A FAREWELL TO ARMS – THE INEXORABLE DECLINE OF CHINA'S EXTERNAL SURPLUS

By Edward Cole

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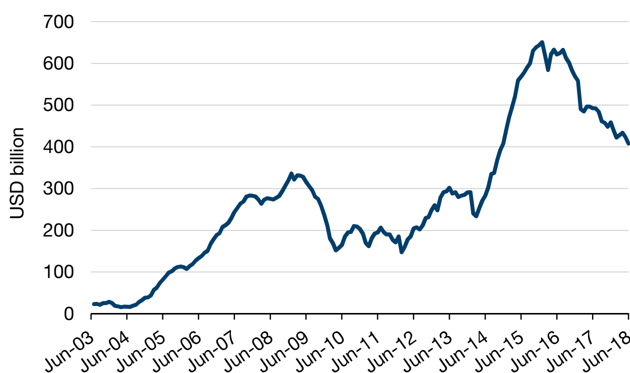
INTRODUCTION

At the end of June, China's State Administration of Foreign Exchange ('SAFE') released revised first-quarter current-account data, showing USD34 billion in quarterly deficit, the weakest data since 1998 when the series began. On a 4-quarter ('4Q') rolling basis, the current account is still running a surplus, to the tune of USD115 billion, c1% of GDP. And the overall balance of payments is in reasonable shape, supported by a record high capital account surplus (USD73 billion in Q1, and USD90 billion on a 4Q rolling basis). From the perspective of financial stability, capital account inflows are unequivocally good news in contrast to the dark days of 2014 and 2015 when capital flight was elevated. However, there is a structural trend in trade and tourism that seems likely to erode current account surplus entirely, even before we begin to consider any further deterioration related to international trade disputes. Markets will need to become accustomed to current account in deficit, with accompanying implications for FX volatility. Below, we set out a few charts explaining the underlying trends.

TRADE

China's headline trade surplus is running at a reasonably healthy USD400 billion on a 12-month basis (Figure 1). Relative to GDP, however, it is close to its lowest level in over 10 years, and has declined by cUSD200 billion (2.5% versus GDP, Figure 2) in the last two years.

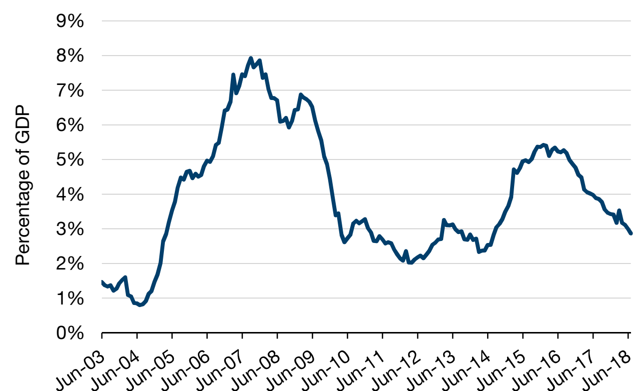
Figure 1. China Trade Balance



Source: Bloomberg, 30 June 2018.

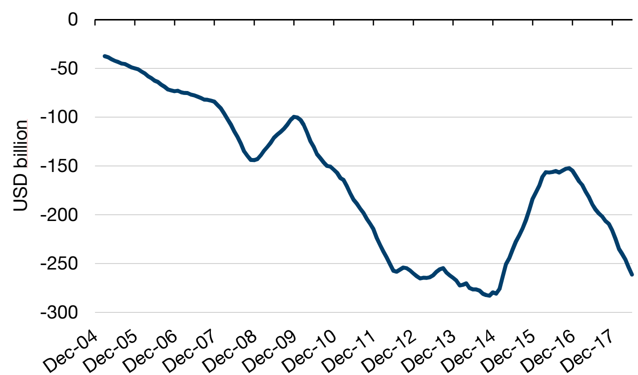
The main driver of this deterioration is energy. Looking at the value of primary energy net imports (crude, LNG and natural gas), China runs a deficit of cUSD220 billion on a 12-month basis. Comparing the primary energy balance chart (Figure 3), with the overall trade (Figures 1 and 2) it is clear that the large improvement in the trade balance began in 2014 when the oil price collapsed. However, it is notable that in April 2010, when crude was at broadly the same price it is today (WTI at USD75/barrel), the energy deficit was roughly half the current level in USD terms.

Figure 2. China Trade Balance as a Percentage of GDP



Source: Bloomberg, 29 June 2018.

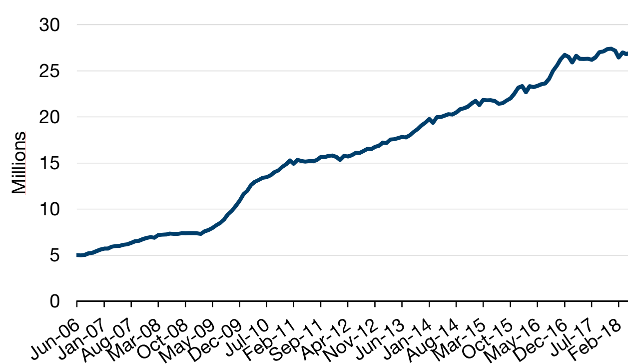
Figure 3. China Primary Energy Balance



Source: Bloomberg, 31 May 2018.

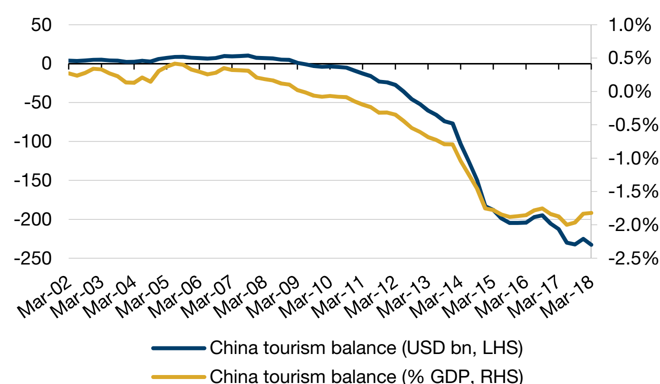
Two things have happened, that are unlikely to go away: first, crude volumes have grown 9% compound since 2010, broadly in line with the compound growth rate of passenger vehicles over the same period; second, China's efforts to clean up its air quality has seen coal consumption peak in 2013, with a growing consumption of imported gas to offset: the natural gas and LNG deficit has more than doubled, to USD4.8 billion, since the beginning of 2016.

Figure 4. China 12-Month Auto Sales



Source: Bloomberg, 31 May 2018.

Figure 5. China Tourism Balance



Source: Bloomberg, 31 March 2018.

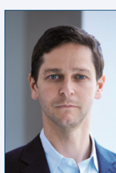
TOURISM

Chinese outbound tourism numbers are running at c.150 million annually, and have grown over 10% annually since data began in 2013. Ten years ago, the contribution of tourism to the current account was virtually zero, whereas there is now a deficit of almost USD230 billion, c2% of GDP. The number of Chinese with passports is estimated to be c120 million (Source: Ctrip), fewer than 10% of the population, and on some projections could double by the early 2020s. It is our expectation that the tourism deficit is set to grow structurally. Indeed, we have an investment in an airport operator, which has been enjoying the tailwind of growing air passenger numbers and duty-free spend.

TRADE + TOURISM = DEFICIT

Putting these two components of the current account together, they sum to over USD450 billion of annual deficit, 3.5% of GDP. The energy deficit will fluctuate with oil prices, but looks likely to rise structurally with volumes and a changing domestic energy mix. In terms of tourism, perhaps Beijing will pull some levers to promote domestic tourism (gaming in Hainan), and over time, and with improving air quality, inbound tourist numbers will grow. In the near-term, however, the tourism deficit looks likely to grow.

This entire discussion has avoided exports, of which there have been USD450 billion alone to the US in the last 12 months, the subject of intense scrutiny by the US administration. We have no particular insight into this side of China's trade balance, but we're acutely aware that Trump's calculus is that China has more to lose from a trade war, and that in the bigger picture the US economy is at a reasonably late stage in its cycle. The structural surplus that emerging markets have assumed for China might soon be a thing of the past.



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Edward Cole is responsible for investment strategy at Man GLG. He joined Man Group in 2015, co-managing emerging-market equity strategies until the end of 2018. He started his career in 2001, working for specialist Eastern European-focused investment banks as an equity strategist during the period of EU accession for former communist-bloc countries, and moved to JPMorgan in 2005 as a global emerging market equity strategist. He has worked in investment management since 2007, managing long-only, long/short and multi-strategy emerging market funds. Edward graduated from the University of Bristol with a BSc in Politics and from the London School of Economics with an MSc in International Development.

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