CHINA ECONOMIC UPDATE DECEMBER 2017

Uneven flows – how distortions in China's data paint a very different picture of global trade

NAB Group Economics

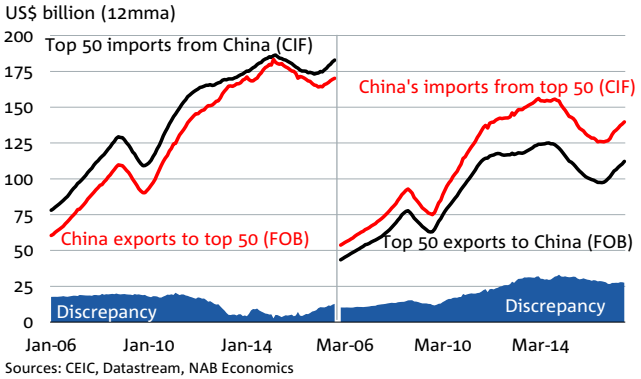
In our monthly updates on China's economy, we have regularly highlighted the disparity between China's official merchandise trade data and the equivalent data of some of its trade partners. Some of these differences are easily explained; however in some cases – most notably exports from China to Hong Kong – the differences may reflect other factors, such as financial flows masked as trade activity to circumvent capital controls. When compared over time, these distortions result in an inaccurate picture of Chinese and global trade flows and broader economic conditions.

MATCHING TRADE DATA HIGHLIGHTS HISTORICAL DISTORTIONS

Unlike most domestic data, Chinese trade data can be compared with international sources, which can provide confirmation and highlight discrepancies. To compare these trends, we compiled data for Chinese merchandise exports and imports to and from its fifty largest trade partners and the corresponding trade data for each of these countries. Based on the Chinese data, the top fifty economies accounted for 92% of the country's exports and 96% of imports in 2016.

TOP 50 TRADE PARTNERS

Discrepancies shifting over times



Sources: CEIC, Datastream, NAB Economics

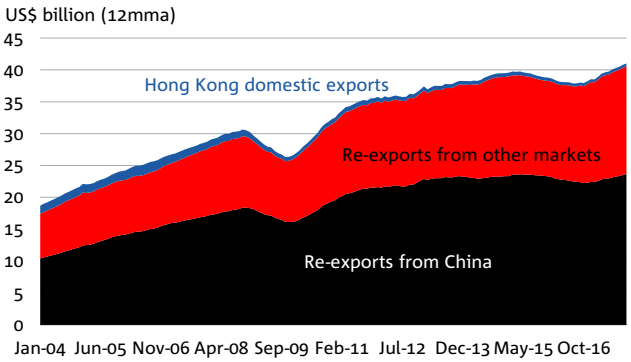
As a general rule, the reported value of imports has exceeded China's export values – averaging US$174 billion for partner imports against US$164 billion for China's exports in 2016 – however the difference between these measures has differed notably over the past decade. There are a range of reasons that these measures diverge. A major reason relates to internationally standardised methodology – export data is typically reported on a Free on Board (FOB) basis, which is the cost of the goods at the port of departure, while imports are usually reported in Cost including Insurance and Freight (CIF) terms – the cost of the products at the port of arrival, with additional transport associated costs added on. These costs vary over time – with freight costs reflecting the supply and demand of shipping at the given point in time.

Timing issues can also lead to some distortion. For example, an export reported in a given month in one country could be reported in the following month for the importer, given the time it takes to ship goods to distant markets. Exchange rate conversions over these time periods could also impact the reported trade values (particularly in periods of high volatility).

There can also be sizeable differences between China and individual economies that are major trading centres – such as Hong Kong and Singapore. A large share of China's exports to these markets are re-exported to other international markets, and the source of the trade flow may be reported differently (as either imports from China or Hong Kong) by China and the trade partner. Exports of domestically produced goods form an extremely small part of Hong Kong's total exports.

HONG KONG EXPORTS

Domestic goods a small part of trade

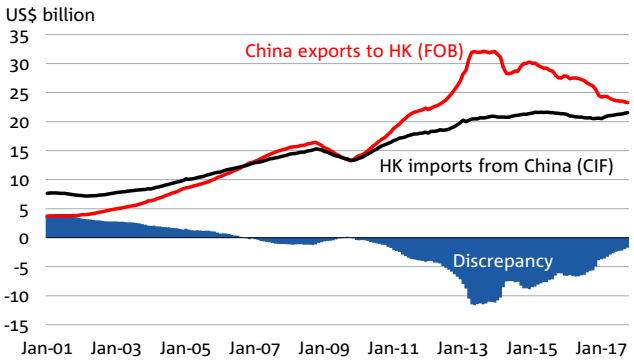


Sources: CEIC, Datastream, NAB Economics

However some of the differences between these measures reflect factors such as false invoicing – a method to disguise capital flows as trade activity (as a means of circumventing Chinese capital controls). This is most notable in the trade flows between Hong Kong and China – with Chinese exports over-valued for most of the period between 2012 and 2016. Over-stated export values may mask unreported capital flows into the country.

CHINA-HONG KONG TRADE

Major distortions point to false invoicing

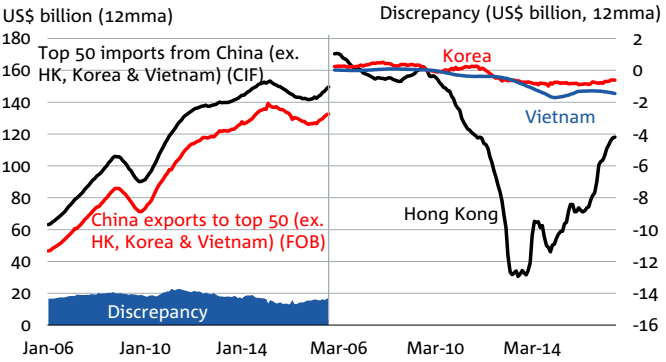


Sources: CEIC, Datastream, NAB Economics

That said, this unusual discrepancy – where China's reported level of exports exceeds the trading partner's level of imports – in not unique, with a similar (if much more modest) trend for both Korea and Vietnam – which may indicate other sources of capital flows than just Hong Kong. When these partners are excluded from the top fifty trade partners, the difference between China's export values and partner import values are far more uniform.

EXPORT DISTORTIONS

Relatively stable discrepancy when HK, Vietnam and Korea are excluded

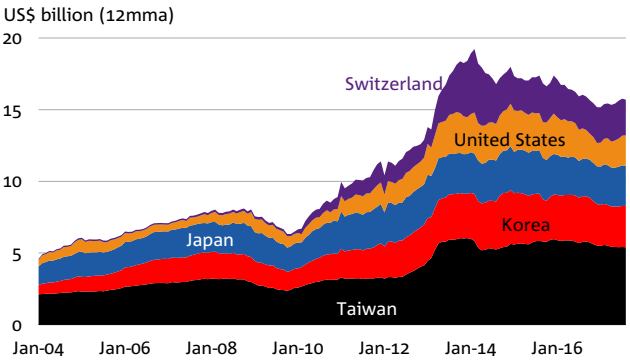


Sources: CEIC, Datastream, NAB Economics

Discrepancies between China and its trade partners are not limited to exports – with a similar trend evident for imports as well. Over-stating imports – again by false invoicing – may allow firms and individuals to mask capital outflows. When comparing the discrepancies between China and individual trade partners, there is no standout destination for outflows (unlike Hong Kong being the major channel for inflows). Instead a wide range of countries have notable discrepancies – including Taiwan, Korea, Japan, the United States and Switzerland (the five largest in 2016).

TOP 5 IMPORT DISCREPANCIES

Import distortions more broad based than export



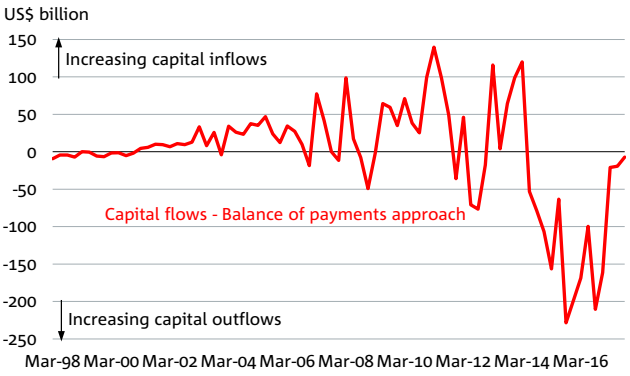
Sources: CEIC, Datastream, NAB Economics

CONCLUSIONS – WHY DOES IT MATTER?

Masked capital flows (particularly outbound) have contributed to a tighter regulatory environment. Foreign capital was attracted to China – particularly in 2013 through 2014 – when returns on investment in the country's shadow banking sector far outpaced the modest returns available in advanced economies and the direction of currency movements were favourable (particularly to the short term carry trade). However as international interest rate differentials began to decline (in part due to tighter regulation around shadow banks) and the exchange rate trends reversed, capital flight started to accelerate over 2015 and 2016. This put significant pressure on Chinese financial markets, already stressed by high levels of leverage in the corporate sector, leading to a rolling back of earlier capital account liberalisation.

CAPTIAL FLOWS

Surge in outflows until regulation tightened



Sources: Bloomberg, IIF, CEIC, NAB Economics

The distortions in historical trade data also add some risk to interpreting the strength of the Chinese and global economy. Trade data is closely watched as an early indicator of broader global economic conditions, with Chinese and partner data painting a different picture – an important issue given that China is the world's largest exporter. For example, Chinese data suggests that exports to Hong Kong fell by 6.3% yoy in the first ten months of the year, whereas Hong Kong data shows an increase in imports of 6.0% yoy over the same period.

This also suggests there could be inaccuracies in China's calculation of GDP on an expenditure basis. While China's national accounts are typically produced on a production basis, an annual expenditure calculation is also produced (the approach most commonly adopted in advanced economies). Historically over-stated exports would artificially increase growth in early periods (such as 2012 and 2013) and under-state more recent growth – presenting an inaccurate picture of recent economic trends.

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