Hearing on "China's Quest for Capital: Motivations, Methods, and Implications"

Thursday, January 23, 2020
Dirksen Senate Office Building, Room 419
Washington, DC 20510

Opening Statement of Chairman Cleveland

Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2020 reporting cycle. Today's hearing will examine the internal and external dynamics of China's financial system, and the risks as well as opportunities China's growing global integration poses to U.S. institutional and individual investors. I want to welcome our witnesses and thank them for their participation.

With stage one of a trade deal inked last week, China has committed to greater access to its banking, asset management, credit and financial markets. At the same time, Chinese securities are being included on global indices. This expansion and access raises reasonable concerns about the transparency, stability, regulation as well as the real value associated with China's markets, assets and lending instruments.

To fuel growth, over the past decade China's banking sector has grown from $9 trillion to a staggering $39 trillion, 8.2 to 21.4 percent of which is estimated by Moody's to be held in shadow lending instruments. Meanwhile, China's debt to GDP ratio exceeded 260% in the second quarter of 2019. The speed, scope and lack of transparency regarding this increase are especially troubling as China seeks closer integration with the US and global financial markets.

Despite a fourfold expansion over the past decade, China's financial system is marked by weaknesses, inefficiencies, and a lack of transparency which challenge an accurate understanding of capital requirements, debt levels, pricing and treatment of bank balance sheets, volume of non-performing assets and general operations. High savings rates historically have reduced concerns about excess debt. However, in the last several years, the flow of credit has far exceeded deposits. Beijing seemed to recognize the risks of excessive corporate debt, but abandoned deleveraging as growth slowed. A renewed surge in shadow banking practices add to the challenges small and medium enterprises face in raising capital. Adding to the costs and terms of borrowing, SOEs are adding to stress in the system by not paying their small and medium corporate suppliers: Data from the People's Bank of China suggests that in the second quarter of 2019, the value of outstanding commercial acceptance bills, essentially IOUs, reached $1.7 trillion.

Financial markets in China are opening at a particularly challenging point in time. Are we on the verge of a prudent period of well supervised credit expansion which could fuel global growth, or are we being drawn in to a swamp of toxic debt, ponzi schemes with no possible legal or financial recourse? Americans investors are not accustomed to China's ongoing practices of random suspension of trading, artificial limits on IPO valuation and interference in corporate operations and practice to serve Communist Party objectives. Although yields seem attractive, there is a nagging feeling that there should be a buyer beware label on the stock connect platforms and Chinese debt and equity sales.

Backstopping the opaque banking and credit sector is China's foreign exchange reserve which suffers its own problems. In the space of just a few years, nearly 25% of the reserves were wiped out in an all-out campaign to shore up the RMB, an undertaking which cost nearly $1 trillion. In 2019, witnesses suggested to the Commission that the lack of transparency may be hiding between $500 billion and $700 billion worth of loans to domestic banks, for which Beijing only holds promissory notes. There is no doubt, Chinas reserves have served multiple policy agendas from subsidizing rates and major banks as they take on regional enterprises non-performing loans to shoring up the RMB and underwriting Belt and Road projects. Again, lack of transparency calls into question the strength and viability of this resource.

As China's economy struggles with the legacy of the fastest debt buildup in history, Beijing seeks to attract U.S. and other foreign investors to ensure growth and the sustainability of the CCP's model. The challenge for our witnesses as well as investors is to better understand what drives the demand for capital and the tools used to raise it especially on US exchanges. Are we looking at a rational model that delivers consistent value and yield? Or five years from now will we be more fully sunk into China's financial system and grappling with a massive toxic debt crisis. I am hopeful our witnesses today will inform our understanding of the debt, equity and investment picture, particularly the impact of global indices on financial market stability. That, in turn, will help inform risk to American investors which my colleague, Commissioner Wessel, will address.