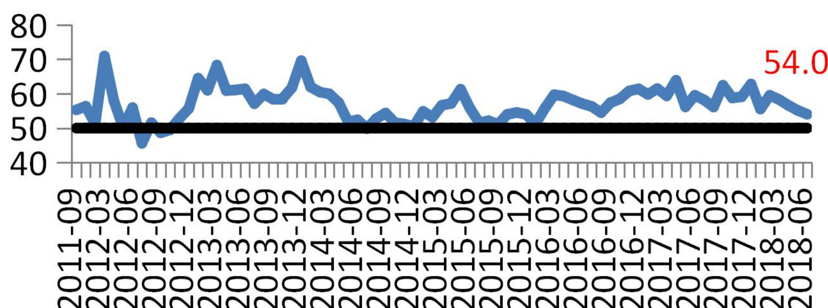
Commentary on the June 2018 CKGSB BCI

Professor Li Wei

In June, the CKGSB Business Conditions Index (BCI) fell slightly from 55.1 to 54.0, remaining just above the confidence threshold of 50 (Figure 1).

Figure 1 Business Conditions Index (BCI)

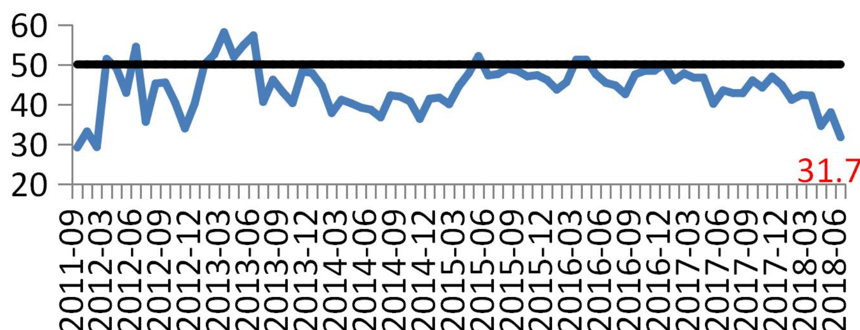


Source: CKGSB Case Center and Center for Economic Research

The deteriorating BCI index aside, other sub-indices have also fallen. The financing conditions and inventory indices both dropped considerably this month, the former to 31.7 (38.0 last month) and the latter to 41.0 (47.0 last month). The prices indices also dropped, the consumer prices index from 67.9 in May to 64.8 in June. The producer prices index fell from 58.3 to 51.0. All other indices show smaller degrees of change. For more details, see the June BCI report in full.

This month, particular attention should be paid to the financing environment index. With such a marked drop, it now lies close to its historical lowest point (Figure 2).

Figure 2 Corporate Financing Index



Source: CKGSB Case Center and Center for Economic Research

This month's financing environment index is the third lowest since the survey began, with the other two lowest being 29.1 (September 2011) and 29.2 (December 2011). This month marks the lowest the index

has been since 2012. It is true that corporate financing prospects have been weak over the long term, but it has rarely been this bad. What we do not know yet is whether this is the start of a major trend, or merely a kink in the data. What is clear is that financing conditions for Chinese businesses cannot escape being labelled "negative."

In last month's BCI commentary, the author pointed out the high efficiency level of respondees' SMEs (mainly the companies of CKGSB alumni) and the very high savings rate in China as a whole. In 2016, total savings to GDP in China were as high as 47%, making China champion of the world's major economies. A high savings rate and a group of excellent companies that have financing trouble? How can this happen? The author's view is that China's financial system has structural problems which mean it cannot meet the needs of the real economy.

At its core, finance is all about allocating resources across space and time. Put simply, some people have good projects but no money, while others have the money but nothing worth investing in. The financial system plays the role of intermediary and bridge, matching the two to guide the flow of funding to good projects, ultimately increasing output and accumulating capital.

The ideal is bountiful, while the reality is mere flesh and bones. We all wish we had financial system that was both efficient and low risk. But if we look at the history of finance, we will find that both developed and developing countries have struggled to get the balance right. Take the US for example. Recognized as having the most advanced financial system in the world, the most mature capital markets, and a global financial center in New York, even the US experiences the occasional financial crisis, most recently in 2008. The subprime mortgage crisis spread across the US and all over the world. In 2000, NASDAQ's internet stocks crashed causing countless investors to lose everything. Japan and the United States have very different economic systems, but they have both experienced serious financial problems. In the second half of the 1980s, there was a sharp rise in asset prices in Japan. Stock prices rocketed, and the cost of all real estate in Tokyo was for a time equivalent to the value of real estate in the entire United States. The highest Nikkei 225 index was 38,915.87 points (December 29, 1989), having been only only 11542.6 points on December 28, 1984. Subsequent events have been recorded in many publications. The asset bubble burst, and the Japanese economy has sunk. And although the government has repeatedly used high-intensity macroeconomic policies to stimulate economic growth, its results have been consistently poor.

Developed countries have frequently been "visited" by financial crisis, and developing countries have not been passed by either. In the 1997 Asian financial crisis, Thailand, Indonesia, South Korea and Malaysia suffered tremendously, with many enterprises going under, including large *chaebols* such as South Korea's Daewoo Group. Living standards dropped, and in Indonesia the financial crisis even triggered political turmoil which led directly to the dismissal of President Suharto who had been in power for 31 years.

China has not encounter financial crisis in the traditional sense after reform and opening up. No major bank has collapsed. But the banking industry was ridden with bad assets in the 1990s, to the point where it was common knowledge that the sector was actually "bankrupt." Following the latest round of banking reforms, China's large and small commercial banks went public one after another, improving their asset status no end. Bank stocks were once again of interest on the capital markets.

Banking reforms in China have been largely successful, but some structural issues remain. First of all, banks are used to "large capital bases". Chinese banks tend to serve large companies as customers, and have little enthusiasm for SMEs. They act more like pawn shops than banks in the market place, placing too much emphasis on the value of collateral when lending, and lacking judgment regarding customers' operations and future profitability. High efficiency, light asset SMEs find it extremely hard to obtain credit from them. On top of this, Chinese banks use a dual interest rate system, offering SOEs and large companies a lower rate than private SMEs. All the data shows that the efficiency of Chinese private enterprises far exceeds that of SOEs, and private SMEs are one of the most dynamic sectors.

More importantly, micro-enterprises are the main drivers of employment opportunities in China today. At the Summer Davos in Dalian on June 28, 2017, Premier Li Keqiang said, “The employment capacity of large enterprises is clearly falling... Small and micro-enterprises account for 80% of jobs in China and are now the foundations of inclusive growth.” We all know employment is key to political stability. So by enabling small and micro-enterprises to prosper, we are not only working towards greater economic efficiency, but also supporting the development of a harmonious society.

The Chinese government is actually very clear about these issues, and has taken measures to address them. On June 24, 2018, the PBOC issued a press release on its official website about lowering the RMB reserve ratio by 0.5 percentage points at state-owned commercial banks, joint-stock commercial banks, postal savings banks, city commercial banks, non-county rural commercial banks, and foreign banks from July 5, 2018. Among them, small and medium-sized banks including the Postal Savings Bank, the City Commercial Bank, and the non-county Agricultural Commercial Bank could use the RRR cuts to offer more small and micro-enterprise loans, and focus on alleviating their funding problems.

One day later, on 25 June, the PBOC and five departments including the CBRC jointly issued “Opinions on Further Deepening Financial Services for Small and Micro Enterprises,” proposing to support small and micro enterprises in areas including credit, fiscal services and taxation, and banking supervision, such as “increasing small loan refinancing and re-discounting quotas to a total of RMB 150 billion, and reducing the interest rate on small loans by 0.5 percentage points.”

However, banks have deep-seated reasons to lack enthusiasm for loaning to small and micro enterprises, and these policies are not likely to dislodge their concerns. Currently, commercial banks have a degree of decision-making power regarding deposits and loan interest rates, but it is extremely limited. Banks cannot lend to different customers by opening up interest rates. Under such circumstances, having a large “capital base” is a kind of low-cost, high-yield operating model. The accounting books of small and micro-enterprise tend to be incomplete and their accuracy debatable. This makes verifying things difficult and costly. For the banks, the choice to lend to a company like PetroChina or lend thousands of small and micro enterprises is self-evident. The case is the same for collateral. In any case, the interest rate difference of lending will not be very large, so collateral is definitely better than no collateral, and collateral is definitely better. Behind the essence of the dual-track interest rate system is the government’s implicated responsibility. Many state-owned enterprises and some large-scale private enterprises receive the support of local authorities. This situation means that the local government issues banking policy, so the banks are naturally willing to give these authorities guaranteed corporate lending, whether it is explicit or implicit.

Whoever started the trouble should bring it to an end. In order to solve the financing issues of small and micro-enterprises, it is necessary to eliminate the related institutional obstacles, or they will waste a lot of time and end up with nothing. The author suggests that the following measures can be considered:

First, reduce barriers of entry in the banking industry and strengthen competition. At present, many banking problems can be put down to “lazy government” and one reason for this is lack of competition. Banks can still make money lying down. If there were more banks, they would have to develop new markets in order to survive and develop. Small and micro-enterprises may well benefit from this.

Second, push for the marketization of interest rates. The central bank has been slow to give up its control of interest rates, and allow commercial banks to determine their own deposit and loan interest rates. But the best small and micro-enterprises can afford higher capital costs, and banks that lend to them could get higher returns. Compared to the exhorbitant rates offered privately, these companies could benefit from lower interest rates from the bank, an indisputable win-win situation.

Third, develop the direct financing market. The main step would be to reform the stock and bond markets and reduce the cost of direct financing. Companies with good credit, especially large ones, could be funded directly on the markets at lower cost than from bank loans. Without so many large companies to take care of, banks would have to turn their attention to small and micro-enterprises to maintain their own levels of growth.

Fourth, take measures to cancel implicit or explicit guarantees made by local governments to protect certain state-owned and private enterprises. Such local government assurances have given these companies inherent disadvantages on the capital markets. Risk is low, so banks have been willing to lend to them, and the money left to flow to small and micro enterprises has dwindled.

In short, policy makers are well aware of the problem and have taken action in the form of various measures. But so far these policies have not been sufficiently targeted. In the short term they may have some effect, but from a long term perspective they appear to be nothing but expedient measures. In order to truly solve the financing problems of small and micro-enterprises, policy makers need to dig deeper and implement true institutional reforms. Everything else is just brewing a storm in a teacup.

This is the author's commentary on the CKGSB BCI report for June 2018. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei

June 29, 2018