THESIGERS

Trust in China's economic data

The People's Bank of China (PBOC)'s decision not to release information about outflows of capital in January 2016 highlights the mismatch between China's global economic standing and the reliability of information about its economy.

Since The PBOC failed to include data on capital outflows in its regular report on the Sources and Uses of Credit Funds of Financial Institutions. The bank seemingly merged the data for the "position forex reserves" into the "other items" category, and altered another key item – a reading for foreign exchange purchase positions in renminbi for all financial institutions, including the central bank. These alterations seem arcane, but highlights how politics trumps all. This is a problem for investment in China. Capital outflows have proven worrying since mid-2015, as fears of a hard landing have stoked stock market declines and yuan devaluation. Indeed, China's foreign exchange reserves fell about USD500 billion in 2015, slipping USD117 billion in September 2015 alone.[1] The falls have since slowed, but remain high.

The PBOC has every right to change its reports, but the timing is questionable, and it is this that has made investors querulous. They fear the government is seeking to hide the economy's frailties. Such opacity is obviously tempting, but it can just as easily encourage investors to expect the worst – as when the PBOC's decision to change its exchange rate regime in August 2015 without explanation provoked the fears of devaluation that led to recent capital outflows.[2]

Opaque and unreliable

Government opacity has a long tradition in China. The imperial bureaucracy traditionally sent out scholar-officials who were trained in classical Chinese, a language often incomprehensible to ordinary people, and who saw scant reason to explain their decisions to local people. They answered instead to the hierarchy, and ultimately to the Emperor.

For all of its revolutionary desires, the Chinese Communist Party (CCP) government retained and even intensified this tradition after taking power in 1949. This stance became especially problematic during the 1958 to 1961 Great Leap Forward, when flawed data contributed to a famine that killed as many as 40 million people.[3] The Cultural Revolution thereafter saw government fall into anarchy, and so it was only once Deng Xiaoping took power that efforts to collect economic data on a modern basis really started.[4]

Statistics in China have since improved massively, even if some shifts – such as the introduction of a new approach in 1998, which changed measures such as the ownership classification system – proved to be missteps. Even so, economists generally argue that Chinese economic data has three core problems: first, that statistics do not correct adequately for inflation (prices are always suspiciously stable); second, that statisticians have struggled to account for the expansion of the economy given the difference in prices in goods and services; and third, and most important, that any statistics must conform to political requirements.[5] This situation was why Premier Zhu Rongji spoke in 1998 of a "wind of falsification and embellishment" in the statistical system.[6]

The wind of falsification has a purpose, however; the Chinese Communist Party cannot afford not to doctor the figures. After all, its legitimacy since the Tiananmen

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Government opacity has a long tradition in China. The imperial bureaucracy traditionally sent out scholar-officials who were trained in classical Chinese, a language often incomprehensible to ordinary people.

Square massacre has rested on two pillars: nationalism and an ability to deliver economic growth. Events over the last year, though, have raised doubts about the government's capacity to maintain growth, not least as the credit binge in the aftermath of the global financial crisis takes its toll, and as the government is struggling to negotiate a complex shift away from an investment-led growth model to one that is consumption-led.

For obvious reasons, the most reported instances of inaccuracy are in GDP figures. A particularly glaring flaw is that provincial GDP figures often add up to more than national GDP, as officials have historically smoothed out figures, or inflated them, a practice known as *jiashui*, or "adding water" (加水).[7] Their incentive for doing so is to demonstrate that they have met growth targets.

Trading data is another concern. Figures routinely show a wide gap between Chinese exports to Hong Kong and shipments booked by the region's customs, who operate to international standards. In January 2016, China's General Administration of Customs recorded exports of USD1.94 for every USD1 recorded by Hong Kong's autonomous administration, resulting in a USD22.3 billion discrepancy between the data sets. This gap seemingly relates to the mispricing of exports to as to facilitate movement of capital out of China, even if transhipments provide some, legitimate distortion.[8] The Hong Kong example is not unique, and has prompted some commentators to ask quite how accurate are figures on China's trade and current accounts.

The private sector is little better. The Chinese Auditing Standards Board has formally adopted international auditing standards, but standards in practice fall well below these levels. Indeed, sources in Hong Kong assert that Chinese companies may keep different sets of books: one for public or regulatory purposes, one for a close-knit internal group and one for those "really in the know" (often family). Moreover, scams, such as faking sales and cash flow, inventing customers, and inflation of inventory figures are common threats to investment values. Consequently, investors struggle to winnow fact from fiction.

Where to turn?

The government is aware of the problem. In 2007, then Party Secretary of Liaoning province (now Premier), Li Keqiang, told the US Ambassador that GDP figures were "man-made" and "for reference only". He said that he relied on three proxy indicators: railway cargo volume; electricity consumption; and total social financing. However, Li's assertion became public in 2012, and officials thereafter seemingly started to doctor even these figures (although it is theoretically possible to verify electricity use by counting the number of coal-hauling trains).[9]

A lively cottage industry of alternative indicators for investors has emerged.[10] Key proxies include:

- Total social financing, a liquidity measure launched in 2011 by the People's Bank of China, which is a wider monetary indicator.
- Fuel consumption, which may be a better indicator than electricity usage, as the indicator includes transport as well as energy generation.[11]
- The amount of coal stockpiled at key storage facilities; some investors resort to paying someone to report frequently on the height of piles of coal as a proxy indicator. Proxies include prices in Australia and in Mongolia. One risk is that this approach may overemphasise investment-led growth.
- Volumes of cement production, as a useful proxy for the housing sector and government infrastructure projects.
- Prices of commodities of importance to the Chinese economy, such as steel and iron.
- Alternative inflationary indicators, based on a selection of prices of certain goods, as the government tends to underplay inflation.

- Export figures, although these are questionable owing to distortions in pricing of goods going in and out.
- The price of currencies linked to China closely by trade, including the Australian dollar (linked to iron ore and coal exports) and Mongolian tugrik (although this pertains really only to coal usage).
- Real estate indicators, which might include the prices of property in main cities, the prices of real estate developers' shares, the number and value of new builds, mortgage lending (this market is quite undeveloped), and perhaps the sale of earth moving equipment.
- Numbers reported by companies that may exemplify a sector; these proxies are most valuable for the consumer economy. Yum Brands, which runs a number of fast food franchises (KFC and Pizza Hut) is one example. Others might include sales of luxury goods by companies might include Chow Tai Fook, the Hong Kong jewellery store; and sales of cars.

Opacity feeds fear

Opacity has become a major liability as a slowdown in the Chinese economy has prompted stock market falls and capital outflows. Investors have struggled to understand the severity of the slowdown, with GDP growth estimates ranging from the official 6.9% down as low as 4%, asking whether it is a rebalance away from investment-led growth, or a debt-led slowdown.[12]

A particularly glaring flaw is that provincial GDP figures often add up to more than national GDP, as officials have historically smoothed out figures, or inflated them (a practice known as *jiashui*, or "adding water (加水).

Another liability is a history of misstatement. China's debt problem is illustrative in this context. Identifying the amount of debt in the system is extremely hard, not least as the government has encouraged banks to roll over debt rather than deem it non-performing, and as banks underreport their non-performing loans. Indeed, in January, the China Banking Regulatory Commission ("CBRC") offered some figures on non-performing loans at Chinese banks, saying they rose to 1.67% of loans by the end of 2015, up from 1.25% a year earlier, and the percentage of "special mention loans", which are liable to turn bad, had risen to 3.79%.[13] However, Bank of East Asia's bad loans at its China business rose to 2.63% - raising questions about whether its Hong Kong base and more transparent reporting methods provided a better sense of the bad loan problem.[14]

In the interim, investors assume the worst. Perhaps in consequence, the Chinese government has sought to stem the downturn with repressive measures, such as restrictions on short selling, investigations into funds, and the replacement of senior regulators. Indeed, a key development in this regard has been the arrest of Wang Baoan, former head of the National Bureau of Statistics, in January 2016.[15] The arrest relates to corruption, but has only reinforced doubts about China's economic data when concerns about the scale of debt are rising.[16]

Conclusion

China's economic data is notoriously unreliable, in large part owing to the Chinese government's prioritisation of its political interests above all else at the expense of hard economic data. This problem is not just of massaging figures to satisfy the government's need. Rather, it is more akin to declaring that something red is actually blue, and then arresting anyone who disputes the assertion. Such a stance would be troubling under any circumstances, but has become especially problematic as the economy has slowed. Trust by decree, even if it does ensure a measure of stability or reliability, is a proposition unlikely to satisfy investors for long, if at all.

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