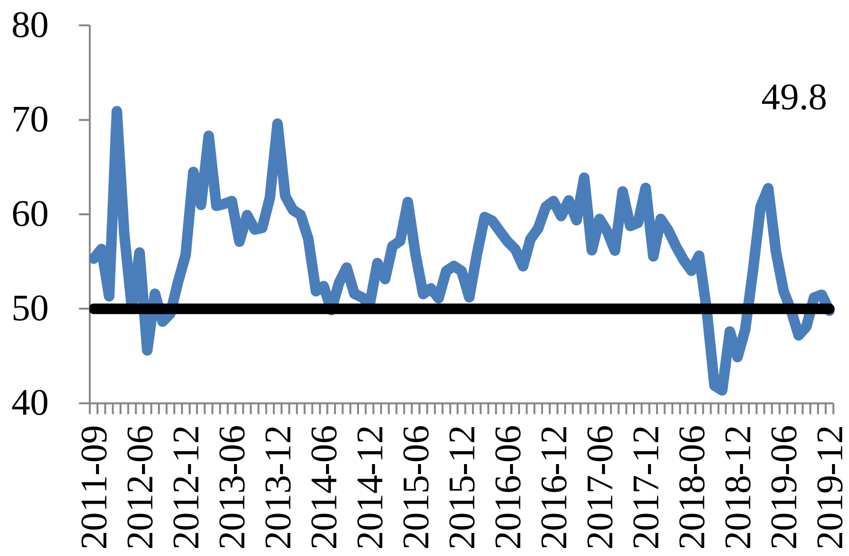
Commentary on the December 2019 CKGSB Business Conditions Index

Written by Professor Li Wei

In December 2019, the CKGSB Business Conditions Index fell slightly from 51.5 to 49.8, just below the confidence threshold of 50.0 (Figure 1). The other indices surveyed remained stable with no big surprises.

Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

As the last BCI of 2019, I will take this opportunity to recap themes of the past year. 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).

Some of this month's indices are especially noteworthy. Firstly, the sales and profit prospects indices, and the financing environment index, have all dropped. While sales are forecasted to fall to a certain extent, our surveyed companies expect profits to be in line for greater tightening, with the forecast falling by nearly 8 percentage points. The financing environment forecast, already low, is expected to fall, although less dramatically. It does appear that our sample, mostly Chinese private firms, is indeed facing tough times, and the word on the street, to this effect, is not without reason.

Second, closely related to economic growth is the issue of employment. This month, recruitment prospects have dimmed. Although it's above the lows we saw from earlier on in the year, recruitment and employment are indeed still low.

Finally, the index measuring consumer goods prices has remained stable, a very different result from the rising official Consumer Price Index (CPI). It should be noted that our sample contains mainly non-agricultural enterprises, and official data cover all sectors. Officially, food prices in November rose by nearly 20% year-on-year. African swine flu has been blamed as the main reason for food price and CPI hikes, and this does make sense. China is both the world's largest pig-producing country and largest pork-consuming country. In 2018, Chinese consumed 55.95 million tons out of the 113 million tons of pork produced worldwide. China consumed nearly half of the world's pork. African swine flu killed a large number of pigs, plummeting the supply and imports failed to make up the large gap. Purchasers of other meats felt the pinch too. As the cost of pork rose, other meats like beef, mutton and poultry also increased. For this reason, all food prices saw a massive price hike. But if you take food out of the November year-on-year CPI, it immediately dropped to 1% growth, a result equally as stable as our own consumer goods index. From this, we can see that while the CPI has surpassed government red lines, it may not be necessary to tighten monetary policy.

Eventful periods and economic stimuli

The above are the author's evaluations of this month's BCI and related data. Now I want to take a moment to discuss China's current economic pattern. This month can certainly be seen as eventful. For all of 2019, the economic situation has been made complicated by the US-China trade conflict. China may not be afraid of a trade war, but it would be complacent to suggest the conflict has had no impact. While trade war noises have been intermittent, people have suddenly discovered that GDP growth has continued to decline, financing costs have risen, willingness to invest has fallen, and unemployment appears to be on the up. People have started calling the decline of the economy, with or without other motives. And with this, pessimism is spreading. At a time when everyone is in pain, but not broken, Yu Yongding, a academician at the Chinese Academy of Social Sciences, published an article on December 1 declaring that the biggest economic problem China now faces is falling growth. He argues that to ensure that the economic growth rate does not fall further, a strong expansionary fiscal policy is needed, and it should be supplemented by a loose monetary policy. In terms of policy, China has considerable space to maneuver, and cannot allow economic growth to slow to under 6%.

Yu has studied macroeconomics for many years and has a reputation that stretches beyond economics. More important is how timely his article was, echoing the saying, "Better by chance than early." His position, together with the Central Economic Work Conference held this month, has become the focus of widespread discussion. For a while, "Where is China's economy headed" was a topic of concern. And primed by the debate, the author hopes to add a modest contribution.

Let us first discuss issues on which it is easy to reach consensus. We all know that China's growth rate is falling. Some believe this should be countered by macroeconomic policies to stimulate growth and set a bottom line. There are actually two problems in this. One is setting a bottom line. Yu thinks it should be 6%. In fact, 6% is unattainably high for most countries in the world. But China has become accustomed to high-speed growth and have not adapted to a falling growth rate. There remains considerable controversy over what number to set, and various rates have been put forward. Yu made it clear that 6% was not his main emphasis and that he hoped by draw people's attention to what was needed to stimulate economic growth in order to prevent it from declining. As to what the bottom line is, there is room for discussion. It seems that coming to an agreement on the rate of growth is a tough job.

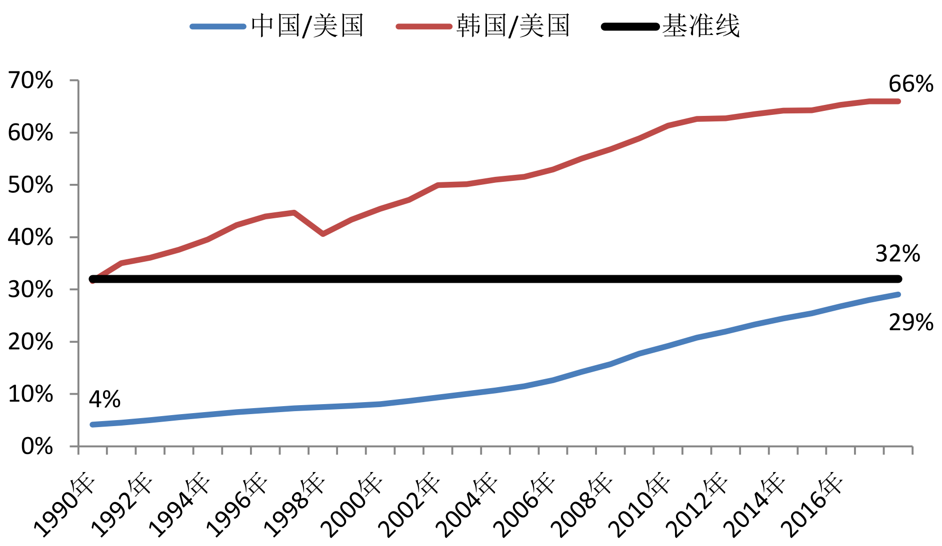
The second is the debate on methods. Yu's point of view mainly considers fiscal policy, supplemented by monetary policy. This is a big problem. Since the government's "four trillion" economic stimulus in 2008, fiscal policy has played a large role in macroeconomic regulation and control, but it still pales in comparison with monetary policy.

Fiscal and monetary policies each have their strengths and weaknesses. Monetary policy, especially credit policy, can have a short term measurable impact, without the need to be agreed by institutions such as the People's Congress, but it lacks precise effectiveness and act more as a floodgate. Fiscal policy has to pass stages of supervision, but is highly targeted and often referred to as drip irrigation. China also has some distinctive macro-control policies, including industrial policy under the jurisdiction of the National Development and Reform Commission.

Assessing China's future economic growth potential

If we want to talk about stopping the economic downturn, we should perhaps think about the question in reverse: Where does the driving force of economic growth come from? Let us take a look at the experience of other countries in comparison with China:

Figure 2 Comparison of economic growth



Blue: China/US
Red: South Korea/US
Black: Baseline

Source: World Bank data

Figure 2 shows China and South Korea's per capita GDP compared with that of the US over the same time period. The benefits of this comparison are: first that South Korea's per capita GDP is significantly higher than that of China. We can therefore use South Korea as a model of China's potential. Second, the unit here is the 2011 constant US dollar (purchasing power parity), largely eliminating the interference of any fluctuation in market exchange rates and inflation.

The comparison starts in 1990. At the time, South Korean GDP per capita was 32% of the US figure. We set this as the baseline. In 1990, China's GDP per capita was only 4% of the US figure, significantly lagging behind the US, and trailing South Korea by a long margin. The latest data node is 2018. South Korea's GDP per capita is the equivalent of about two-thirds of the US, firmly a developed country. China has also made considerable progress, and is now equivalent to 29% of the US figure, but is still clearly a developing country. Significantly, China in 2018 had not yet reached the baseline at which South Korea began the 1990s.

Figure 2 shows that although China had a low starting point, its economic policies have ushered in decades of economic growth, raising living standards by a countless factor for a generation of Chinese people. The "Chinese miracle" narrative is true and given China's size, only India has the chance to reproduce such a "miracle."

In 1990, the output of one American person was equivalent to that of 25 Chinese. By 2018, this indicator had fallen under 1 to 4. If the US maintains its growth rate of the past 28 years for the next 28 years, and if China continues to reform and open up and can repeat what South Korea did between 1990 and 2018, then in 28 years from now, China's per capita GDP will be roughly two-thirds the GDP per capita of the US. But to achieve this goal, China's per capita GDP growth needs to stay around 4.5% for the next 28 years.

Maybe 4.5% seems a bit low. After all, China's economy has been growing at 10%, but there are a few points that needs explaining. The first is GDP per capita. In the case of population growth, the GDP per capita growth rate is lower than GDP growth. Second, if China develops at this rate, unless something goes majorly wrong with the US, there is a high probability of China entering the group of developed nations. In the past, a huge gap between China and the United States meant that growth was easy to achieve. Companies from the developed world led the way, giving China a clear direction, and a lot to imitate in terms of advanced technology and business models. But as the gap narrows, China's industries are reaching world standards. Moving forward, China can't simply grow through imitation. Instead, independent research, investment in development and exploration must play a bigger role. It is inevitable that growth will slow, and we must curb our enthusiasm. China's neighbor, Japan is a case in point. In 1990, according to the constant US dollars (purchasing power parity) calculated in 2011, Japan's GDP per capita was equivalent to 83% of that of the US, but by 2018, this number had fallen to 71%. In economic history, examples of developing countries leapfrogging developed nations are not universal, but they are by no means uncommon. And it is not just Japan that has recently disturbed the upward momentum. Argentina has, with some force, returned to the ranks of developing countries.

The above analysis of growth in China, South Korea, Japan, and the US offers only an estimate of the potential China has for the next few decades. China has the potential for economic growth, but if the internal and external conditions are not right, then this potential is only on paper. A few key questions must be addressed first. Should we stimulate economic growth? How to stimulate it and what's the key to success? What means and methods are appropriate?

The key is TFP

The above questions are hard to answer. From recent media reports it seems everyone has an opinion to share. So we will do the same as for the first question and ask it the other way around: From 1978 to now, China's annual GDP growth rate (constant, non-purchasing power parity) has been close to 10%. Even with such an incredibly low starting point in 1978, forty years of consecutive high growth is a rare phenomenon.

How has this been achieved? In the 2017 winter issue of the Journal of Economic Perspectives, Professor Wei Shangjin from Columbia University published an article entitled, *From "Made in China" to "Innovated in China": Necessity, Prospect, and Challenges* with researchers from two other institutions, discusses sources of economic growth in China since reform and opening up.

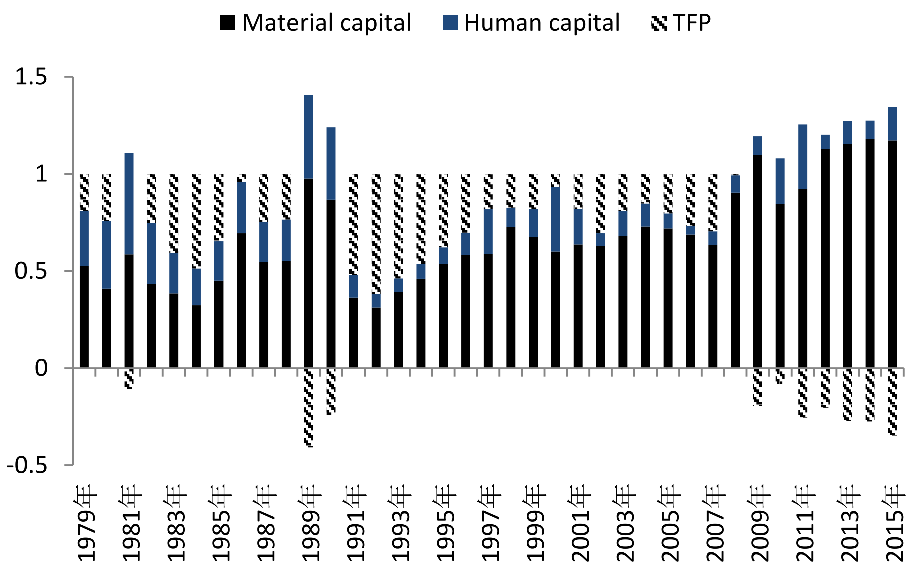
He divides the sources of economic growth into three parts: material capital, human capital, and total factor productivity (TFP). The first two are easy to understand, referring to certain manmade objects such as machines, and to people, their education and their skills. TFP rarely crops up in everyday life, but is an important way of measuring economic efficiency. Strictly speaking, TFP is a residual or residual value. Factors that are hard to explain but have an impact on GDP growth are all considered TFP. However, in general, economists see TFP as the increase in efficiency brought about by technological advances. This technological progress does not only cover technology in a broad sense, but also related visible and invisible factors such as institutional innovation.

For example, assuming a 6% year-on-year GDP growth rate in 2019, after calculation, material capital and human capital did indeed grow 6%. Calculating the weighted average + TFP year-on-year growth rate, TFP grew 0% in 2019. Furthermore, under the assumption that the year-on-year GDP growth rate is unchanged, if year-on-year growth of material capital and human capital is 5%, then the TFP year-on-year growth rate is equal to 1%. If the year-on-year growth rate of material capital and human capital is 7 %, then the year-on-year growth rate of TFP is equal to -1%.

The introduction of the concept of TFP and the advancement of related research is a milestone in the development of economics, because researchers have found that economies that have achieved long-term economic growth to become rich countries, such as the US, have had TFP as their main source of economic growth. Some countries that have relied on increasing physical and human capital investment to achieve economic growth may have achieved rapid high-speed development and even become superpowers, but have not been able to avoid sharp decline in economic growth, or even economic collapse, with the Soviet Union as a case in point.

These empirical research results and historical cases can be used to give profound inspiration to future generations. To achieve sustainable economic development in the long run, sustainable improvement of TFP is essential. In the paper co-authored by Wei Shangjin, the data tracks China's economic growth from 1979 to 2015:

Figure 3



Source: article co-authored by Wei Shangjin et al.

In Figure 3, the left-hand vertical axis represents percentages, with 0.5 meaning 50%, and -0.5% meaning -50%. In ten of the 37 years recorded, TFP was negative. In other words, in retreating, TFP dragged the GDP growth rate downward. Why this happened in 1981 is unclear. The situation in 1989 and 1990 must be related to political storms at that time. It is interesting that only with the "four trillion" economic stimulus plan can we explain the wave of TFP "breakdown" that began in 2009. As the data is only up to 2015, we do not known what has happened since.

The current debate about the Chinese economy can be described as complicated, but many people agree that the 2008 global financial crisis and subsequent massive economic stimulus plan have had a huge and far-reaching impact on the current economic climate. In 2009, credit swelled, high-efficiency companies narrowed their horizons and reduced borrowing. Local financing platforms boomed. Local governments gorged on investment and funding opportunities. The banks and the central government could have restricted such behavior, but the financial crisis and the "four trillion" economic stimulus plan completely changed this. In hedging against disaster, the three parties joined forces to push the pendulum aside. How much of the money lent to local governments and poured into infrastructure projects can be repaid? What we can say is that among long-term effects and positive externalities, if these projects are so great, then how come TFP is negative?

In the end, these local financing platforms can only be used for loans, borrowing new in exchange for old. When loans cannot be shifted, they can be moved off chart. Supervisors saw the danger of losing control of off-balance sheet issues, so they began financial rectification. In the end, they made SMEs bear the cost. Problem loans are moving around, and repayment dates are continuously pushed back. We hope to exchange time for space, but it results in more and more time spent and a growing number of problem loans. Scarce resources such as funds are sunk into inefficient areas, and the efficiency of the entire economy is diminishing. The decline in TFP is thus justified. Under certain conditions, it can be compensated by an increase in physical and human capital inputs, but the growth of these two inputs turns unsustainable as their marginal costs rise sharply. If we cannot reverse the current adverse trend and get TFP back on track, the chances are that China's economy will face a severe test in the near future. The main outcome is likely to be a sharp decline GDP growth.

What can be done about it?

Above, I discussed China's future economic growth potential and issues related to TFP. The next thing I want to address is based on the current situation. What can be done now?

Yu's position has pushed the issue of economic growth to the foreground. I partially agree with his point of view, and partially feel it can be further developed. What I agree with is that China is indeed facing the risk of economic downturn. It is necessary to take certain measures to control this risk, similar to measures taken by the Federal Reserve to rescue financial institutions during the crisis in 2008. The risk of moral hazard has grown, but sometimes for the sake of stability of the entire market this has to be the case.

Following on from the above analysis however, we must clearly understand where the current predicament is coming from. Obviously, radical macroeconomic policies and insufficient structural reforms have led the Chinese economy into the mire of long-term negative TFP. If we now imitate the "four trillion" economic stimulus plan again to underpin GDP growth, and continue to stall structural reforms, we risk compounding the situation. Therefore, I think a two-pronged approach should be taken: one using macroeconomic policies, preferably fiscal policies, to underpin the economy. This would increase the incomes of people with low incomes and this increased income can be easily converted into consumption rather than savings. More consumption will help boost the economy. For the people, GDP is not all that important. As long as real income is growing, whether the GDP growth rate is 6% or 5% is of little relevance.

It is high time to step up structural reforms that have been lacking in the past. No matter how the external economic situation evolves, structural reforms cannot end. In recent discussions, people talked of how the Chinese government carried out structural reforms while underpinning economic growth in the late 1990s. In my opinion, China was hit by the Asian financial crisis and a tepid climate for foreign trade. After Deng Xiaoping's Southern Tour in 1992, economic construction took off, but the economy soon overheated. After the tightening of macro-economic policies, economic enthusiasm fell rapidly, but huge non-performing loans were left to gradually surface. A large number of state-owned enterprises are inefficient and on the verge of bankruptcy. If these enterprises were to go bankrupt, unemployment would trigger immediate social problems, but the upkeep of these enterprises means the Chinese economy remains heavily burdened.

Given this situation, the Chinese government has implemented a series of policies to ensure growth, the most famous of which is the issue of special government bonds for infrastructure construction. At the same time, the Chinese government has withstood the pressure to bankrupt inefficient state-owned enterprises. It is sometimes the case that the reallocation of resources across time, regions, industries, and institutions can have a dramatically positive effect on TFP. For example, the Chinese government's bankruptcy of state-owned enterprises may make a large number of workers unemployed. This is hardly a good thing, but from the perspective of economic efficiency, these inefficient state-owned enterprises rely mainly on bank credit to survive. This credit is no different to the state-owned enterprises than government fiscal allocations. In other words, they may be unable to repay the loan or return the credit. Are they not wasting precious national credit resources? Once bankrupt, the banks no longer need to lend them money, leaving them freer to lend in accordance with commercial principles. From an overall perspective, higher efficiency companies will have a better chance of getting credit. The flow of funds from places with low output to places with high output will definitely help increase TFP.

As long as China can put TFP back on track, the problems we face will not last long. At the beginning of this century, the problems facing the Chinese economy were stacking up. This was not just a question of a single bank's non-performing loans. All the same, China continued to carry out structural reforms. With favorable internal and external factors, rapid growth restarted and lasted until 2008. In hindsight, rapid economic growth made many of the major problems appear smaller or even disappeared – For example, the problem of non-performing loans in the banking industry in the late 1990s. What if there was no structural reform and no new round of economic growth? It seems bad loans in the banking industry are still overwhelming the economy! This is why Yu reminded everyone that while it is right to attach importance to economic growth, more importantly, we must find out the causes of growth decline and target policies to deal with it. Otherwise, we may actually face a situation in which the economic growth rate is dependent on fiscal leverage which is not sustainable.

How to deal with interest groups?

China has had a fateful modern history, but reform and opening up was undoubtedly a good move. Unfortunately many in China have not fully realized it. We often say that China has a large population and weak foundations. This is often understood in a negative sense: the country's poor foundations make it hard to develop the economy. But it can also be understood in a positive light: China is a big market, with limitless avenues for future development. While this is almost exactly the opposite, it shares a single essence.

The PRC was established in 1949, and with it domestic conflict soon subsided. China had the conditions to build a peaceful environment for economic development. However, various domestic and foreign reasons, and the Chinese government's perspective and judgment, meant a defense economy + state-owned enterprises + closed-door nation model was chosen. This plan had its advantages. It meant military mobilization would be straightforward. By the end of the Cultural Revolution, we found out that the world had moved on from "war and revolution" to an era of "peace and development". The so-called evil capitalist countries – United States, Japan, Germany and Britain – were among those with the highest living standards. The quality of living of the Chinese people, by comparison, was shocking

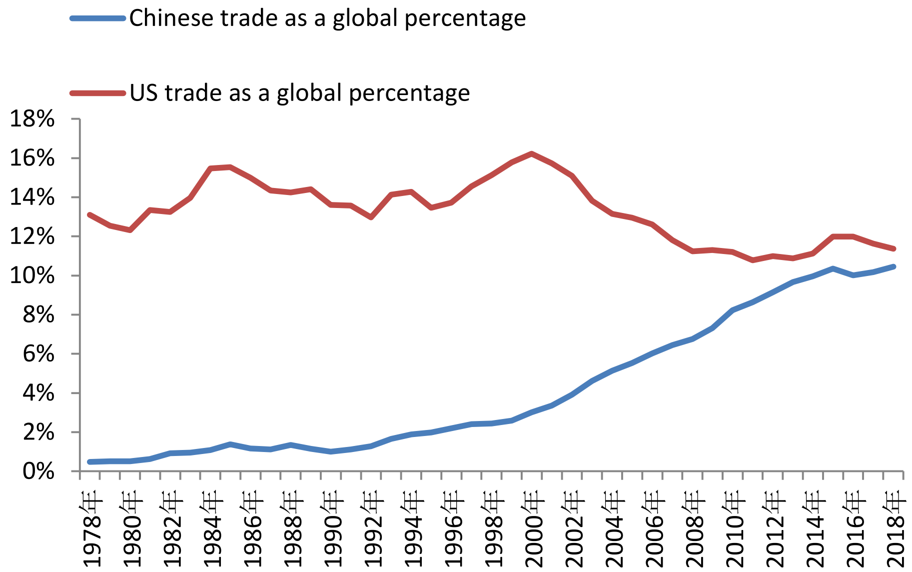
The Chinese government began to carry out economic reforms based on their own national conditions. Where policies restricted the development of productive forces, they changed direction. Here are three examples: Compared with the contracted production, collective management could not stimulate farmers' enthusiasm for production. Therefore, after practice and controversy, contracted production came to replace collective management and continues to this day.

Compared with collective management, the main change with contracted production was the operating mechanism. Material and human capital inputs did not increase, but countless studies and statistics have shown it was this change that brought China a consistently better harvest. This is textbook case of how to obtain economic growth by improving TFP.

Another example is urbanization. According to the World Bank, urbanization rates for China, the US, and the world overall were 18%, 74%, and 39% respectively in 1978. By 2018, these changed to 59%, 82% and 55% with China beating the world average. In most parts of the earth, especially in developing countries, the output of a person in the city tends to be significantly higher than that in the countryside. Therefore, as urbanization grows, agricultural workers transfer their labor from places with low output to places with high output. In this process, even if neither material nor human capital is increased, labor output will be boosted significantly, a pool of TFP.

Before joining the WTO, there was a view that joining the WTO may have a greater impact on the Chinese economy, because industries in China with low productivity would be unlikely to cope with international competition. This is not completely unreasonable, but opening up the country, accepting foreign investment, and actively joining international divisions of labor have proven to be the best way to improve economic efficiency.

Figure 4

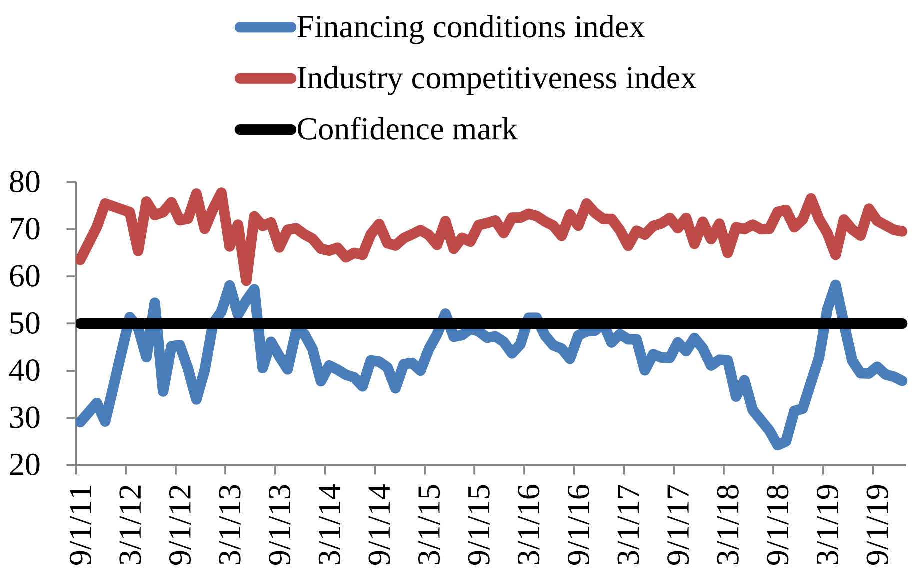


Source: World Bank data

Figure 4 shows that China joining the WTO and actively integrating into the world economy has strengthened its economy and companies' efficiency as a whole. Related economic growth is still largely due to improvements in TFP.

It can be said that most of China's economic growth since 1978 is a history of improving resource allocation and increasing TFP growth. In the past few years, due to various reasons, China's structural reforms have been light. Our BCI data fully reflects this:

Figure 5



Source: CKGSB Case Center and Center for Economic Research

The problem in Figure 5 has been said many times in our data reports and reviews, but recently has worsened rather than improved. Enterprise competitiveness reflects the relative efficiency of surveyed firms compared to others in the same industry – The higher the value, the stronger the company's competitiveness in the industry and the higher its efficiency. It is said that such high-efficiency companies should be favored by financial institutions, but the corporate financing environment index shows another picture. These companies have scored financing negatively for a long time, which means that they are "vulnerable" in the financial market. Efficient companies have no way to get funds, so where have the funds gone? Without funding, TFP stays low.

Specifically, structural reforms, or policies that increase TFP, will ultimately benefit the country and the people, but in the short term these policies will generate winners and losers. In the foreseeable future, this will likely be the biggest challenge for China’s economy. Discussions in this area have not yet begun. Perhaps the first step is to discuss structural reforms in an open and honest manner.

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

CKGSB Professor Li Wei

December 24, 2019