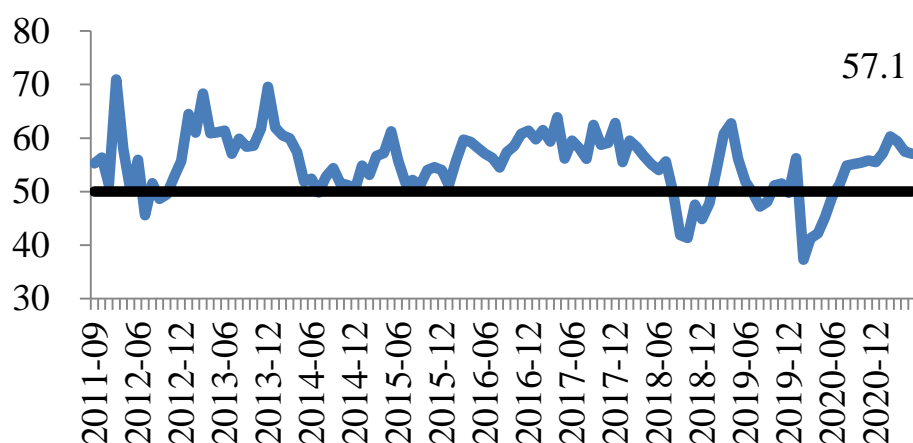


## Commentary on the May 2021 CKGSB Business Conditions Index

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In May, the CKGSB Business Conditions Index (BCI) fell marginally from 57.5 to 57.1 (Figure 1).

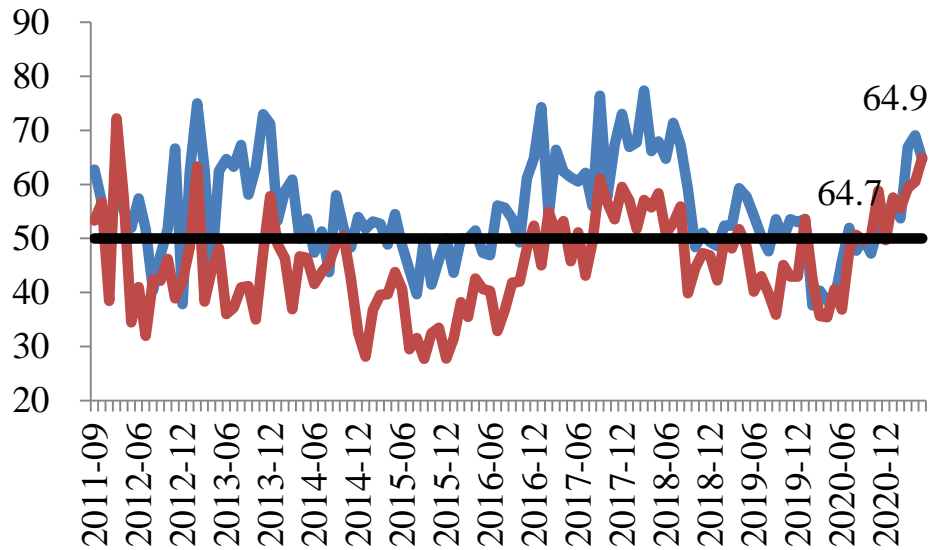
**Figure 1 Business Conditions Index (BCI)**



Source: CKGSB Case Center and Center for Economic Research

Similar to last month's data, the focus of this commentary will also be price prospects (Figure 2). Although consumer price prospects have fallen this month, the index of producer price prospects continues to rise, with the index surpassing the consumer price prospects index, a rare phenomenon over the past decade during which we have conducted the BCI. Notably, both indices are at a high level near 65 reflecting an expectation of inflation, due to infrastructural spending. With this, the demand for industrial products has grown, especially bulk commodities, which has led to the continued rise of producer price expectations.

**Figure 2 Price Indices (BCI)**

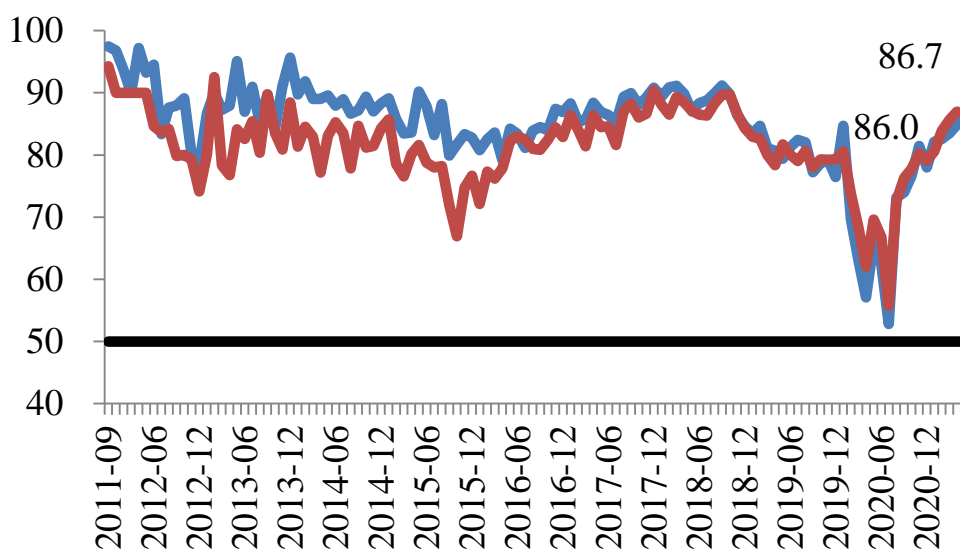


Source: CKGSB Case Center and Center for Economic Research

Blue: Consumer prices; Red: Producer prices; Black: Confidence threshold

Echoing this, the cost index is also high (Figure 3). Since February of this year, overall cost prospects have been higher than labor cost prospects. From Figure 2 we can see that companies are under pressure, and are increasing their pricing to push pressure downstream or to the consumer. When most of these pressures are pushed downstream, inflation will become more obvious in the economy.

**Figure 3 Costs Indices (BCI)**



Source: CKGSB Case Center and Center for Economic Research

Blue: Labor costs; Red: Overall costs; Black: Confidence threshold

Considering the current trend, decision-makers appear to remain at the sidelines. This is not hard to understand. Although inflation is forming, there are other variables at play. If the global economy, especially the U.S. economy, tanks, China will have to confront an unfavorable external environment in which exports suffer and growth falls. If China takes the initiative to fold macroeconomic policies to cope with inflation, then negative factors may be superimposed on each other, economic growth may worsen, and deflation may be next.

Based on the above considerations, the leadership will not limit its use of macroeconomic policies altogether. Although this makes sense, on the other hand, if we wait for inflation to develop further and then adjust macroeconomic policies, it may be necessary to overcorrect to bring the economy back to life, which creates a greater risk. We do not face an easy choice, but rather one of the lesser of two evils.

However, these considerations are relatively short-term. Although important, they cannot really determine the future of the economy. This will always be productivity. What it depends on is Total Factor Productivity (TFP). This concept of residual value refers to outputs that are not the result of an increase in capital and labor but value brought about by technological progress, business model innovation, or systemic reform of the economy.

Generally speaking, there are three ways to improve the TFP. One is to encourage resources to flow from low-efficiency to high-efficiency industries. For example, a large number of farmers in China have moved out of rural areas to work in the cities for its secondary and tertiary industries that have higher efficiencies than the primary industry since China's reform and opening up. Thus TFP is increased. Another is to reallocate resources from low-efficiency to high-efficiency companies. Take Shagang Group as an example – If Shagang Group, a highly efficient company in the iron and steel industry, acquires another bankrupted steel company, the resources flow to the institution with a higher efficiency. A third is to transform technologies, improve management or carry out systemic changes to improve the way companies use their resources.

Forty years since China's reform and opening up, its economy had some dazzling achievements, but developmentally speaking, it is still a developing country in need of reform. The good news is that as long as the Chinese economy carries out active structural reforms and allows resources to flow to industries and companies that can create more output, the Chinese economy can achieve sustained development. This is very different from the situation in developed countries. Therefore, in addition to responding to short-term economic changes, what is more important is that we need to maintain a stable economic environment, and at the same time step up structural reforms to improve efficiency. This is the only way China can continue to stay ahead without tripping up along the way.

This is a commentary on the CKGSB BCI report for May 2021 to which you are welcome to refer

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for detailed statistics. Do not hesitate to contact the BCI team by email for the accompanying BCI data report.

CKGSB Professor Li Wei

27 May 2020