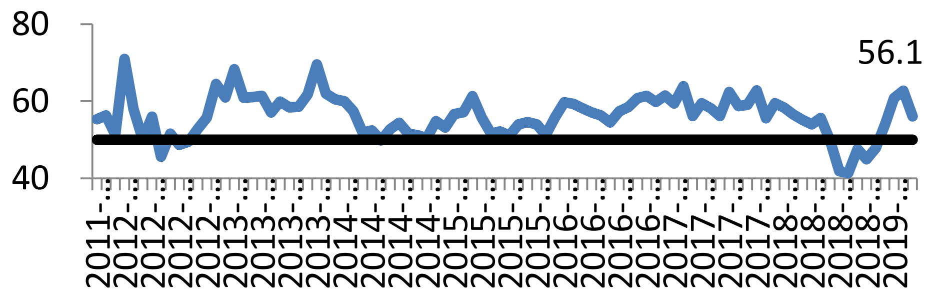
Commentary on the May 2019 CKGSB Business Conditions Index

Professor Li Wei

The CKGSB Business Conditions Index fell to 56.1 in May. This marks a clear deterioration from last month's figure of 62.8 (Figure 1), either representing the start of a new trend or a short-term reversal of positive macroeconomic signs. At the very least, May's result suggests a cooling of business sentiment regarding the prospects for doing business in China over the next six months.

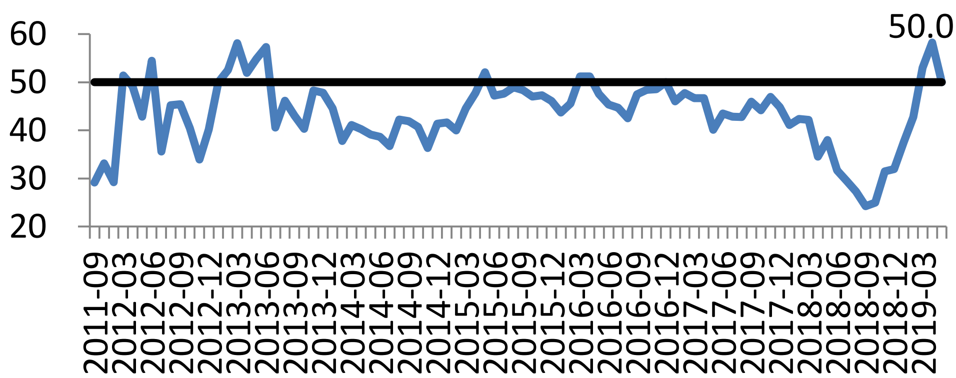
Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

We should note that the financing sub-index fell to exactly 50.0 this month. Survey respondents are neutral about funding forecasts over the next half year. Last month, in contrast, this sub-index registered its highest ever since the survey began in 2012 (Figure 2). From this drop in expectations, we understand that our sample group is undergoing a definite contraction in their financing capacity.

Figure 2 Financing conditions index



Source: CKGSB Case Center and Center for Economic Research

Apart from the main BCI and sub-indices, other forecasts have seen some movement although this has not been particularly striking. For more data, please see the May BCI report.

The BCI commentary this month makes four main points. The first considers changes in the financing environment. In detailed terms there may be differences of opinion, but broadly speaking most finance experts agree that China is implementing a dual-track capital market system. State-owned enterprises and some large privately-owned enterprises enjoy preferential treatment because of their ownership status and scale. Loans are quite simply easier for them to raise and less costly to maintain. A number of these companies are frankly underperforming. On the other side, some private enterprises, especially small and medium-sized enterprises, are not supported by state-encouraged funding, are in a weak position in the capital market, have trouble raising funds, are subject to high capital costs, and have borne the brunt as the government cleans up the "grey area" of the finance sector. This is despite these companies being more efficient and better recruiters.

From 2017 to 2018, the central government made steps to tidy up financing. As the author has written in previous commentaries, this was a necessary step. However, reorganization is bound to lead to contraction. The question is, in this case, which part of the balance sheet will financial institutions shrink? Past experience tells us which players are most likely to fall victim. Although private SMEs are more efficient, they are vulnerable to this type of reorganization. In the many rounds of financial contraction that have gone before, private SMEs have been refused loans and credit from financial institutions, raising tension, causing a breakdown of relations, and even heralding their demise. Since the middle of 2018, the government has seen the drawbacks of de-leveraging and financial consolidation in this respect. Therefore, it has quickly changed its course and implemented a looser credit policy for private SMEs. As a result, the funding problems of private SMEs have eased rapidly, and the financing environment index has, last month at least, reached its highest value in history.

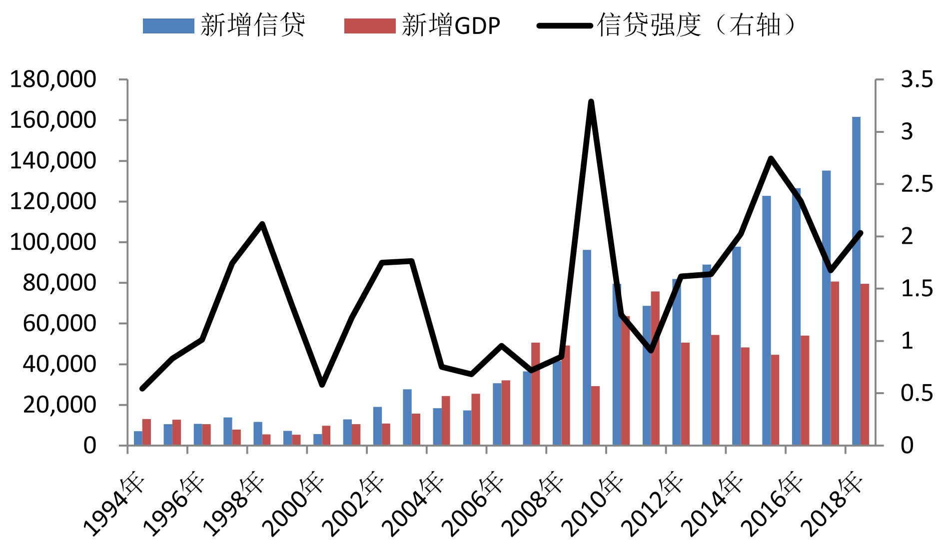
However, this month's sharp fall in the financing index shows just how fragile the recent spate of optimism has been. With only the slightest indication of a change in direction by the government can affect forecasts to head south immediately. This is a reminder of an important question: how can China release financing constraints on private SMEs? Loosening credit only solves the current problem. The real issues need major institutional reform, such as what to do with state-owned enterprises, breaking down soft budgetary constraints, turning them into real market entities that compete with private enterprises on a single starting line. Such reforms are tricky, but if they are not carried out, financing will be a perennial problem for private SMEs.

The second point is the impact of the trade war. Some have been surprised that the US-China trade war has not eased up, but instead has become worse. In fact, China's dependence on foreign trade is far less than it was over a decade ago. According to the World Bank, China's current account surplus was nearly 10% of GDP in 2007. Alarmingly, exports accounted for around 35% of GDP. By 2017, these figures have fallen to 1.3% and 19.8% respectively. The sharp decline suggests China's dependence on foreign demand has significantly fallen. The impact of the trade war on the Chinese economy should be correspondingly limited.

However, the trade war's impact does not stop at trade. A significant number of Chinese companies have listed overseas, especially tech companies. The US stock exchanges are major listing destinations. Chinese giants such as Alibaba, Baidu and JD.com have all listed in the US, and their valuations will inevitably come under strain. China has also become an important overseas market for many US companies. For example, China is the second largest market for Apple's iPhones. The tension between China and the US will not only slow down development in such firms and bring uncertainty across the economy. Most importantly, it will affect peoples' confidence in the future.

Thirdly, government stimulus does not work as well as it did in the past. Quantitative easing has been the government's go-to policy since the global financial crisis in 2008, having a remarkable impact the first time round, resulting in a V-shaped economic rebound. But the cost of responding this way every time there is a problem is too high, especially as the impact decreases every time.

Figure 3 Financing conditions index



Note: New credit = blue bars; Increased GDP = red bars; Credit strength = black line

Source: Wind

As can be seen from Figure 3, credit intensity rises sharply when an economic stimulus is introduced, leading to a sharp decline in economic efficiency. However, such large amounts of credit actually face declining efficiency if implemented constantly. If a certain growth rate red line of say 6% is set, but cannot be fulfilled, only three options remain. One is to temporarily abandon the red line and carry out structural reforms to lay the foundation for healthier growth in future. The second is to increase the scale of economic stimulus, achieve short-term goals, pushing the problem far into the future. The third is to fix the data. These choices have all been discussed in the industry. What is lacking most now is determination and perseverance.

Fourth, the US government's suppression of Chinese companies such as Huawei is worth noting. The Trump administration has begun to focus its efforts on Chinese tech, which will profoundly shake up the supply chains to global technology companies. Over the past forty years, China's reform agenda has created a huge economic miracle, and a large part of this is due to opening up to the outside world. Since the beginning, Chinese companies have rejected closed-door development. Instead, they have actively invested in a global division of labor and in global competition. They have used their comparative advantages to reach the end of the 'smile curve,' and have created many internationally competitive companies, such as Huawei.

China's high-tech sector has prospered in an environment of marketization and openness, and considers global cooperation as a given. The US is a leader in global technology, and Huawei is not alone in having strong long-term partnerships there. The US government has clearly decided to undermine these partnerships. Although Huawei has other markets in Europe and Africa to cushion the impact, if it has to completely decouple from the US, this will have a huge negative impact. From a broader perspective, this could lead to the end of the global technology supply chain, and slow future innovation. The impact of this may be far greater and longer than the impact of the trade war itself. The future of China's tech industry has an uncertain future.

This is the author's commentary on the CKGSB BCI report for May 2019. Do not hesitate to contact the BCI team by email should you have further questions.