and the West should pay careful attention to the material economy. But Ferguson's China supremacy presentation didn't mention the negative human wealth effects of China's one-child policy on the shortage of female mates, the general disregard of public safety, and shortage of essentials like agricultural water and arable land.

Ferguson projects that China will have closed the material goods gap by 2016. This fits right in with popular group-think that China is an unstoppable growth machine. But it is this type of group-think that warned no one about the pending financial crisis in the U.S. in 2008 and now ignores serious potential problems in China.

Bailouts, Railroading, Cover-ups, and the Chinese “Miracle”

China is becoming a version of the U.S., but it's the version that builds lots of Penn Centrals in record time to connect slapped together empty cities before going bankrupt.

When Ferguson claimed China downloaded killer apps from the West, he left out one that is literally a killer in the form of reckless disregard for public safety. China's Ministry of Railroads, an entity with rapidly growing debt of 2.1 trillion yuan (\$330 billion), was bailed out when the National Development

and Reform Commission announced it had “[government support](#).” (See Gordon [G. Chang’s October 23 article](#) in *Forbes*.)

The bigger problem is the shoddy construction of China’s high speed railroad system, and cover-ups by railroad management. It turns out that railway bridges were constructed by untrained unskilled migrant workers and rocks and gravel were tossed into pier foundations instead of concrete. Unqualified workers also built tunnels. When tunnel problems manifest themselves, they usually involve suffocation of passengers. If you ever wondered how the Chinese can slap together an infrastructure so fast, here’s your answer. It literally slaps it together. Fixing the construction problem may ultimately be more costly than having done it properly in the first place. But the social issues are an even bigger disaster for Chinese government.

In July 2011, [two bullet trains on the Wenzhou Line crashed](#). Officials claimed a lightning strike caused the accident, and tried to suppress reports.

After officials claimed everyone was removed from the carriages, bulldozers buried the rubble and onlookers screamed as bodies fell out of the windows of the about-to-be-buried carriages. Then after it was formally announced that all of the bodies in the carriages had been removed, a four-year-old girl was found alive in the wreckage. A spokesman for China’s Railway ministry told the reporters shouting at him that it was a “miracle.”

Tens of Millions of Mate-less Men

China’s population comprises more than 1.3 billion people. According to [Unnatural Selection](#), China has 121 male births for every 100 females, whereas the highest natural ratio is around 106 males per every 100 females. Wikipedia’s 2008 figures show that in the under 15 age group, there were already 113 males for every 100 females. I’m sure young men and women have given this ratio at least a passing thought, and it’s getting much worse.

Putting aside the issues of selective abortion of female fetuses, female infanticide, and the implications of household formation, this means a growth in the tens of millions of frustrated men dispersed throughout China.

The apparent euphoria of western pundits like Ferguson when discussing China makes me wonder if they downloaded an app for a peculiar kind of dementia. Everything we want or need in life comes to us through our relationships with other people. The quality of our relationships, or human wealth, defines the quality of our lives. Ignoring this is a socio-economic hand job. China is fundamentally impoverished in a way that is irreparable in the short run.

China's Housing Price Crash

There's a myth that low leverage makes a housing price crash immaterial. Many Chinese home buyers pay cash, but others make high down payments. Some reported down payments are as low as 30%; high by U.S. "standards," but still painful when housing prices drop 30%. Some investors have bought multiple properties. Even if one pays upfront in full, a housing price decline has a huge impact on how wealthy investors feel.

Here's the most benign case. Suppose a buyer pays cash for an empty investment property. The buyer still has to maintain the property. If housing prices remain stagnant (or go down), and food prices and other prices escalate (as they have), will that buyer feel richer or poorer? Will he have a higher appetite for liquidity or a lower one? Will other potential investors observe this and want to buy real estate so they can enjoy the same delightful experience?

The critical problem is that home prices in China are sliding fast. Some analysts say the "[tipping point](#)" started in September and they expect it to get much worse. Chinese newspapers reported riots in Shanghai after developers slashed prices to dump inventory. Contracted home buyers saw [prices cut 25%](#). Some property developments in Beijing have had price cuts of [20-30 percent](#). China's empty "[ghost cities](#)" are seeing price discounts of 30 percent for upfront cash payments. Mainstream U.S. financial media is now reporting possible housing price declines of [20-30 percent](#) for major Chinese cities next year.

China's Debt and Coming Hard Landing

Nothing creates a hard landing better than a housing collapse. Property construction accounts for more than 13% of China's GDP up from around 3% of GDP in 1999 according to the China National Bureau of Statistics.

Local Chinese governments have mounting debt to fund infrastructure projects of [10.7 trillion yuan \(\\$1.7 trillion\)](#) and depend on land sales to fund payments. According to investment management company GMO debt in Local Government Funding Vehicles amounts to around 1/3 of China's GDP. The projected slowdown in land sales will pose a huge problem, no matter whose numbers one uses.

A huge problem in analyzing China's debt problems are off-balance sheet obligations. No one knows the size of local government debt obscured by off-balance sheet vehicles. Hidden national government debt includes "support" such as for the railroad and a variety of other guarantees have ballooned China's real debt.

Then there are the obvious problems with undercapitalized banks. When most people think of “Jim” and “China” they think of China advocate Jim Rogers or China skeptic Jim Chanos. Many people haven’t heard of Jim Antos, an analyst at Mizuho Securities in Asia. According to Antos, loan growth has slowed to 15% from 30%, but the unsustainable current level of bank loans stands [at \\$6,500 per capita in 2010](#). Gross domestic product per capita is \$4,400. [The CIA estimates 2010 GDP per capita at \$7,600 adjusted for purchasing power parity.] On a scale of one to ten, he rates China’s debt problem an eight and Greece’s debt problem a ten.

GMO reports that Fitch estimates that 35% of bank loans are directly or indirectly tied to the Chinese property market, and UBS estimates it at 40-50% of outstanding loans. No matter which is correct, a pullback will be brutal. (“Between Errors of Optimism and Pessimism,” by Edward Chancellor, GMO, September 2011, and “China Real Estate—Final Destination,” UBS, August 25, 2011.)

These loans don’t count active [private lending frauds](#) that fleece entire towns and enrich local bureaucrats, accomplices of “property developers” turned con artists.

Swindles have become so commonplace that James Grant, of the [Grant’s Interest Rate Observer](#), calls China “The People’s Republic of Madoff.” Research firm Muddy Waters gives foreign investors ample reasons to be wary. It’s been documenting suspicious numbers reported by a plethora of small cap Chinese reverse merger companies listed on foreign exchanges. Muddy Waters’ skepticism about a larger company, Sino Forest, caused its stock price to plummet.

If that weren’t enough to make investors nervous, Jim Chanos, President and founder of Kynikos, [told Bloomberg](#) that many large cap shareholders don’t realize that all they have is an operating agreement with mainland companies, not control of hard assets.

China has loaded itself up with debt. Unfortunately for Chinese citizens, China also down-loaded the “killer app” of socializing credit risk. Bank deposits are low yielding and the borrowing rate is either very low or negative which encourages explosive loan growth, also known as a debt bubble. (“China Financial Markets: Time to relax credit?” by Michael Pettis, Guanghua School of Management, Peking University, October 31, 2011.)

As for China’s official growth figures, one has to be suspicious of government numbers when ministers have already shown they will try to bulldoze over horrific facts. Discovery of the truth takes a miracle.

When Will Strain Lead to a Crash?

China is on track for making as much of a muddle of its economy as many countries in the West have done. While being a fast-growing creditor country helps mitigate the consequences of its folly, the consequences are catching up with China. Are these problems overstated? That's impossible to tell without reliable numbers. The question to answer is how quickly and to what degree will China's problems affect its economy? After all, one wants to be able to get in a good short trade just before it all falls apart, if that is where this is headed.

Dylan Grice points out that anecdotal evidence can be misleading and China may "keep the plates spinning for a few more years." ("Popular Delusions: On China's swindles: how big is the bezzle?" by Dylan Grice, Societe Generale Cross Asset Research, November 4, 2011.)

It would be useful to come up with a measurement that indicates when things are just about to fall apart. Based on my own anecdotal experience in Iran, one cannot predict the timing of a collapse with certainty, but a good leading indicator is when rats start leaving the sinking ship in droves.

Chanos ("China Chaos") Derivatives

Grice provides a clue for the timing of China's collapse. Since 1990 around 18,000 officials have fled taking an average of around \$7 million per flight. Special purpose credit derivatives (perhaps you prefer the term "discredited" derivatives) are a leading indicator for China's hard landing. I call these "China chaos" derivatives, or "Chanos" derivatives.

If the rate of change of public officials fleeing the country, $df/dt > x$, where x is yet to be defined, or the acceleration in fleers, $d^2f/dt^2 > y$, where y has yet to be defined, or the rate of change of the average amount of loot $dl/dt > z$, where z is yet to be defined, then conditions of the Chanos Equilibrium have been violated and destabilization will occur.

Stated differently, when you see the absolute amount of embezzled wealth fleeing the country suddenly increase, or when you see a sudden increase in the absolute number of Chinese officials leaving the country on "holiday," or when you see an acceleration in the number of officials leaving the country in a stealthier way, you'll know China is sinking.

See also: "[China 2012: The Year of the Bull \(Rogers\) or the Bear \(Chanos\)?](#)" *TSF*, January 9, 2012.



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