Saving the Economy: Avoiding Irreversible Damage

Commentary on the February 2020 CKGSB Business Conditions Index

By Professor Li Wei

We were psychologically prepared for poor results to this month's CKGSB BCI, but the actual figures are worse than we had imagined. This month, the BCI reached a historic low, reflecting the extreme pressure faced by Chinese companies. There is now an urgent need to improve business conditions so that companies can avoid irreversible damage.

A confidence crash

What does it mean for the BCI index to drop 18.9 percentage points to an all-time low of under 40? From the data, we can see that sales and profit forecasts have plummeted. Companies lack business, or have not yet resumed work after the Chinese New Year holiday, and therefore have no revenue. As shown by improved inventory forecasts, there is a reliance on warehoused goods. This improvement in the inventory index is hardly a good thing, as it means companies cannot produce new goods. Financing conditions have slid only slightly. In the current climate, financing is the least of anyone's worries.

A decline in company cost performance was expected - whether labor or overall costs, we should note that a declining index is standard. But when it comes to prices, if the dramatic fall continues, we can expect deflation.

Another cause for concern is this month's investment and recruitment indices. These two have stayed relatively high for a long time, but both fell to around 43 this month. Companies are no longer considering expansion as they have in the past. Instead, they are expecting contraction. If this goes on, economic downturn is a natural conclusion.

Since December 2019, an outbreak of a novel coronavirus named Covid-19 by WHO, has stopped China in its tracks as quarantine measures to prevent further spread of the virus has impact businesses across the country. This month BCI survey, we included an additional four questions about the outbreak. Companies have responded with statistics that show the dramatic impact of these preventative measures. To save the economy, there is an urgent need to improve China's business climate.

45% of companies surveyed have been unable to resume work, and 49% have only just resumed. Among reasons for difficulty resuming work, the seriousness of the epidemic itself accounts for 40% of cases, and staff trouble returning to the workplace accounts for 33%. The return of employees may be directly related to the epidemic as well as preventative measure put in place by the government. Most importantly, most companies believe they will not be able to get back up to speed by the end of February. A total of 32% believe they will have resumed between 0% and 40% by the end of February. A total of 29% believe they will have resumed 40% - 60%, while only 28% believe they will have resumed 60% - 80%, and the remaining 11% believe they will have resumed 80% - 100%. In other words, 61% of companies believe that by the end of February, their production capacity will not recover more than 60%, indicating a month that has largely gone to waste.

Three hypotheses

We know that the service industry has been hit hardest by the epidemic with stores in many cities unable to operate normally, and industry and agriculture are relatively better. We also know that 60% of enterprises believe that the recovery rate of production capacity will not exceed 60% by the end of February. We use this to make a relatively vague assumption: the output value of agriculture and industry will decline by 40% year-on-year in the first quarter of 2020. The service industry fell by 60% year-on-year. At a later time, the economy returned to normal operation and was no longer affected by the epidemic. In this case, the real GDP (constant prices in 2019) of the three industries in the first quarter will be 0.53 trillion yuan, 4.91 trillion yuan, and 5.10 trillion yuan. The overall decline was 51.7% over the same period last year, equivalent to RMB 11.27 trillion.

We have calculated the possible economic downturn in the first quarter of this year according to two hypotheses, and will consider the economic impact based on these possible scenarios.

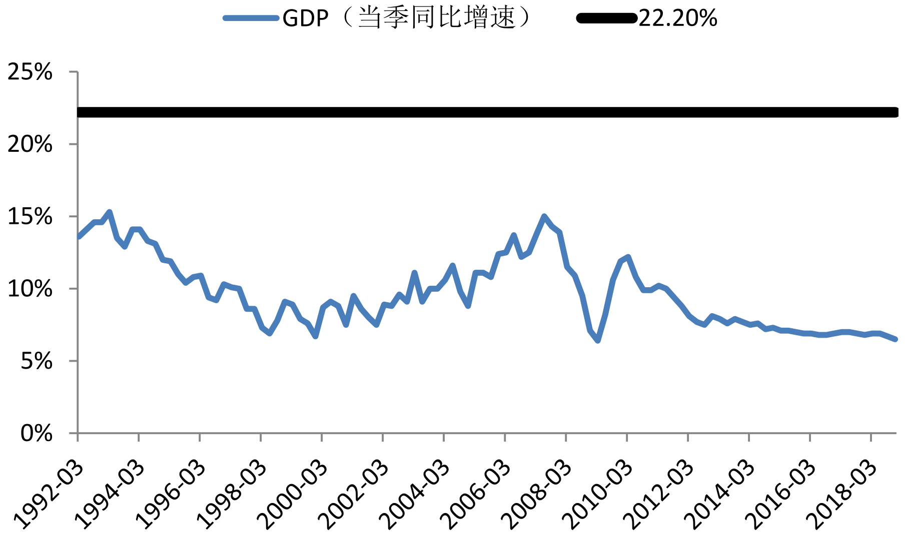
Hypothesis one: China's GDP growth target remains unchanged at 6%. What level of economic growth do we need in the next three quarters to achieve this target.

Hypothesis two: The second, third, and fourth quarters of this year are not affected by the epidemic, with growth remaining the same as last year. What will be the overall GDP growth rate this year?

Let us consider the first hypothesis: Last year's GDP was calculated as (2019 constant price) RMB 99.09 trillion. Growth of 6% means this year's GDP should be RMB 105.03 trillion (2019 constant price). If, as we suggest above, Q1 GDP 2020 will lose RMB 11.27 trillion, we need to make up for this loss over the next three quarters. This would mean RMB 17.22 trillion added to the GDP of the next three quarters if prices are constant with 2019. This means a 22.2% year-on-year increase in the last three quarters of the year.

What kind of scenario is this? Let's look at a chart below

Figure 1 Year-on-year quarterly GDP since 1992



Source: Wind

The above figure represents the real year-on-year growth rate of China's GDP in each quarter since 1992. Obviously, no quarterly value has exceeded 22.2%, but we must achieve 22.2% quarterly growth for the remaining three quarters of the year if we are to reach the 6% annual target. Such a growth rate is close to impossible to achieve without a large-scale government stimulus. We will have to adjust our growth target this year.

What about the second hypothesis? If the 6% growth rate in the second, third, and fourth quarters remain unchanged, what will be this year's overall GDP growth rate?

As with the first hypothesis, China will have lost RMB 11.27 trillion in GDP in the first quarter, and GDP in the next three quarters will have grown by 6% as in 2019. This makes the total GDP in 2020 RMB 92.45 trillion, down by about 6.7% year-on-year.

The above two assumptions are made on a quarterly basis. Although the epidemic situation is still severe, there are signs of recovery with some business resuming operations again. The National Development and Reform Commission (NDRC) reported on February 19 that "Judging by Guangdong, Jiangsu, Shanghai and other industrial hubs (municipalities), at least 50% of production has recovered. From an industry perspective, the resumption and production of materials related to epidemic prevention and control, such as face masks, has been above 100%. On February 17, such producers were working at 110% capacity. SMEs still face many problems: hold-ups with workers returning, poor transportation and logistics, and reestablishing supply chains. Relevant parties are actively seeking ways to help companies resolve these problems."

What if we make a more detailed estimation of the situation of each month according to the working day? First, the working days in January, February, and March 2020 are 17 days, 21 days, and 22 days, respectively. Due to the characteristics of the industry, many sales occur on weekends, so the working days are counted as natural days. We assume that the operating rates of the three industries in January were 100%; the operating rates of the primary and secondary industries were both 40% in February and the tertiary industry was 20%; the primary and secondary industries rebounded again in March to 100%, the tertiary industry is 40%. The economy will no longer be affected by the epidemic in the next three quarters.

Optimistic assumptions such as these give us hope that for primary and secondary industries, operating rates in Q1 will reach 79%, and those of tertiary industry 54.1%. From this we calculate that Q1 GDP at constant prices may reach RMB 14.05 trillion, a 35.6% fall on the same period last year.

Such an outcome would be better than for Hypothesis 1 or 2, but still a grim prospect. If the 6% growth target of last year is to be achieved, GDP growth rate in the next three quarters must be as high as 17.7%. If the next three quarters still only grow by 6%, the annual GDP growth will be negative 3.2%, and China's GDP will have actually fallen marginally.

Optimize quarantine measures to get people back to work

Considering the above assumptions and estimates, we already know that the impact of Covid-19 on China's economy will be huge. Therefore, we need to improve existing policies. The most important are cost-effectiveness, and boosting economic growth.

First of all, regarding quarantine measures, we have the possibility of optimization. When it comes to isolation, everyone is now familiar with the epidemiologist's concept of R0, the virus reproduction number. This is the average number of individuals an infected patient will pass the disease to without external intervention, and in the absence of immunity. The larger the R0 number, the harder it is to control an epidemic.

The key to controlling the spread of an infectious disease is to lower the R0. One of the best ways to do this is targeted isolation. For example, after finding an infected person, it is imperative to immediately trace back those who have been in close contact with them for a certain period of time, and put them into immediate isolation. Large-scale blockades and restrictions to human movement are costly. If, in some places in Hubei, targeted isolation cannot be carried out on suspected patients, and all confirmed patients are isolated for treatment, patients who have not been isolated may still transmit the virus to their families and neighbors in densely populated communities.

On the basis of effective epidemic control, we must create conditions for enterprises to resume work. At present, in addition to rent, loans, and labor, companies cannot resume production, which has hit China's SMEs hard.

The key now is to give companies something to do and allow them to open their doors to business. Only then will they have the revenue to pay their rent and staff. As market participants, they need the space to breathe, so they can find their own way through the crisis, using their own survival instincts. Of course, this is premised on there being effective localized disease control. For Wuhan, the pace may be slower, whereas in Shanghai it can be a lot faster.

Here I would like to say that there are generally two problems for enterprises. One is general business injury, such as the loss of non-core personnel and temporary logistics blockages. These problems are relatively easy to fix, and something that causes only moderate concern. Another problem is major business injury. If shops are closed for too long and production cannot be carried out for a long time, they may suffer from a liquidity crisis and face bankruptcy. In such a situation, resolution is much harder.

Assisting in financing is a distinct possibility, especially for SMEs. They may be small, but such companies are the mainstay of China’s labor market. It is often the case in China that even if liquidity is released at a state level, it does not trickle down to the smallest companies. This last mile of financing is habitually blocked. So how can we change things this time? Perhaps we should get new institutions involved and use new methods to make loans to small and micro enterprises, even if non-performing loan rates rise slightly.

We now face multiple objectives, the top one being epidemic prevention. But maintaining effective economic operations can help stabilize the national sentiment as well as provide a solid foundation for epidemic control. It is the responsibility of any modern government to find a balance among competing objectives. We can defeat this outbreak, and we have the ability to resume effective economic operations as soon as possible.

This is a commentary on the CKGSB BCI report for February 2020. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

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