Commentary on the July 2019 CKGSB Business Conditions Index

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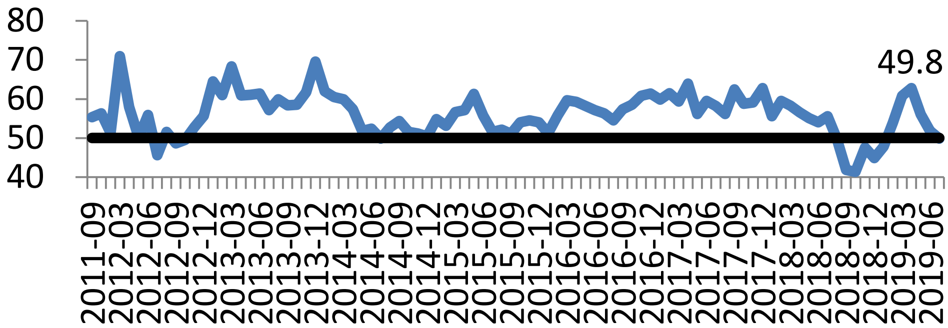
The CKGSB Business Conditions Index fell to 49.8 in July, a drop from last month's 51.8 and the first time since January that the index has fallen below the confidence threshold of 50.0 (Figure 1).

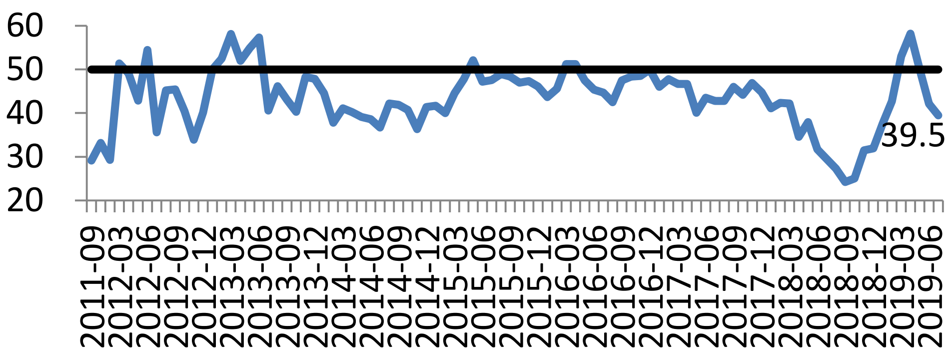
Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

We should note that all four sub-indices fell this month, most noticeably the financing sub-index, dropping below 40.0 (Figure 2). In September last year, this sub-index fell to its lowest ever figure of 24.2. With the relaxing of national credit, financing optimism among our sample climbed again. The indicator climbed to its highest historical value of 58.2 only in April this year. However, good times were not set to last. Just three months later, financing expectations are completely deflated again. To many, this is a remarkable reverse of fortunes.

Figure 2 Financing conditions index



Source: CKGSB Case Center and Center for Economic Research

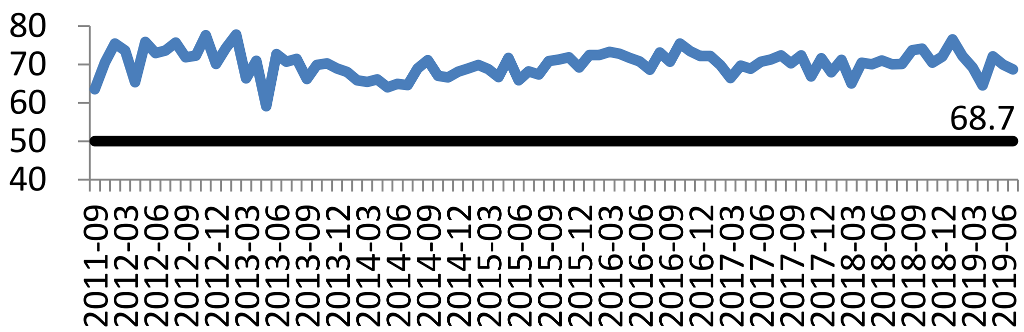
Apart from the main BCI and sub-indices, other forecasts have all shifted in different directions this month. Cost have stayed stable, financing and recruitment forecasts have fallen slightly, consumer prices are expected to fall to some degree and producer price forecasts have had a minor rebound. The overall impression is still not positive. For more data, see the July BCI report.

This month’s data has once again reminded the author that old issues in the Chinese economy have still not been resolved. Triggered by the slightest relaxation, they make waves, but the situation remains dire. Let’s look at the corporate financing index.

Financing of businesses is part of a country’s financial system, and for any modern country it has to be done right. Economic history tells us that the rhetoric of industriousness and courage leading to wealth is, even when not laden with ulterior motives, a blind myth. There will aways be national projects that lack money, and there will always be “vacant money” in the system. But an efficient financial market, and vacant money being put to good use determines a country’s ability to increase productivity, develop the economy and improve living standards for its people. In other words, finance is the “brain” of an economy. If your legs fail, you can get around in a wheelchair, but if your brain fails, there’s very little you can do.

So what is the current state of China’s finances? We refer to the numbers. Figure 2 above shows very clearly that our survey participants are having a lot of trouble obtaining funds. In short, the corporate financing environment is awful. This leads to another question: What kind of companies are we surveying? In our survey, we asked respondents with companies that stand out in their respective industries, taking the industry average as 50. The higher the value, the higher the company’s value, the higher the industry competitiveness index. Over the long term, our sample has performed above average (Figure 3). In other words, we are talking about a group of outstanding, highly efficient Chinese companies.

Figure 3. Industry competitiveness



Taking these two sets of figures together, it becomes evident that the companies with the most efficient operations that are most in need of money have the most serious trouble getting funding. They also report the highest costs. Put in another way, money is not flowing to the parts of the economy that are best suited to putting it to good use. This phenomenon cannot be explained from a market perspective, because the most efficient companies should be able to afford the highest capital costs, and investors should be willing to allocate funds to companies that perform best. If it is difficult for an efficient company to get funding, this might be due to a gap in the market, but when it’s a group of efficient companies, there has to be an institutional reason.

When efficient companies cannot access enough money, we have landed in the realm of financial repression. This was first theorized by American economists Edward Shaw and Ronald Mckinnon in 1973 as an analysis of developing economies’ financial systems. The theory essentially explains how governments use administrative means to directly participate in or indirectly interfere with financial institutions and markets, so that resources in society can flow to all levels of government, institutions and economic entities at minimal cost. The objective of these institutions and economic entities is generally to implement government, social and economic policy. In a financial system with less government regulation, funds flow to projects with a high return on investment and low risk.

Depositors who provide socially loanable funds will receive higher returns on investment from competing financial institutions or markets. Financial repression is essentially an institutional arrangement for imposing invisible taxes on depositors who provide lendable funds. It provides funds below the rate of market return on investment for all levels of government, state-owned enterprises, and other entities that implement governmental development policies. This is an effective means of increasing the financial might of a government and reducing its related businesses, and financial burden.

China is a significant financially repressed country, and financial repression has made a tidy sum for the government. For example, according to Roger Gordon and the author's research (2001), from 1991 to 1998, the Chinese government levied invisible taxes on depositors amounting to around 2% of GDP.

One example is China's new high-speed railway. It is currently expanding in all directions, and now represents China's signature offering abroad. However, according to Professor Zhao Jian of Beijing Jiaotong University, even if operating costs are taken away, the total revenue of high-speed rail cannot pay back the interest on its construction. Investment needs real economic returns. The market is unlikely to participate in this kind of loss-trading for long. Capital is limited, and generosity towards some results in harsh treatment towards others. When the Soviet Union pushed anti-market resource allocation to the extreme, it ended up with huge military strength and an impressive military complex (military industry, heavy industry, etc.) which made people far less envious of the economy of the United States. But with the decline in energy prices, the strength of the state was revealed: Living standards at a standstill; people queuing for bread and meat. No matter how impressive, aircraft cannons still cannot be eaten! In the end, the Soviet regime lost the support of its people.

Soon after the Cultural Revolution, the Communist Party realized it had to develop the country's productive forces and improve living standards as the only way to maintain popular support. This has turned out to be true. While the former Soviet Union took up arms in a stare-off for global hegemony with the US, the Chinese Communists gave up "output revolution", cast aside its swords for plows, and quietly forged a "Chinese miracle" instead.

If we want to continue to write about China fulfilling its dreams, then it is crucial to remember both positive and negative lessons. Growth in the Chinese economy will inevitably slow. Its continued success depends on brainpower: allocating funds to the most efficient companies. And to do this, eliminating financial repression is an essential step.

This is the author's commentary on the CKGSB BCI report for July 2019. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei

July 25, 2019