Economics focus | The incredible shrinking surplus

Is China deliberately understating the size of its trade surplus?

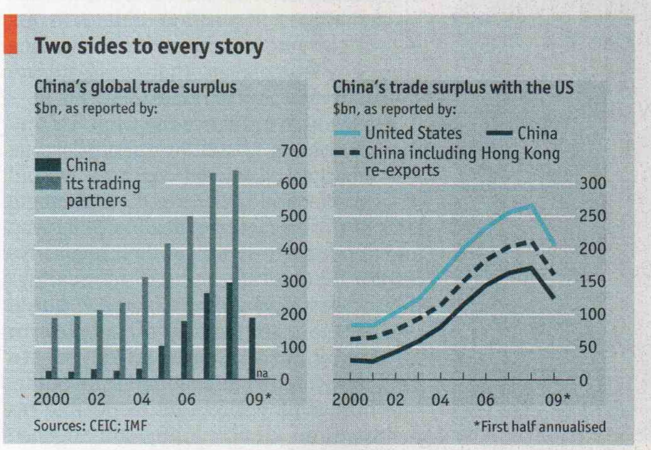
CHINA'S current-account surplus is seen by some as the root cause of the financial crisis. The good news is that after widening year after year it is now shrinking much faster than expected. In the first half of this year the surplus narrowed to \$130 billion, one-third lower than a year earlier, and barely half its level in the second half of 2008. Not only has China's merchandise trade surplus narrowed, but investment income from China's stash of foreign reserves has also dropped. Arthur Kroeber at Dragonomics, an economic-research firm, predicts that the current-account surplus is likely to drop to 5% of China's GDP this year, down from 11% at its peak in 2007. Belatedly, China seems to be doing its bit to rebalance the world economy.

But how accurate are China's figures? In theory China's trade surplus with America should match the deficit that America reports in its trade with China. The government in Beijing claims that its surplus with America fell to \$62 billion in the six months to June. Yet official statistics from Washington, DC, show that America ran a deficit with China of \$103 billion during the same period. There are similar disparities with other trading partners. China's reported surplus with the euro area is only half as big as the number published by European statistical offices. Even more striking is its trade balance with Japan: China says it had a deficit with Japan in the first half of this year, but Japanese data show instead that Japan ran a deficit with China.

China's economic statistics are notoriously dodgy. Components of GDP do not add up; the sum of provincial GDP is always much bigger than the national figure. It would appear that China's trade figures are no better. Moreover, the discrepancy is consistently in one direction: China reports smaller bilateral trade surpluses than those suggested by its trading partners' data. If you add up all countries' trade with China (using the IMF's Direction of Trade Statistics database), then the world ran a trade deficit with China of about \$650 billion in 2008, more than twice as large as the \$295 billion surplus logged by China itself (see chart, left-hand side). That \$350 billion difference was nearly four times as big as the gap ten years earlier. Is China running a large trade deficit with Mars? Or, as conspiracy theorists conclude, is Beijing deliberately understating its embarrassingly large surplus?

In fact there are rather less sinister explanations for much of the discrepancy between China's numbers and those of its trading partners. The most important is that a lot of China's trade is shipped through Hong Kong. It is often difficult for China's statistical agency to track the final destination of such exports, so goods which are exported from China to Hong Kong and then re-exported to America, say, are usually recorded by officials on the mainland as exports to Hong Kong. By contrast, it is easier for customs officials in importing countries to determine the true country of origin, so America correctly records these same goods as imports from China. Likewise, America's exports to China which go via Hong Kong may be recorded as exports to Hong Kong, while China will count them as imports from America.

Hong Kong re-exporters also add a mark-up of around 25% to goods they handle, which drives a further wedge between the value of China's exports and their import value at their destination. The result is that official statistics overstate the true size of America's and others' deficit with China, while Chinese statistics understate its surplus. If re-exports from Hong Kong are included in China's exports to America, the gap between the trade figures reported by China and by America is reduced by about half (see chart, right-hand side). This still leaves a big shortfall, however, and it does not explain why China's global trade surplus (which includes all trade with Hong Kong) is so much lower than the sum of bilateral trade balances reported by the rest of the world.



Balance cheat?

Another factor is that countries report exports and imports on a "customs" basis. Imports include the cost of insurance and freight but exports are recorded on a "free on board" (FOB) basis, which excludes such charges. An importer will always show the value of goods to be 5-6% more when they arrive than when they left the exporting country. If all shipping costs were excluded from the sums, China's surplus would be bigger but its trading partners' deficits would be smaller. Indeed, China's government does report its trade surplus with imports on an FOB basis as part of its half-yearly balance-of-payments accounts. In 2008 it was \$360 billion, \$65 billion larger than on a customs basis.

A study in 2007 by America's Treasury adjusted China's trade with over 100 countries to include re-exports through Hong Kong and exclude shipping and insurance as well as the mark-up charged by Hong Kong re-exporters. This increased China's trade surplus in 2005 by \$75 billion and reduced the sum of deficits reported by the rest of the world by \$140 billion, so the discrepancy between the two figures fell from over \$300 billion to \$90 billion.

Much of the remaining gap probably reflects disguised capital flows rather than a deliberate ploy by Beijing to understate its trade surplus. In order to dodge capital controls and move money out of China, firms declare exports at less than their true value, or imports at more. Firms also use such wheezes to transfer profits to affiliated firms in low-tax areas, such as Hong Kong. The money then comes back to China as foreign direct investment to take advantage of more favourable tax treatment. Such disguised outflows are unlikely to be increasing, however. If anything, given that China is bouncing back faster than the rest of the world, exporters have more of an incentive to over-invoice exports as a way of bringing foreign money into the country. This suggests that the country's trade surplus is declining as rapidly as it claims.

China's trade surplus—and hence its current-account surplus—is almost certainly bigger than that reported by Beijing, even if it is much smaller than the combined deficits reported by America and other trading partners. But for the rest of the global economy, the crucial thing is not the precise size of China's surplus, but the fact that it is finally shrinking. ■