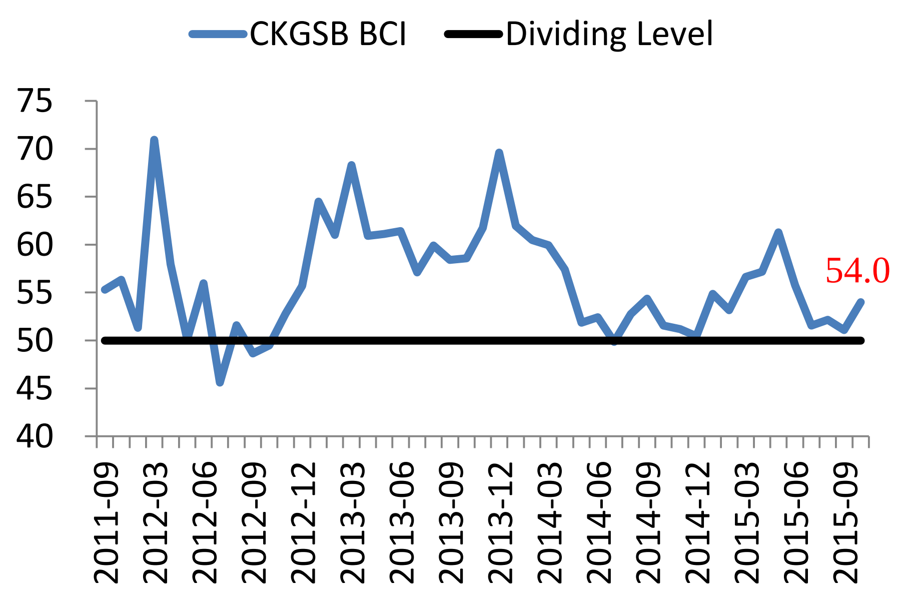
CKGSB BCI

October 2015

Nov. 5, 2015 CKGSB Case Center and Center for Economic Research

In October 2015, the CKGSB Business Conditions Index (CKGSB BCI) posted a figure of 54.0, a mild rise over the previous monthly reading of 51.1, but remained slightly above the confidence threshold of 50, above which conditions are expected to improve over the next six months and below which conditions are expected to deteriorate (as shown in Figure 1). The BCI hit a 14-month high of 61.3 in May 2015 before sliding steadily, with readings for the three months from July to September hovering above 50, indicating that the sample firms (which are mostly run by CKGSB's students and alumni) became less optimistic towards business conditions over the next six months. Despite a moderate rally this month, the Index failed to rise above 55, and it is still unclear whether or not the ongoing momentum will hold. As a result, we are maintaining cautious optimism with regard to these short-term economic trends.

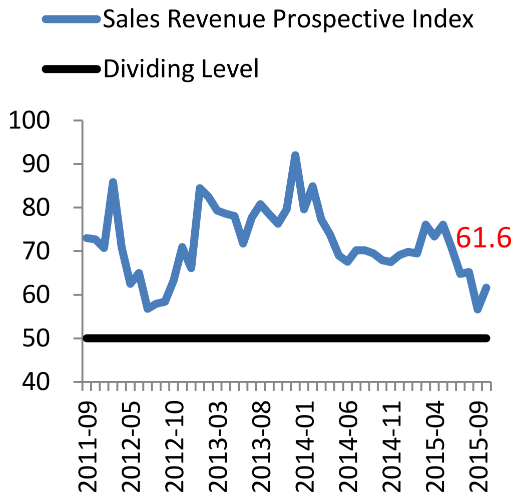
Figure 1



Source: CKGSB Case Center and Center for Economic Research

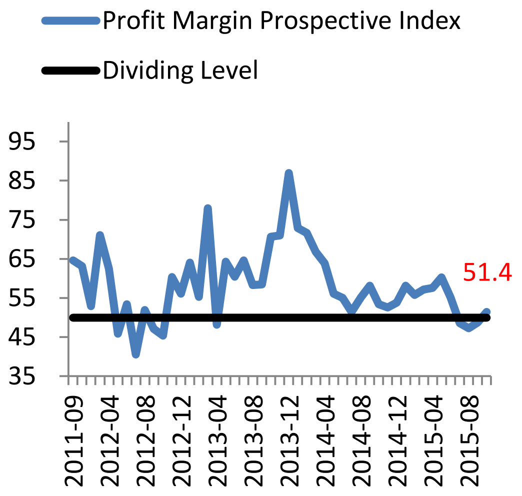
Expressed in terms of an arithmetic average value, the CKGSB BCI is an aggregate index consisting of four component indices respectively for sales revenues, profit margins, inventory levels and financing climate, with the first three being prospective indicators and the last one a current indicator. Detailed analysis of the four indices for October is discussed below.

Figure 2



Source: CKGSB Case Center and Center for Economic Research

Figure 3



Source: CKGSB Case Center and Center for Economic Research

In October, one component index dropped, whereas the others moved up, with the sales revenue index posting relatively strong growth, up to 61.6 from 56.6 in the previous month.

The prospective index for profit margins also witnessed a mild rise this month to 51.4 from 48.7 in September, bouncing back over the mark of 50. As shown in Figure 3 (above), the index has rarely been below the 50 mark over the past three years, however, it continued to slump over the past few months, coming out at 60.3 in May and then going down below the mark of 50 from July to September. This month, the index snapped its downward spiral to get back slightly over 50, but the trend reversal isn't that impressive, indicating that firms still have weak confidence in their profit prospects in the near future. Since profit margins are a function of multiple factors such as costs and product prices, the prospective index movements, without doubt, are a sign of changed business conditions. The relationships among this index and other variables as well as underlying problems will be discussed in detail below.

Figure 4

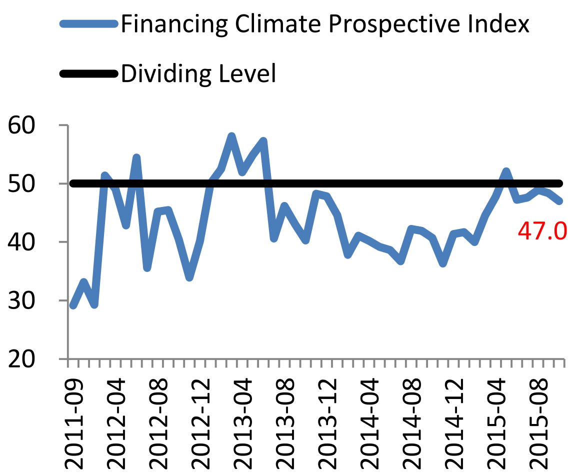
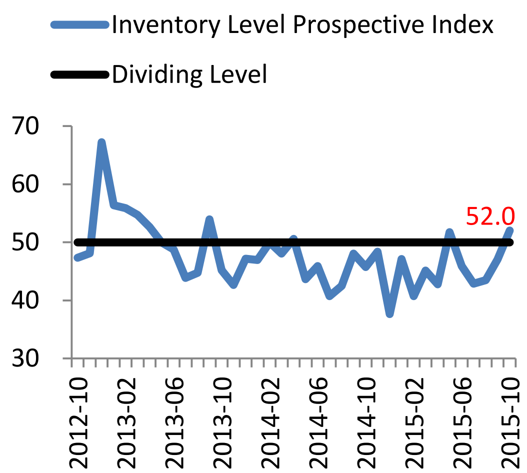


Figure 5



Source: CKGSB Case Center and Center for Economic Research

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The prospective index for financing climate edged down to 47.0 in September, from 48.4 in the previous month. As **Figure 4** shows, the index has long stayed below the mark of 50, even at a level of as low as 40 or 30, suggesting a tough financing environment in which sample firms operate, as evidenced by their long-standing difficulties in raising funds and ever-rising capital costs. It is important to note that the prospective index tends to focus too narrowly on the financing conditions faced by domestic consumption-focused private SMEs, as it always does when an overwhelming majority of the respondents are from such a section of the business population.

Being well aware of these fundraising difficulties faced by private SMEs, the central government has rolled out a series of measures to lower social financing costs. For example, the PBoC reduced the RRRs (for large deposit-taking institutions) six times since February 18 2012, and slashed the benchmark deposit interest rates (for one-year term deposits) eight times since June 8 2012, to a record low of 1.5%. In addition to these broad-based monetary-easing moves, the central bank went further to make, more than once, targeted RRR cuts for the financial institutions tasked with the mission of shoring up small/micro businesses and agribusinesses. These policy initiatives show the great pains and firm resolve with which the central government has worked to tackle this dilemma faced by cash-strapped private SMEs.

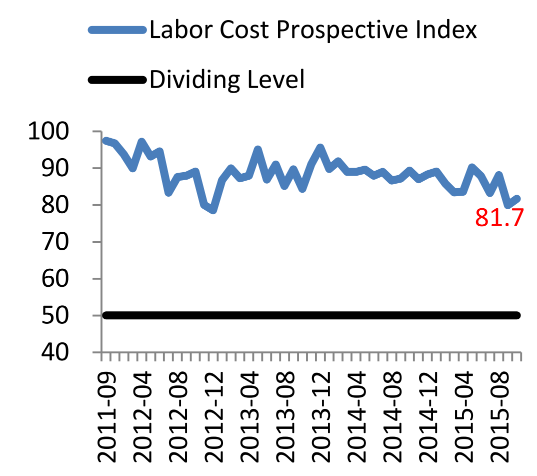
However, as shown in our indices, the central government's great efforts to slash financing costs for private SMEs and facilitate their healthy growth failed to deliver satisfactory results as expected. The glaring contrast between an unfavorable financing climate and SME-friendly monetary-easing policies highlights intractable structural problems deep-rooted in the economy behind fundraising difficulties for private SMEs. One case in point is, amid the continued slowdown of GDP growth, private SMEs are more prone to debt defaults compared with SOEs. With the right risk pricing mechanism put in place, higher default risks of this kind should have presented no problem, since, for example, banks may lend at higher loan rates to private SMEs than financially strong SOEs. But the interest rate control mechanism by the central bank results in considerable spreads for financial institutions, and thus, greatly contributes to their profits. So, for the purposes of pursuing more profits and avoiding risks, banks, of course, have more incentives to lend to SOEs since they are in much better financial positions than private players. But is it possible that SOEs like PetroChina default on their loans? And with implicit government guarantees, would anyone be worried even if they did default?

In our opinion, as market-based interest rate reforms deepen over time, it will be difficult for banks' current profit models to deliver as well as they have done in the past. Even then, profit-driven banks will either have strong incentives, or be forced, to price their credit risks and lend at a loan rate based on their risk assessments to private SMEs. Arguably, the loan rates for private SMEs will still be higher than those for their state-owned counterparts in the future, but still much lower than the costs of funds incurred otherwise from private financings, such as trust loans. For private SMEs, it is the loan rate liberalization that makes a great difference in alleviating their burdens.

The prospective index for inventory levels nudged up to 52.0 from 47.0 in the previous month. It had briefly climbed above the mark of 50 in May 2015, up to 51.7, before sliding steadily over the subsequent months until it reversed the downward trend in October, creeping back over the confidence threshold once again. But will it extend the ongoing momentum or quickly retreat below the threshold once more? We will maintain a wait-and-see attitude, but this much is certain: judging from the historical patterns, no marked improvements on inventory levels at the firms surveyed are expected anytime soon.

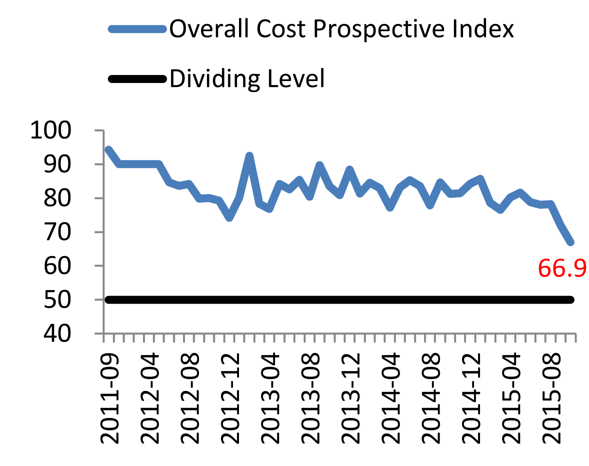
In addition to the CKGSB BCI, a series of related indices for costs, prices, investment and recruitment are also compiled based on respondents' expectations. Let us begin with the cost-related indices.

Figure 6



Source: CKGSB Case Center and Center for Economic Research

Figure 7



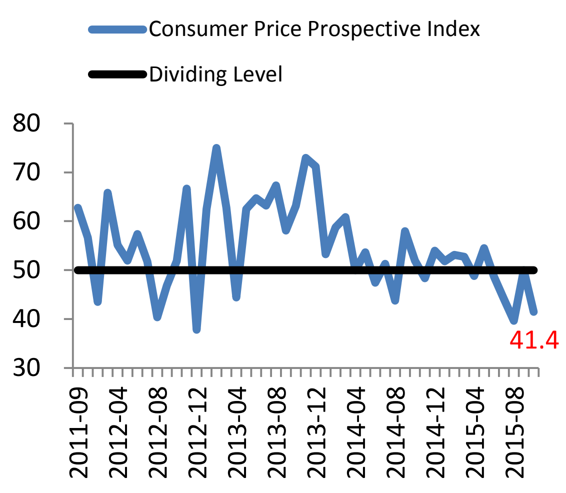
Source: : CKGSB Case Center and Center for Economic Research

The labor cost index, also a prospective one, edged up to 81.7 in October from 79.9 in the previous month, while the overall cost index dipped to 66.9 from 72.0. As a result of structural transformations in China's overall economy, the labor cost index has long been hovering at relatively high levels. The labor cost index is less subject to cyclical variations and has a higher predictability rate. However, the overall cost index nosedived this month, dropping to 66.9 – below 70 for the first time since the launch of this index. Most noticeably, the index recently experienced a sustained sharp decline, falling by 11.3 points so far from the reading of 78.2 in August.

Having followed the same trend over the past four years, the two indices diverged this month. Whether they will converge once again or diverge further in the near future remains to be seen. However, given labor costs are a part of overall costs, a fall in the overall cost index must have been a result of factors other than ever-rising labor costs. In our opinion, there may have been two possible factors at work: overcapacity and cost reductions. Worsening overcapacity has led to repeated price slashes for both upstream and downstream products, contributing to lower overall costs for producers, while cost reductions in one way or another (for example, shrinking operations) are imperative if an enterprise is to survive a chilly winter. Now that most of the sample enterprises have continued to expand in recent years (as discussed further below), cost reductions should have been a far smaller contributing factor, if indeed they were even one at all. Therefore, we think that it may be more reasonable that the drastic fall in the overall cost index was attributed to intensified overcapacity.

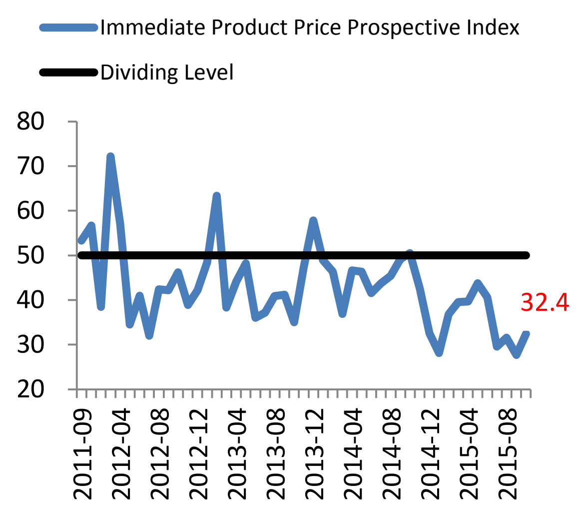
Price-related changes also didn't go unnoticed. The consumer price prospective index plummeted once again, down to 41.4 from 50.0 in September. The index has truly had a rollercoaster ride over the years. On the other hand, the intermediate product price prospective index edged up from 27.7 to 32.4, yet remained in extremely low territory. In general, all the price-related indices have stayed weak since January 2014. To be more specific, the consumer price prospective index fared rather well, having stayed above the confidence threshold most of the time, albeit with noticeable deterioration and uncertainty of late. In contrast, the intermediate product price prospective index has almost always put up a poor showing, even falling below 30 points three times (28.1, 29.5 and 27.7 in January, July and September 2015, respectively).

Figure 8



Source: : CKGSB Case Center and Center for Economic Research

Figure 9



Source: : CKGSB Case Center and Center for Economic Research

Based on our data, costs are currently hovering at sky-high levels, while prices have long remained low. So, despite decent sales performance, cost pressures have not been passed on through price hikes to end consumers or downstream producers, leading to shrinking profit margins. Once again, we think such a scenario reflects overcapacity, one of the most serious structural problems in the Chinese economy.

Overcapacity is not about a glut of everything in China, since there is no need for more products and services. On the contrary, as China has just joined the ranks of middle-income countries, huge domestic demand necessitates massive investments in a wide variety of sectors, including health, education and senior services, to name just a few. The overcapacity at the moment is, in essence, a result of resource misallocation, that is to say, too many resources were sunk into those sectors with low ROIs and low social needs, especially the iron & steel industry. To tackle this problem, structural reforms should be launched to let market forces play their own roles, driving unwanted resources out of those sectors plagued with overcapacity into the ones badly in need of them. To be sure, these overhauls will bring about some brief pains, such as slowing growth, rising unemployment and a strong backlash from vested interests over their loss of benefits, and thus, will meet stiff resistance. But in the long run, it is a step forward China has to take in the best interests of the economy.

Overcapacity goes hand in hand with rapidly mounting debt. As a matter of fact, they are two sides of the same coin. Based on calculations from Standard Chartered Bank and the McKinsey Global Institute, as of the second quarter of 2014, the total debt as a percentage of China's GDP was 251% and 282% respectively, compared with just 70% in 2002 (Standard Chartered's figure) or 121% in 2000 (McKinsey).

As for China's total debt and its share of GDP, most market analysts, despite a little difference in their calculation results, have agreed on their growth trends: the debt level is high and rising rapidly. Indeed, there is sufficient ammunition available to the government to keep them down – for example, colossal amounts of state-owned assets – yet the ever-increasing debt load, if not properly handled, will likely remain a big risk to the Chinese economy.

Worsening overcapacity, as shown in our findings, will surely have significant implications for economic dynamics and the overall employment situation. As such, how should we respond to these developments? At the symposium China' s Economic Reform and Growth Potential held by CKGSB on September 21 2015, Mr. Wei Jianing, Deputy Director-General of the Macroeconomic Research Dept at the Development Research Center of the State Council, shared his valuable insights, offering three options: the first is *Blood Transfusions*, meaning government subsidies are maintained to prop up these inefficient entities (mostly SOEs); the second, *Surgical Operations*, namely, market-oriented reforms of money-losing enterprises, such as less or no bank lending to them, M&As, layoffs, bankruptcies and so on, are implemented, and rigid budgetary constraints are put in place, with market-based criteria applied to their performance evaluation; and the third, *Anesthetic Treatments*. In contrast with sweeping restructurings, this option applies less pressure and, as a result, meets less resistance.

However, Mr. Wei further explained to the audience that, either blood transfusions or anesthetic treatments should simply be a means to mitigate the pain and complexity of surgical operations, rather than a valid alternative to them. Otherwise, the main thrust of all the efforts would be called into question.

In this regard, we have learned some lessons. For example, in the 1990s, for the purpose of keeping inefficient SOEs afloat, steady streams of bank loans, some even in the name of maintaining social stability, were pumped into them, resulting in a RMB NPL mountain of many trillions. In the end, the government had to deal with the mess by re-lending, leaving society to foot the bill for their malfunction. Without the rapid economic growth seen over the subsequent years, which helped to reduce the debt overhang, we might still be deep in the debt mire.

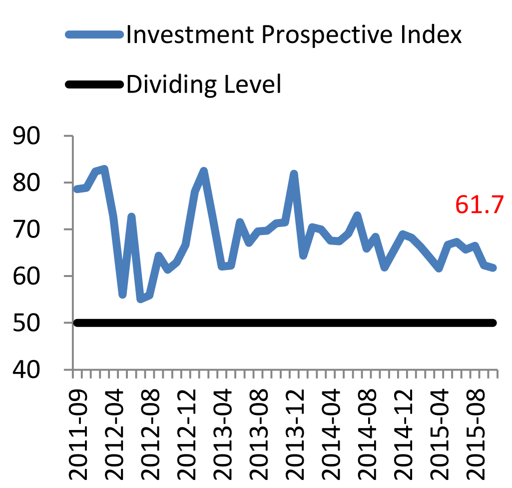
Thus, from this perspective, we think the government should consider widening the range of target economic growth rates, say, in the 6%-7% range, to offer more leeway for sweeping restructurings. The good news is that Premier Li Keqiang reportedly said the other day that China has never asserted that its target growth rate is set in stone, but is rather designed to maintain the economic growth rate within a reasonable range. This public statement helps shake off various constraints of a rigid GDP growth target. At this point, we even can move another step forward and set some specific goals for restructurings, but these goals should be flexible in nature, so that we can make steady advances, staving off the prioritizing of a short-term target growth rate at the expense of far-reaching structural adjustments.

In addition, Mr. Wei also proposed that the Chinese economy should shift gears going forward. To be more specific, he said state-led investments should give way to market-driven private investments. This aligns with findings from our BCI surveys, which show that overburdened, private firms continue to defy gravity and manage to hit their targets, with the sales revenue prospective index having long hovered above 50, meaning that their potential profitability has looked promising for a long time.

In terms of structural reforms, we agree with Mr. Wei. But economic reform is needed to straighten out the government-market relationship, which manifests itself in two dominant patterns: the effective small-government, plus efficient big-market, as can be witnessed in the UK and the US, and the effective big-government, plus small-market model, as seen in the former Soviet Union and in pre-reform China. Following the former pattern, the UK and the US have managed to be among the most prosperous countries in the world. Moreover, China's reforms and opening up over the past decades were as a result of shifting toward the former pattern: energizing the market through decentralization of power and profit redistribution, and then ushering in decades of breakneck growth. From our perspective, China's reforms should aim towards the effective small-government, plus efficient big-market model.

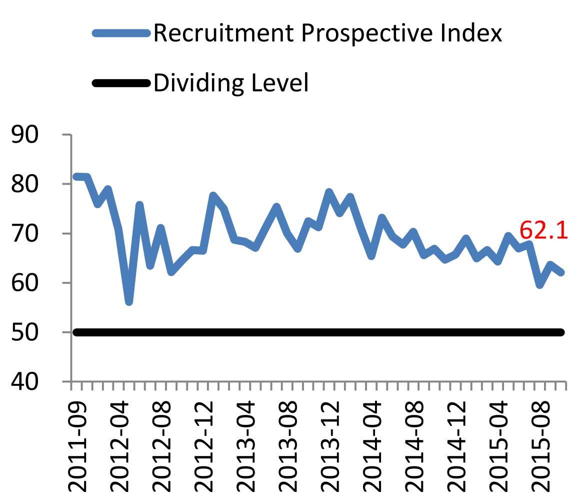
Let us turn to the next topic: the investment and recruitment indices. This month, the two indices both saw a marginal dip to 61.7 and 62.1 respectively from their September figures of 62.3 and 63.6. Since the launch of our program in September 2011, most indices have witnessed some marked fluctuations, such as the profit margin prospective index, the inventory level prospective index and even the BCI itself, and yet there were a few that have remained relatively stable all the time, in particular, the cost-related indices and these two in question – the investment and recruitment indices.

Figure 10



Source: : CKGSB Case Center and Center for Economic Research

Figure 11



Source: : CKGSB Case Center and Center for Economic Research

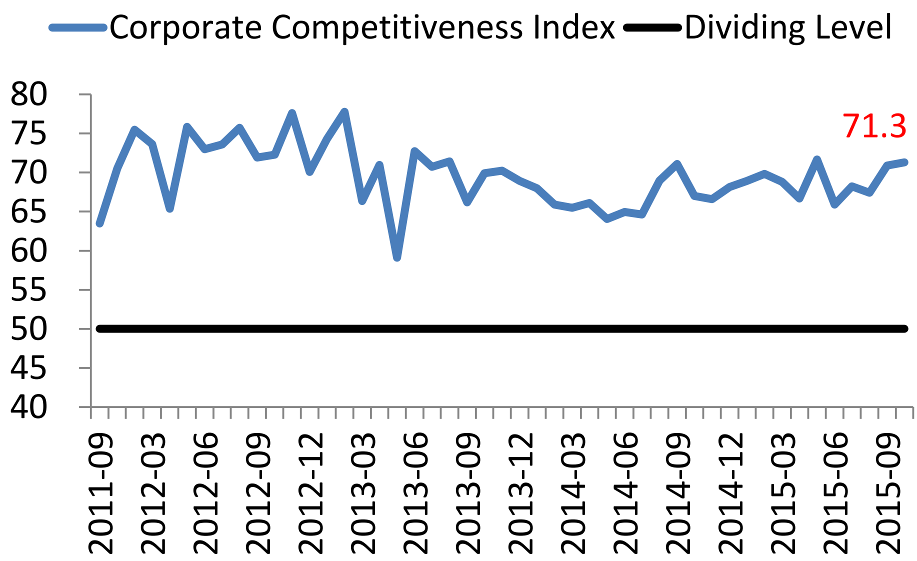
The two indices have long been at rather high levels – well above the confidence threshold of 50. Since September 2011, the investment index has never been below 60 except on three occasions, and has even risen above 80 four times. Meanwhile, there is a similar story for the recruitment index: for most of the same period, its readings have been above 60, except in the 50-60 range on a couple of occasions.

As discussed above, the overall landscape for the Chinese economy is not very good: huge cost pressures, a tough financing climate, rather weak prices and small profit margins despite decent sales revenues. Yet funnily enough, even in such an unfavorable context, firms are all still trying to expand, by continuing to invest and hire. So why are they making such seemingly contradictory decisions?

For these firms, adversity may be the right time to pursue expansion. But there might perhaps be another possibility, namely that, from the firms' perspective, only through expansion can you survive a chilly winter. This view is true of the real estate sector: stimulated by favorable policies recently introduced by the government, the sector is starting to recover, with multiple related sectors, such as iron & steel, cement and glass expected to pick up soon. Whenever the economy weakens, the government has tended to fall back on its tried-and-tested tactics to jumpstart it. This was the case in 2009 as well as in the more recent past. So firms that contract during difficult times more often than not miss out on opportunities once the economy recovers. As such, it seems to make sense for firms to face up to the headwinds in this way. But what implications does this have for the overall economy?

Finally, there is one question in our survey related to corporate competitiveness. In the questionnaire, we ask respondents to indicate whether their firm is more, the same, or less competitive than the industry average (50), and from this we derive a sample competitiveness index. Consequently, as our sample firms are in a relatively strong competitive position in their respective industries (71.3 in October 2015, as shown in Figure 12), the CKGSB BCI indices are higher than government and industry PMI indices, and, put another way, China's overall situation is worse than shown in this report.

Figure 12



Source: CKGSB Case Center and Center for Economic Research

Notes:

CKGSB BCI Introduction

In June 2011, the CKGSB Case Center and Center for Economic Research initiated a project to gauge the business sentiment of executives about the macro-economic environment in China – called an index of business conditions.

Under the direction of Professor Li Wei, in July 2011, the two research centers designed and tested the BCI survey. In September 2011, the first surveys were distributed and results computed. Since May 2012, the research team has published monthly BCI survey reports.

Explanation of the Index

The CKGSB Business Conditions Index (CKGSB BCI) is a set of forward-looking, diffusion indices. The index takes 50 as its threshold, so an index value above 50 means that the variable that the index measures is expected to increase, while an index value below 50 means that the variable is expected to fall. The CKGSB BCI thus uses the same methodology as the PMI index.

The survey asks senior executives of companies whether their main products are for consumers or non-consumers, and then asks how they think product prices will change in the next six months. Based on survey responses, we have been able to report expectant changes in consumer and producer prices.

The BCI is generated wholly on the basis of statistics gathered from leading enterprises, many of whose executives have studied, or are currently studying, at Cheung Kong Graduate School of Business. In the questionnaire, we ask respondents to indicate whether their firm is more, the same, or less competitive than the industry average (50), and from this we derive a sample competitiveness index. Consequently, as our sample firms are in a relatively strong competitive position in their respective industries, the CKGSB BCI indices are higher than government and industry PMI indices, and, put another way, China's overall situation is worse than shown in this report.

Compilation

During each survey, respondents are asked to indicate whether certain aspects of their business (e.g. sales) are expected to increase, remain unchanged, or decrease over the forthcoming six months as compared to the same time period last year. The diffusion index is calculated by summing the percentage of "increase" responses and half of the "remain unchanged" responses.

Of all the indices measured for the CKGSB BCI, the overall business conditions index is an aggregate index, which has been calculated, since December 2012, by averaging its four constituent indices of sales, profit, financing environment and inventory. The aggregate BCI index before December 2012 uses a different composition of constituent indices, and is therefore not directly comparable to the current BCI index.

About CKGSB

Established in Beijing in November, 2002 with generous support from the Li Ka Shing Foundation, CKGSB is a private, non-profit, independent educational institution and the only business school in China with faculty governance. The school offers innovative MBA, Finance MBA, Executive MBA and Executive Education programs. In addition to its main campus in the center of Beijing, it has campuses in Shanghai and Shenzhen and offices in Hong Kong, London and New York.

CKGSB faculty, through their on-the-ground research and close relationships with leading domestic executives, provide global thought leadership on both the theory and the practical reality of real-life business in China. They consistently generate important insights into areas that are poorly understood outside of China, such as the globalization strategies of Chinese companies and competition and collaboration among state-owned enterprises, private businesses and multinationals.

CKGSB is the only business school in China with the reputation and resources to attract faculty from top business schools such as Wharton, Stanford, NYU and INSEAD. The majority of CKGSB faculty members were born and raised in China before leaving to study and teach abroad. Their bicultural backgrounds have endowed them with a valuable capacity to interpret global business in the context of both China and the West.

Disclaimer

This report is based on public information and field research carried out by CKGSB Case Center and CKGSB Center for Economic Research. Sources of these data are deemed reliable, but the two Centers do not guarantee their accuracy and completeness. Opinions expressed in this report reflect only the judgment of the researchers in the two Centers on the day when the report is released, and are subject to change without prior notice. CKGSB holds no liability for any loss that might be brought about by using this report. Readers are advised to use their own discretion and to consider whether any comment or suggestion given in this report is suitable for their personal situation.

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