Commentary on the November 2019 CKGSB Business Conditions Index

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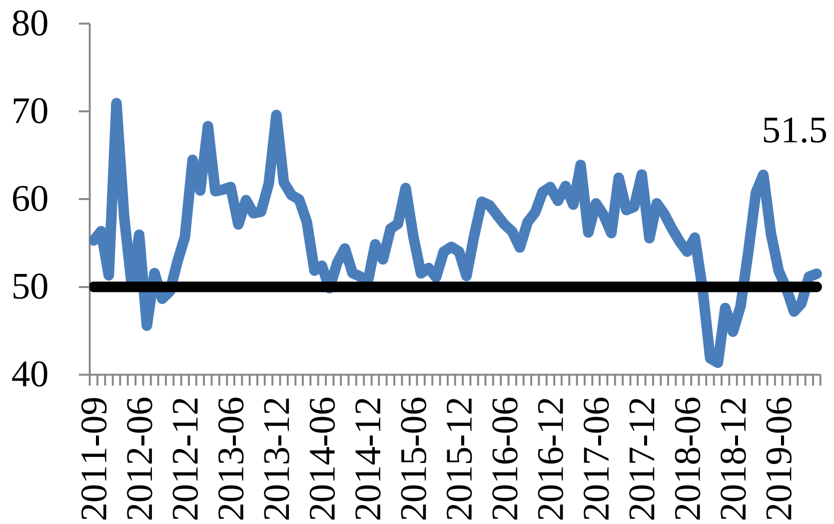
This month, the CKGSB Business Conditions Index rose slightly, from 51.2 to 51.5, remaining just above the confidence threshold of 50.0 (Figure 1).

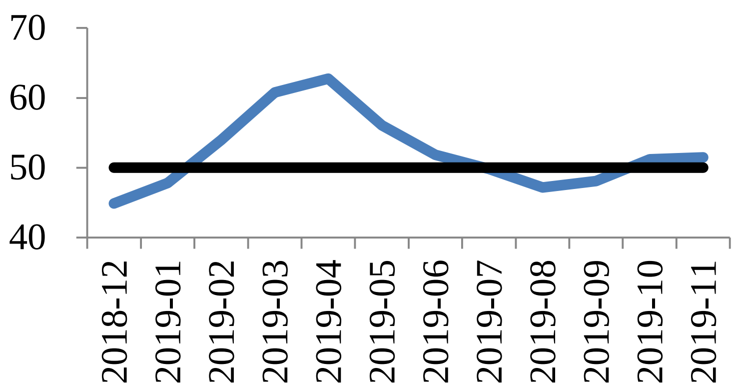
Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

The other indices surveyed for are relatively stable with no big surprises. As we are approaching the end of the year, the author will take this opportunity to recap themes of 2019. From December 2018 to November 2019, the BCI has seen wide-ranging ups-and-downs, only now settling into a stable pattern once more (Figure 2).

Figure 2 BCI over the past 12 months



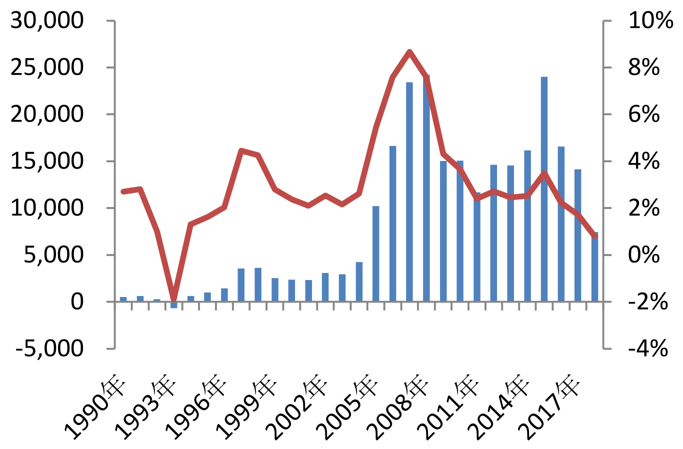
Source: CKGSB Case Center and Center for Economic Research

How should this BCI of extremes be viewed? First let's consider reasons why we had this result. Over the last year, the external environment has exerted a considerable impact on business operations, especially those that focus on external demand. Although US President Trump's clamoring for a trade war has been going on for a long time, allowing various circles to act on and digest the direction of US government policies, it is inevitable that the eventual tariff hikes from one of China's most important trading partners, naturally caused significant pain for Chinese private firms focusing on the US market.

Although China has made great progress in its 40 years of reform and opening up, most indicators show that China is still a developing country. Data from Wind suggests China's 2018 per capita GDP (current rates) is RMB 64,644, which is almost US$10,000. So while China has high-tech companies like Huawei that have mastered certain core technologies, most companies operate on a processing level, with neither core technologies nor competitiveness. These enterprises earn hard cash in foreign trade, and are sensitive to trade related price fluctuations. U.S. tariff hikes have caused discomfort for companies with core technologies and patents, but for them only profit margins are really affected. For hard grafting Chinese private firms in foreign trade, profits and losses are first to be affected. A rise in tariff rates may be a "catastrophic disaster" for them. So while Trump's tariff attack has been prolonged, and the Chinese government has responded actively in various ways, many small Chinese traders have succumbed to the pressures, especially in the first half of 2019.

However, although external factors are important, today's Chinese economy is large and dominated mainly by domestic demand. So unless the world enters a trade war the likes of which have not been seen since the 1930s, shifts in external demand will not exert substantial influence on its economic growth.

Figure 3 Value of exports of goods and services since 1990.



Note: Blue bars are net goods and services in units of 100 million RMB; red line is as a proportion of GDP
Source: Wind

Figure 3 clearly shows that while China is still a big trading country, compared with 10 years ago, foreign trade is no longer such a large constituent part of the economy as a whole. In this context, the US-China trade war may not deserve as much attention as it is getting.

Since the trade war is not the "culprit" of economic fluctuation, who is? In fact, internal factors are always at the heart of change and development. Its per capita GDP may not be as high as in a developed country, but, China has an amazing volume to exploit. After 1978, China entered the fast track of economic development on the back of its reform and opening up campaign. This opening up has gone from strength to strength, the private economy has blossomed, foreign capital has flown in, related policies and laws have evolved, and institutional innovation has taken place.

Having such a large country with such complex political and economic reform needs has created a situation in which China has to innovate, and also weed out counterproductive forces. In the process, the economy has to keep going, and cannot overturn in the rapids. Like with the tightrope, keeping the show going involves both balance and a forward momentum. From the experience of countries around the world, this inevitably creates contradiction. Reform is about breaking with the old balance, shaping a new balance, and pushing forward. We do not know if the old and new forms of stability can be connected seamlessly, just as we do not know if the new form of stability can adapt to institutional needs and those of development. Humans have limited brainpower, and although each crisis will have some features in common with those of the past, they will also have unique aspects. When seen with the enhanced vision afforded by hindsight, we should recognize that preventing and responding to a crisis is by no means easy.

However, despite the risks, this is how economic development and reform has happened across the world throughout history. On the one hand, constraints to development are lifted, and on the other hand, various risks are subjected to control so that they do not become systemic. Even in the United States, with one of the most developed market economies in the world, a financial crisis erupts almost every 10 years. As developing countries have systemically weak foundations and plenty of loopholes, once an economic crisis sets in, the damage can be greater, risking interrupted economic and social development, and nationwide stagnation. Indonesia and Argentina went through such economic crises in the early 2000s.

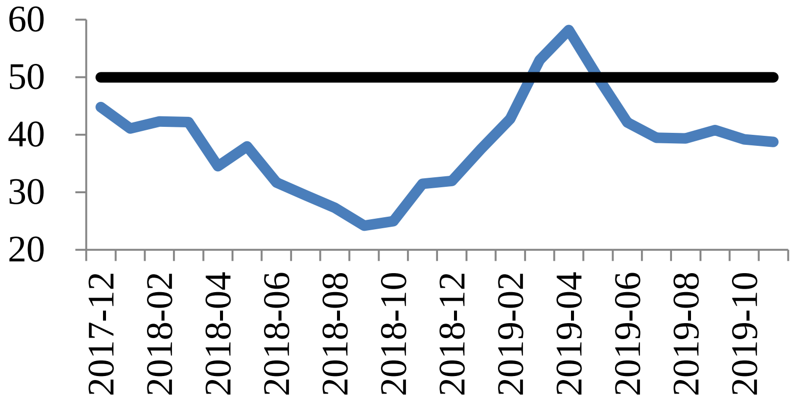
Having said so much about reform, development, and crisis, can this analytical paradigm be applied to recent shakeups in the Chinese economy? What caused this year's BCI to fluctuate? In my opinion, this is all about changes in the funding status of private enterprises. Private SMEs have long suffered from high costs and finance trouble. Whenever financial institutions tighten their money supplies, the first to lose out are private SMEs.

These private SMEs often have a serious issue with short-term financing for long-term investments, due to their weak position in the capital markets. If the external situation is calm, borrowed funds can be kept until a loan's maturity, having a minimal impact on operations. But if conditions change, banks may not extend loans, or may raise interest rates, a severe test for any small company without strong risk limitation capabilities.

Recently, China's financial regulatory authorities have put an end to some of the worst of the financial "chaos", including off-balance sheet financing. However, off-balance sheet financing has simply moved from the light to the shadows, increasing the risk of uncertainty. This question needs to be addressed by regulatory authorities. Such rectification makes sense and the Banking and Insurance Regulatory Commission has made progress. What is unexpected, however, is that this contraction of off-balance sheet financing has had such an impact on financing options for private SMEs. Because of this, there has been a backlash against financial consolidation.

After a short period of hesitation, decision-makers took action to slow down the course of financial consolidation, and eased credit to some extent. Although not a cure, such measures can alleviate the worst of the negative impact of earlier policies. Financing conditions for private SMEs may still not be ideal, but they have stabilized at least, albeit at a low level of confidence (Figure 4).

Figure 4 Financing conditions in the BCI over time



Source: CKGSB Case Center and Center for Economic Research

Clearly, these government policies are effective, but they should only be considered as an emergency solution. What is next? The financing of private SMEs appears to go wrong at the level of financial institutions and related enterprises, but in fact, their financing should act as a pump for the entire economy. On the surface, banks should not refuse to lend to private SMEs. However, from their perspective, private SMEs may have high operating risks and insufficient collateral. Banks often struggle with this kind of business. That being the case, why should banks do business with such companies? We cannot say on the one hand that the bank should be profit-oriented and act as “real banks” while simultaneously telling them to have a political conscience and grasp of the overall situation. That’s fine when these two are in line. But what if they are not aligned? Then what should the banks do?

Based on past experience, it seems that at the moment, we cannot do anything to solve the financing issues of private SMEs. To have a more substantive solution to this problem, I am afraid that in the future, we have to commit to ongoing and stronger reforms of the finance sector. We need new financial institutions, which emerge from the market and are rooted in the market. These could turn SME funding into a sustainable profitable business, instead of turning it into a ploy to get cheap capital from the state. They would act like venture capital (VCs), raising funds by seeking investors, investing in emerging companies, and exiting when they go public. The entire process, a complete business model, would not need a penny of government funding. Looking at China’s larger high-tech companies, they have all been nurtured by VCs. VC investment is limited by field and may not suit all private SMEs but it is a useful reference to building a new financial ecology.

Finally, the author wishes to emphasize the importance of openness. China’s economic reforms have gone hand in hand with openness since the beginning. This brings in resources, money, but also new ideas and new concepts. Many parts of the Chinese economy have achieved marketization and opening up in the past 40 years, but finance has not. To date, financial institutions are still mainly responsible for supporting state interests, and regulation has impeded market competition. Of course, the financial sector is prone to problems and the US is a good example, but regulation play an important role.

Without opening up and reform of China’s financial sector, the future of it will face a dead end. But if we were scared of the risks back in 1978, would China have witnessed today’s economic miracle? It is time to regain the courage of yesterday, reconfirm our commitment to opening up to the outside world in finance, implement policy uniformly across the nation, expand competition, let the market choose the winners, and use the market to solve today’s issues. Financing for private SMEs will improve just as it has for VCs in China. Slowly, China’s finance sector will achieve a fundamental upgrade, and this may go down as another feat in modern political economy.

This is a short commentary on the CKGSB BCI report for November 2019. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei

November 29, 2019