

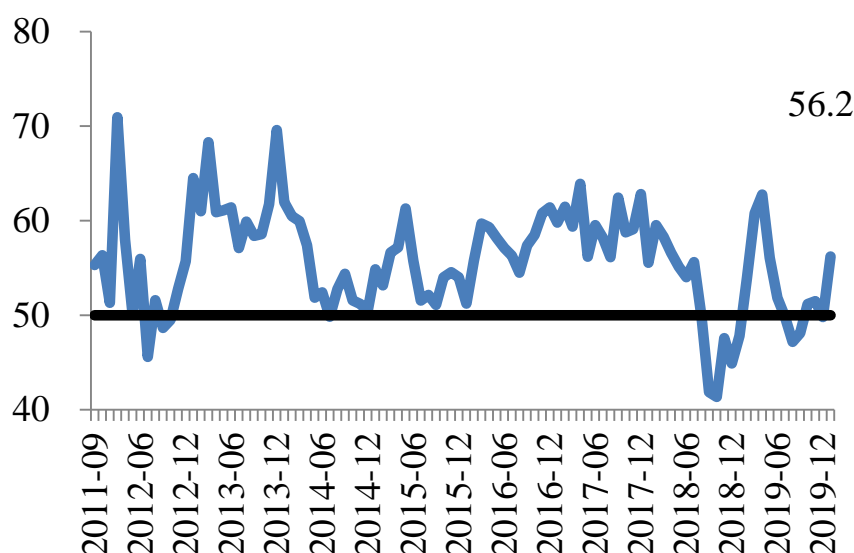
Commentary on the January 2020 CKGSB Business Conditions Index – Have we reached a turning point?

By Professor Li Wei

What exactly is a turning point? In the words of Yu Yongding, respected member of Chinese Academy of Social Sciences (CASS), a turning point is defined as the first derivative of zero. For most people, this means nothing, but luckily everyone has their own sense of when a turning point has been reached – you can tell when a trend changes. This could be when a slowing economic growth rate suddenly switches direction. Such a turning point has been reached with this month’s BCI and related indices.

In January 2020, the CKGSB BCI registered 56.2, a fair climb from last month’s 49.8. This is a bright spot in an altogether gloomy economic climate.

Figure 1 Business Conditions Index (BCI)



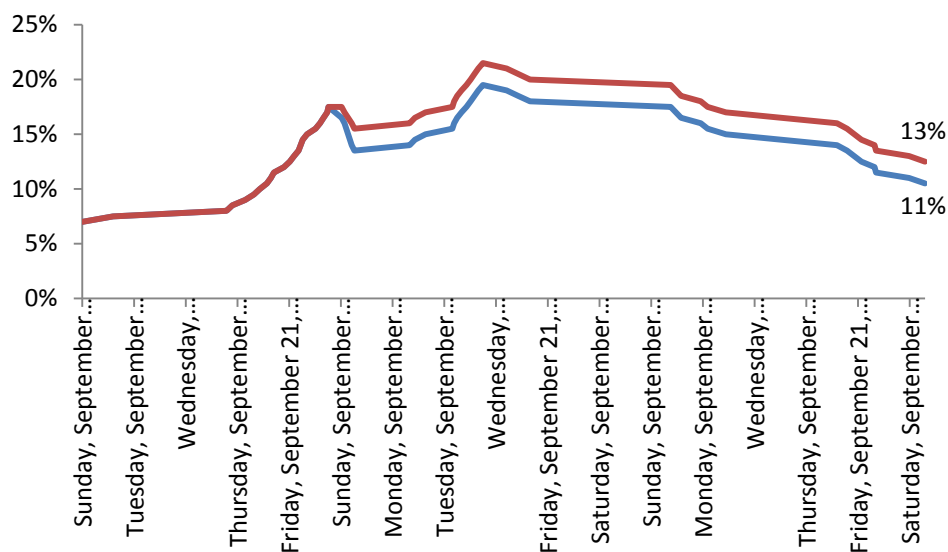
Source: CKGSB Case Center and Center for Economic Research

The rise of the overall BCI index shows the combined strength of the sub-indices. Some figures are particularly noteworthy. The consumer product price forecast is stable, suggesting that the impact of food inflation has been limited, but producer prices are forecasted to rise by 10.6, the fifth highest rise for this index in a single month. This index has been weak for a long time, so why the sudden spike? Producer products are not consumer-facing, being traded between companies. Consumer product prices are impacted by reputation due to their contact with consumers, whereas producer products are only traded upstream and downstream in an industrial chain, remaining unknown to the outside. They are more stable and also have a wider impact on the economy. So when producer price prospects jump, we should take note.

As mentioned earlier, an important feature of the BCI and related indices this month is a rise in profit prospects. As a forward-facing index, the BCI asks, “What change in profit do you expect in the next six months compared with the same period last year? This month, the answer to this question was met with high figures. Our survey respondents are resounded optimistic on profit.

In December 2019, government figures, scholars, business people and regular folk had all taken up macroeconomics - discussing the economic downturn, and how to weather the storm. It seemed certain that the government would enact economic stimulus policies, but what exactly would these policies consist of and how strong would they be? In fact, the government was curtailed most large-scale stimulus policies. What is certain is that on January 6, 2020, the central bank reduced the statutory deposit reserve ratio by 0.5% (Figure 2).

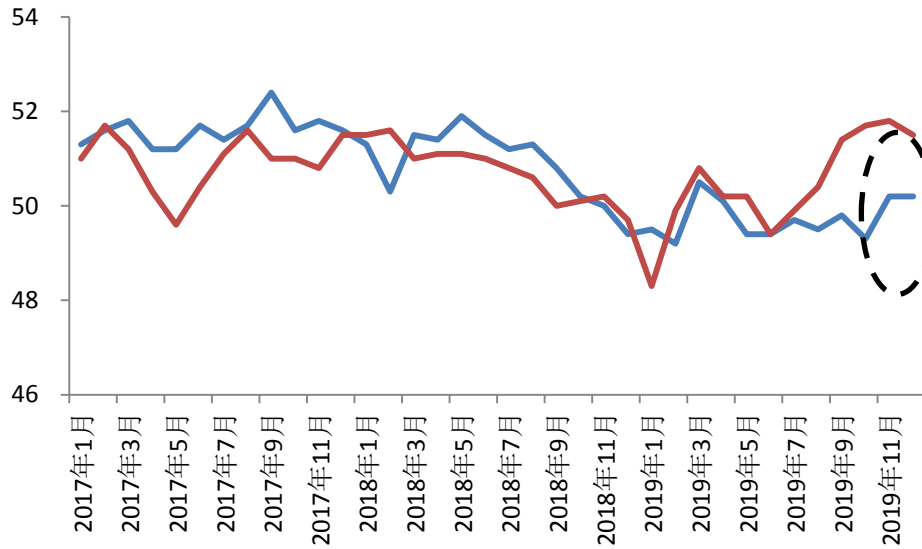
Figure 2 Deposit rates at Chinese financial institutions (blue: small and medium deposit financial institutions; red: large deposit financial institutions)



Source: Wind

Actually, signs of economic recovery were captured not just by the BCI, but by the official national PMI too.

Figure 3 China's PMI (blue: National Statistics Bureau) and PMI (red: Caixin Journal)

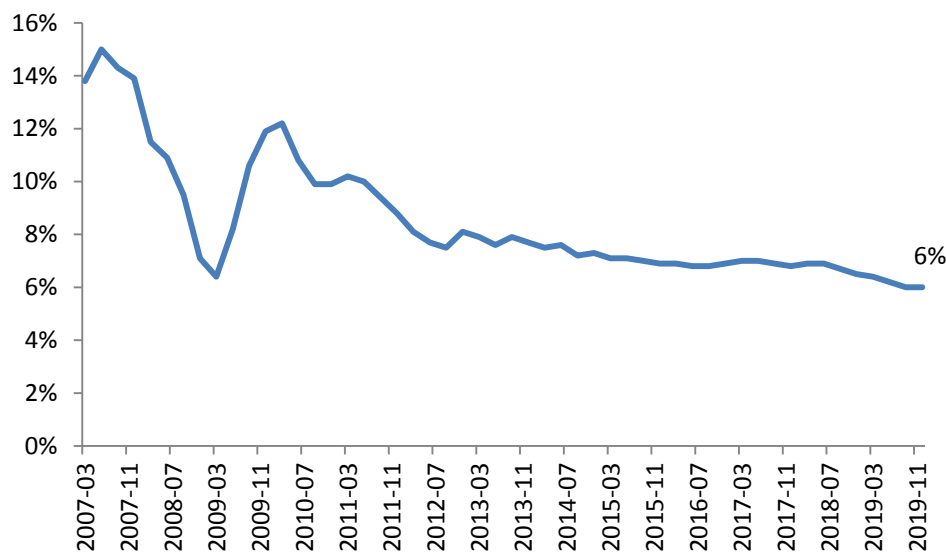


Source: Wind

As can be seen from Figure 3, both sets of PMI data are above 50. In other words, most companies are expanding and the economy is far from recession.

Another key indicator is GDP. Over the past ten years, China's growth rate has fallen significantly (Figure 4). In the second quarter of 2007, the GDP growth rate was as high as 15% at constant rates. By the fourth quarter of last year, it had fallen to 6%, nine percentage points lower. Of course, in the past, the country had a good foundation. Any decent policies would bring about rapid growth. But now we have a large base. Even with no major policy errors, it will be more difficult to achieve the kind of rapid growth we have seen in the past.

Figure 4 Quarter-on-quarter growth at constant rates



Now we face an important question: Where does our sample's rebound in confidence come from?

In 2019, the risk of bankruptcy, layoffs and other issues loomed large over the economy. Now, the economy appears to have stabilized once again. After sifting through this month's data, I believe that the current optimism can, to an extent, be down to the signing of phase one of the US-China economic and trade agreement, which took place on 15 January.

This may seem surprising. How can a bilateral trade agreement have such a big impact on the confidence of Chinese business people? After all, China is a major economic power now, and foreign trade accounts for a limited percentage of its GDP. Take a look at published economic papers however, and you will find plenty of food for thought.

A well-known book among Japan scholars is one by anthropologist Ruth Benedict written in 1946 called, *The Chrysanthemum and the Sword: Patterns of Japanese Culture*. The author posits a very interesting thesis, namely that Japanese military recruitment ads read like US anti-war propaganda. The interpretation may be different, but the author thinks China's current situation is actually quite similar to her observations of Japan. After Trump took office, he launched a trade war against China. As the situation worsened, China and the US both took actions that hurt the other, which led to increased support for the trade war from all sides. But the currently announced US-China phase one trade deal, is largely an overreaction. Much of the text published is consistent with the spirit of Chinese domestic reforms. In other words, on the surface, the trade war hurt China a lot, but it may end up being beneficial to China's reform agenda and China's hopes for higher quality growth. To put it bluntly, if implemented in accordance with the current terms (with an indispensable amount of doctrine), expectations will rise about China's future, something both sides may not have realized at the outset.

Take intellectual property for example – 20% of the trade deal involves intellectual property, reflecting the importance the US attaches to this issue. In China's previous legal disputes that violated trade secrets, the burden of proof rested on the plaintiff. In other words, the plaintiff had to provide supporting evidence, which, if insufficient, would lead to acquittal. Due to the burden of proof, it was difficult for plaintiffs to win civil cases involving infringement of trade secrets. However, this agreement clearly stipulates that in civil judicial proceedings regarding the infringement of trade secrets, if the secret holder provides preliminary evidence including indirect evidence and reasonably points to the defendant as the violator, the burden of proof is transferred to the defendant. In other words, if defendants cannot prove their innocence, the court may convict him. This greatly strengthens the protection of intellectual property rights.

Economists generally agree that the protection of property rights is good for development. Without protection, no one can make future claims on their interests, which means people will be less likely to invest and produce. The same goes for intellectual goods, a higher form of property.

Medicine is a good example and one specifically mentioned in the trade agreement. Modern medicine relies entirely on research and patents. For any new drugs, costs run into the hundreds of millions or even billions of dollars. When any new drug fails to secure certification, shares in pharmaceutical companies are affected, and the producer may even be bankrupted. If successful, the development of a new life-changing drug will bring in huge revenue, but to ensure shareholder profits, a robust patent system is needed.

If a drug company spends huge sums on research for a breakthrough drug, while other firms ride on its success, doesn't it lose out? Yes, and for this reason, research companies need patent protection to carry out their work. The US-China trade agreement has increased patent protection for foreign-funded new drugs, reduced unreasonable costs, and in doing so, improved the environment for Chinese drug innovation. The climate has shifted, everyone has been incentivized to innovate, and offenders face higher costs if they violate the rules.

But doesn't this mostly benefit US firms, especially big pharmaceuticals? On the surface, this is indeed true, but China has a large number of individually dispersed drug factories, many of which are

interested in doing R&D, but cannot do so while intellectual property protection is so weak. From this point of view, if the treaty is implemented, the biggest beneficiaries may be Chinese innovators in the field.

Think back to the warnings China faced the year it joined the WTO about how industries would be destroyed by foreign competition. In reality, China's economy went about seizing opportunities on its way to becoming a world economic power. Now if we want to follow the path to high-quality growth, we must learn and innovate. To do a good job of innovating, we need, more than anything, patent protection and other such systems in place. China may face pressures from the US and capitalize on the advantages. Perhaps, after many years, we will look back and be grateful for the pressure to establish a decent patent system. Only under such system will China develop its own Pfizer and Novartis.

In summary, we do not yet know why the BCI soared in January. We do not know what will happen next. But I believe that today's optimism is tied to the successful conclusion of phase one of US-China trade negotiations. There are two aspects to this connection. The first is that the signing of a trade agreement may exert external pressure on domestic structural reform; the second is that economic disputes have brought considerable uncertainty to Chinese domestic economic activity. The dispute has not been put to bed, but short term deterioration is less of a risk now that part one has been signed. It means companies can begin investing and producing again. The temporary cooling of the trade dispute has worked its way into the Chinese economy in a beneficial way.

This is a commentary on the CKGSB BCI report for January 2020. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

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