

Executive Summary

Section I

Over the period 2000 to 2011, cumulative illicit financial flows from China totaled a massive US\$3.79 trillion, if one were to exclude the country's intra-regional trade with Hong Kong and Macao. We found that if adjustments for such trade were not made, the resulting outflows due to trade misinvoicing were significantly understated due to trade data distortions. The sharp rise in illicit outflows, from US\$172.6 billion in 2000 to US\$602.9 in 2011, implied an increase of about 7.2 percent per year in inflation-adjusted terms, which was just below the 10.2 percent average rate of economic growth.

While our estimates are based on gross outflows, they do not differ much from the net of illicit inflows from outflows—a methodology with which we disagree with because there is no such thing as “net crime.” Nevertheless, even if illicit inflows are netted from illicit outflows, China still suffered net illicit outflows of US\$3.75 trillion over this period. One of the adverse effects of illicit flows from China has been a worsening of the country's income inequality as the rich get richer through tax evasion (which comprises by far the major portion of such outflows) and through using the world's shadow financial system to shelter and multiply their illicit wealth.

Misinvoiced trade between Chinese companies and the United States increased from US\$48.8 billion in 2000 to US\$59.0 billion in 2011. The volume of trade misinvoicing between mainland China and the United States rose to US\$72.0 billion before the financial crisis of 2008, but has declined since then, probably as a result of lower growth in bilateral trade between the countries.

The commodity groupings most susceptible to trade misinvoicing include UN Commodity Trade Statistics Database (COMTRADE) group 84 (nuclear reactors, boilers, machinery, etc.) and group 85, (electrical and electronic equipment), with the sub-group for electronic circuits (HS Code 854231) showing the largest cumulative illicit outflows (US\$84.1 billion). Trade misinvoicing related to the sub-group for mobile phones (HS Code 851712) increased at the fastest pace from 2007-2011. This is consistent with previous studies at GFI which indicate that the more specialized a product, the easier it is to misinvoice.

Section II

A significant part of the illicit outflows from China round-trip back to the country as recorded foreign direct investment (FDI). Such round-tripped FDI is given preferential treatment vis-à-vis domestic capital such as tax concessions, government guarantee of loans extended by foreign corporations to domestic firms, land and other facilities at concessional rates, etc.

However, a lot of licit money also leaves China as FDI in places like Hong Kong and the British Virgin Islands (BVI), only to then be laundered into another entity and reinvested in China as FDI from Hong Kong or the BVI. It is a complex money laundering scheme used in order to take advantage of favorable regulations for FDI and to allow high net worth individuals (HNWIs) to secretly accumulate wealth in contravention of government regulations and oversight.

Mainland China and Hong Kong are the largest foreign direct investors in each other's economy, with the BVI serving as the 2nd biggest foreign direct investor in both mainland China and Hong Kong, and BVI serving as the largest recipient of FDI from Hong Kong. Indeed, it appears that while the BVI invested a massive \$213.7 billion in mainland China in 2010, nearly all reciprocal investment in the BVI from the Chinese mainland was routed through Hong Kong. The BVI has a population of about 28,000 and a GDP of only around US\$1.1 billion, so it is hard to see how it can undertake such massive FDI outflows unless funds were routed back in via Hong Kong, and/or subsidized by illicit funds.

Of the roughly US\$2.83 trillion that flowed illicitly out of China from 2005-2011, US\$595.8 billion wound up as cash deposits or financial assets (such as stocks, bonds, mutual funds, and derivatives) in tax havens. On average, roughly 52.4 percent of investments that flowed into tax havens from China during 2005-2011 were illicit while 47.6 percent were licit.