

CKGSB BCI

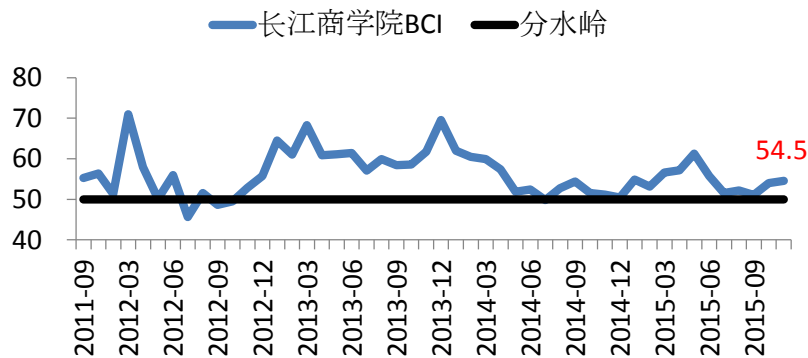
November 2015

10 December 2015

CKGSB Case Center and Center for Economic Research

The CKGSB Business Conditions Index (BCI) registered 54.5 in November, a slight rise on October's mark of 54.0, but also not far off the confidence threshold of 50 (Figure 1). In May 2015, the BCI was at a considerably higher 61.3, but for the next three months (July, August and September) it has been only slightly above 50. This shows that for the majority of relatively successful firms in China, optimism about business conditions over the next six months has been waning. Despite a small rebound towards optimism last month, the index has not yet topped 55, and whether or not the positive trend will continue remains to be seen. The short-term macroeconomic conditions will need further examination in order to assess whether this turn to optimism will last.

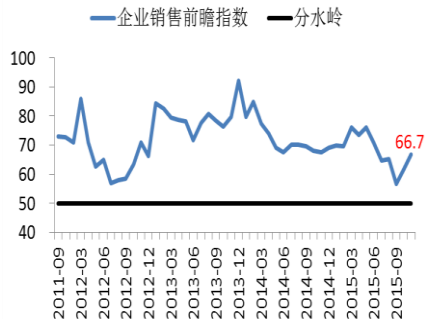
Figure 1 CKGSB BCI



Source: CKGSB Case Center and Center for Economic Research

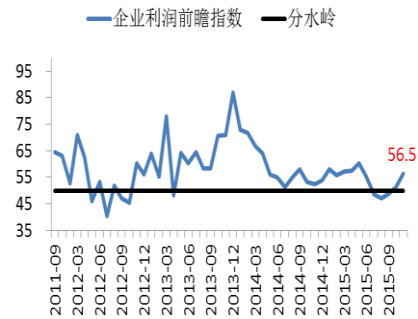
The CKGSB BCI comprises four sub-indices for corporate sales, corporate profits, the corporate financing environment and inventory levels. Of these four sub-indices, three are forward-looking indicators, and one, corporate financing, measures current business sentiment. These four sub-indices for November will be discussed below.

Figure 2. Sales



Source: CKGSB Case Center and Center for Economic Research

Figure 3. Profit

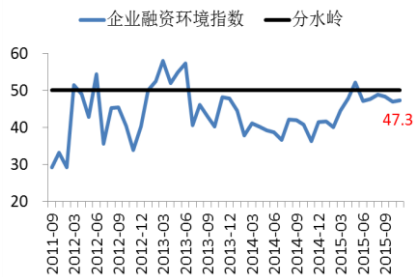


Source: CKGSB Case Center and Center for Economic Research

Of the four sub-indices, three rose and one fell last month. The corporate sales index rose from 61.6 to 66.7 in November.

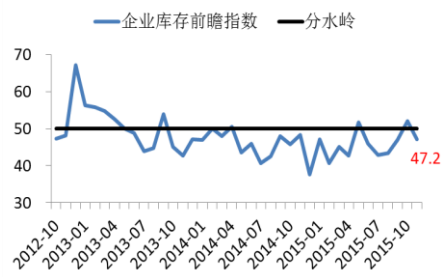
The profit index also rose, from October's 51.4 to November's 56.5, continuing its upward trend. From Figure 3, we know that in the four years since this survey began, profit expectations have rarely registered lower than 50, but in recent years, a sharp decline in profits led the index from 60.3 in May to under 50 in July, August and September. In October, profits returned to over 50 and last month registered over 55. This represents a turn to optimism in this regard.

Figure 4. Financing



Source: CKGSB Case Center and Center for Economic Research

Figure 5. Inventory



Source: CKGSB Case Center and Center for Economic Research

The financing index rose slightly last month from 47.0 to 47.3 but remains below the confidence threshold of 50. From Figure 4, we can see that over the long term, this index has languished below 50 and in some months is even below 30, showing the consistently poor conditions for obtaining financing in China, long-term financial issues, and high costs. It is important to note that this reflects the BCI sample of mainly private Chinese SMEs with their focus on the domestic market.

The central government is very clear about the current state of financing for private SMEs and has taken a series of measures to reduce the cost of social financing. Since February 18, 2012, the People's Bank of China (PBOC) has cut the statutory reserve ratio (for large deposit-taking financial institutions) a total of seven times. Since June 8, 2012, the PBOC also cut its benchmark

interest rates (on one-year deposits) a total of eight times, leaving the rate at the current 1.5%, the lowest since data has been collected. In addition, the central bank has repeatedly lowered the statutory reserve ratio to financial institutions that serve small and micro enterprises and agriculture-related firms. From this we can see that the central government is addressing the pain caused by financing problems among SMEs.

The central government has spent a lot of time thinking of ways to reduce the cost of financing for private SMEs, hoping to foster their development. However, our index shows that the effects of their policies are not ideal. On the one hand, we see monetary easing for private SMEs, but, on the other hand, we see the poor financing conditions in which they operate. This comparison makes clear that their problems in this regard are structural. With the shift to a slower pace of GDP growth, SMEs have a greater risk of default than SOEs. This higher risk should be resolved by loan pricing mechanisms: lending to private SMEs at a higher rate than to SOEs. However, current interest rate controls offer a greater margin to banks and this spread is their main source of profit. Profit-making and an aversion to risk make banks more willing to lend to SOEs, since how, the thinking goes, could a massive company such as PetroChina not pay back its loans?

At the same time, this has created another problem, related to the profitability and scale of banks. The bigger their scale, the greater the profits to be generated by bank spreads, with the result that having a “broad base” has become a rational choice. In such a situation, banks have no interest in risk-based loan pricing for SMEs. This leaves SMEs unable to obtain financing or having to resort to higher cost capital markets such as trusts, or provide enough collateral to banks so that they are accepted on their books, turning the bank into a kind of pawn shop. Therefore, this index reflects on the limitations of central government policies to reduce financing costs and improve financing conditions for SMEs.

In other words, the structural problems of SME financing are hard to solve with any comprehensive policy. Ending the problem will ultimately depend on reforming relevant policy aspects, such as developing the direct financial markets via financial reforms, enabling large companies with good credit to access financing directly from the market, weakening the power of the banks’ “big barrier” environment and forcing banks to develop their customer base among SMEs where they previously were unwilling to tread.

It is gratifying, however, that when the central bank announced the recent RRR rate cut on October 23, it also announced that they “would no longer set a deposit rate float ceiling for commercial banks and rural cooperative financial institutions.” The central bank also said that the current asset side of financial institutions has been turned over to full market-oriented pricing, with market-oriented pricing on the liability side reaching more than 90%. The PBOC retains its benchmark interest rate of 1.5 times the upper management limit for deposits (including one-year deposits) and from this “the liberalization of interest rate controls is only one step away.”

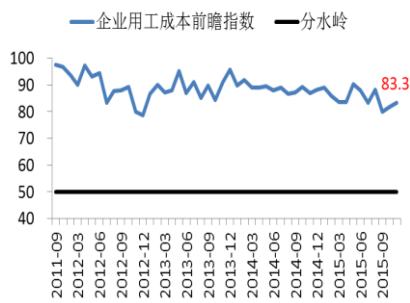
We believe that if interest rate reform continues in earnest, policy-driven spreads will gradually disappear and the original profit model for banks will be hard to sustain. Banks will then actively or passively learn how to price credit risk for profit considerations and other aspects, and will use this ability to give loans to private SMEs at appropriate rates. It is conceivable that, in the future,

bank loan interest rates for SMEs will be higher than for SOEs, but these rates will certainly be less than the cost of capital from private financing trusts. For private SMEs, this has been a real burden.

The inventory index dropped last month, falling to 47.2 from 52.0. In May 2015, the index had briefly risen to 51.7, crossing the confidence threshold, but it rapidly fell again in October, and last month fell under 50 yet again. Hovering around the confidence threshold, inventory levels clearly show signs of instability. How this will play out, only time will tell. But one thing is very certain, and that is that from historical data, the inventory situation is not optimistic.

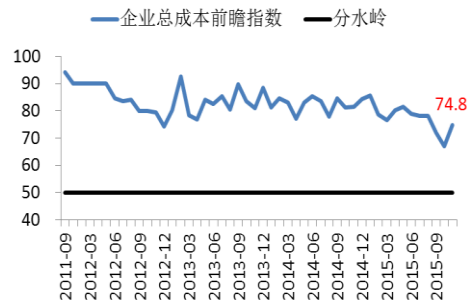
Besides the main indices, we also surveyed respondents on forecasted costs, prices, investment plans and employment conditions, to form a supplementary set of indices. First we will consider the costs side.

Figure 6. Labor Costs



Source: CKGSB Case Center and Center for Economic Research

Figure 7. Overall Costs



Source: CKGSB Case Center and Center for Economic Research

Last month, the labor costs index rose slightly from 81.7 to 83.3, and overall costs rebounded from 66.9 to 74.8. There is not much to say about this, except that this index has maintained a high level over the long term, showing that high labor costs are structural rather than cyclical.

On October, the total costs index dropped below 70 for the first time, attracting attention. Given high labor costs, the drop in total costs can only mean a decline in non-labor costs. There are two interpretations: the first is that overcapacity has seen a dramatic deterioration and downstream product prices have been slashed leading to a drop in overall costs. The second possibility is that businesses are preparing for a slow period, and in retreating, have found all sorts of ways to reduce costs. As this sample is still in an expansionary mode, the first possibility holds more water. Now that costs have shown a significant rebound, indices now deserve particular attention going forward. If the upward trend continues, it is possible that October was an anomaly, but if it drops below 70 again, it may show that the overcapacity problem is deepening.

Comment [MD1]: I did not find any more of this later, so I deleted it.

On the prices side, the consumer prices index rebounded last month from 41.4 to 46.0, and producer prices continued to hover at a low, but improving, level, rising from 32.4 to 33.5. From January 2014, prices have been sluggish, with consumer prices looking comparatively more healthy and mostly above the confidence threshold, but the situation has now deteriorated

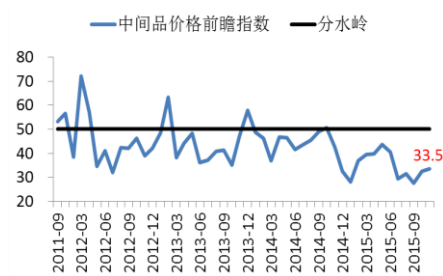
markedly, with the future trend unclear. Producer prices are consistently reported to be suffering from poor performance, only once above 50 (50.5, October 2014). This index has dropped below 30 on three recent occasions (January, July and September 2015, with marks of 28.1, 29.5 and 27.7, respectively).

Figure 8. Consumer Prices



Source: CKGSB Case Center and Center for Economic Research

Figure 9. Producer Prices



Source: CKGSB Case Center and Center for Economic Research

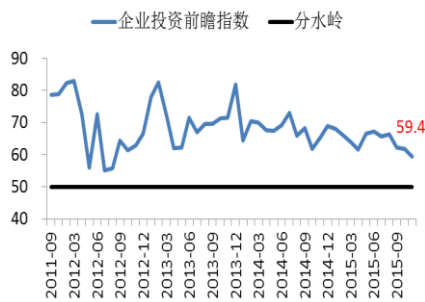
From our data, the high costs/low prices combination means that companies cannot increase prices to consumers or downstream producers to steer their way out of cost pressures, meaning that, despite acceptable sales, the profit index is performing poorly (despite two months of rebound in the profit index, the index is at a low level compared with 2013 and the first half of 2014). This echoes an earlier point about one of the biggest structural problems facing the Chinese economy – manufacturing overcapacity. This does not indicate that Chinese people are now so well off that they do not need as many goods or services. On the contrary, for a middle income country, China's domestic demand is healthy, but there are countless sectors in dire need of investment, including healthcare, education and pensions. Overcapacity is a result of misallocation of resources, such as, for example, placing resources in low return sectors like the steel industry. Overcapacity means economic structural reforms need to be carried out, allowing the market to guide an outflow of resources that has become stagnated, and configure a way to put valuable resources to better use. In the short term, such reform may trigger a greater slowdown with rising unemployment likely to damage vested interests, and this causes resistance to such a plan. However, for the long-term health of the Chinese economy, this is an unavoidable step.

Overcapacity and the growth of debt are linked. In fact, they are two sides of the same coin. Inefficient industries are unable to gain sufficient profit or cash flow from operations alone, so in order to function, survive and even expand, burgeoning debt is accumulated. As debt increases, so economic pressure will build up and when the debt burden spills over into crisis, economic and social unrest may result. We need to monitor debt, but as of today, there is little cause for optimism in this regard.

According to the Chinese Academy of Social Science (CASS), from 1996 to 2014, China's total debt-to-GDP ratio rose sharply from 113% to 235.7%. The highest proportion was in non-finance sectors, and in 2014, the total non-finance corporate debt-to-GDP ratio was 123.1%.

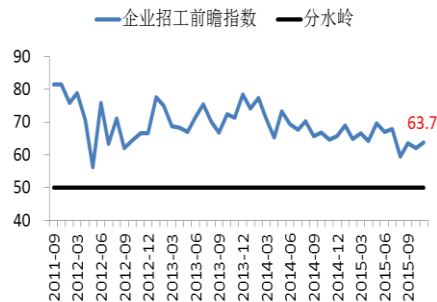
Following the discussion of costs and prices, investment and recruitment will be considered. The corporate investment index fell from 61.7 to 59.4, with the labor demand index rising slightly from 62.1 to 63.7. These two indices are interesting, since from September 2011, while other indices have fluctuated significantly including profit and inventory and the overall BCI, these two and the costs indices have remained consistent.

Figure 10. Corporate Investment



Source: CKGSB Case Center and Center for Economic Research

Figure 11. Labor Demand



Source: CKGSB Case Center and Center for Economic Research

The investment index and labor index have been above 50 in the long term, and comparatively high at that. Taking investment as an example, since September 2011, the index has been between 50 and 60 four times, and the rest of the time above 60, and above 80 on four occasions. The labor demand index has only been between 50 and 60 twice, and above 60 for the rest of the time, twice registering above 80.

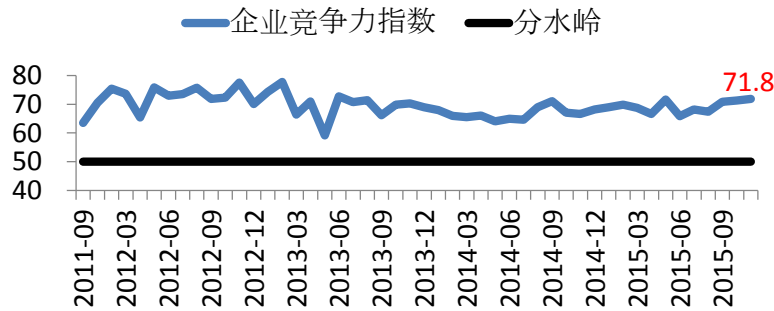
While sales are still good, cost pressures are mounting, a long-term poor financing condition exists and prices and profit performance are weak. But what is most interesting is that firms are still in expansionary mode, ploughing more money into investment and recruitment. With such poor short-term business expectations, why are businesses making such counter-cyclical decisions?

Perhaps, for good quality companies, a time of adversity is indeed the right opportunity to expand. But there is another possibility, that for companies “expansion is the only way” sums up how industries such as real estate, and the related sectors of steel, glass, and cement feel under the government’s favorable policies. Whenever there is an economic downturn, the government applies the logic it first used in 2009, and then again more recently, leading companies to expect an expansionary period following a contraction. From this perspective, reverse-cycle business operations make sense. But what about for the economy as a whole?

Finally, the BCI is generated wholly on the basis of statistics gathered from leading enterprises whose executives have studied or are 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 (an index reading of 71.8 in November), the CKGSB BCI indices are higher than

government and industry PMI indices and the conditions for most companies are even more difficult.

Figure 12 Industry Competitiveness



Source: CKGSB Case Center and Center for Economic Research

CKGSB BCI Introduction

In June 2011, CKGSB Case Center and Center for Economic Research initiated a project to gauge the business sentiment of executives about the macroeconomic 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. From May 2012 to November 2015, the research team has published 43 monthly BCI survey reports.

Explanation of the Index

The CKGSB Business Conditions Index (CKBCI) 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.

We ask companies for information pertaining to their relative competitive positions in their respective industries. Based on survey responses, we compute a competitiveness index for our sample. The higher the competitiveness index, the more competitive our sample firms are in their respective industries.

Method of Calculation

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 Cheung Kong Graduate School of Business

Education for a New Era of Global Business

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.

Thought Leaders on Business in China

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.

World-Class Faculty with a Global Perspective

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.

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