Commentary on the March 2021 CKGSB Business Conditions Index

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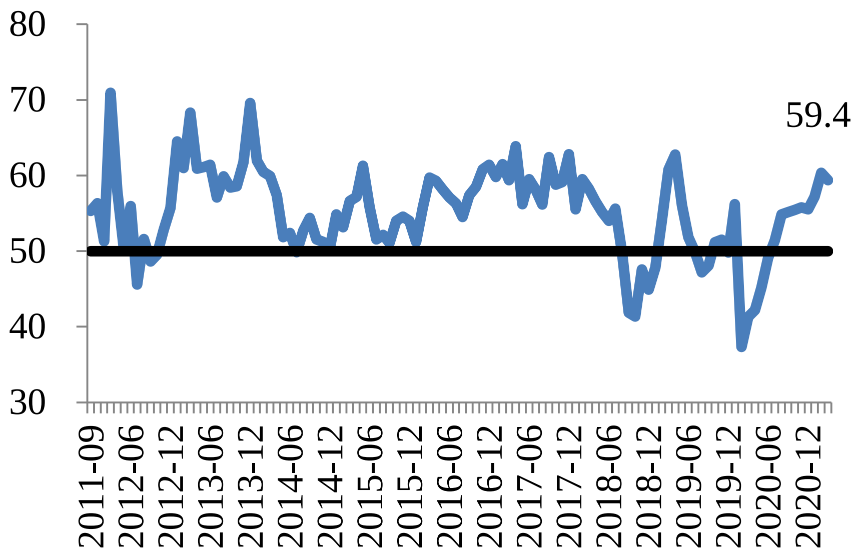
In March, the CKGSB Business Conditions Index (BCI) reported a slight fall from 60.3 in February to 59.4 (Figure 1).

Figure 1 **Business Conditions Index (BCI)**



Source: CKGSB Case Center and Center for Economic Research

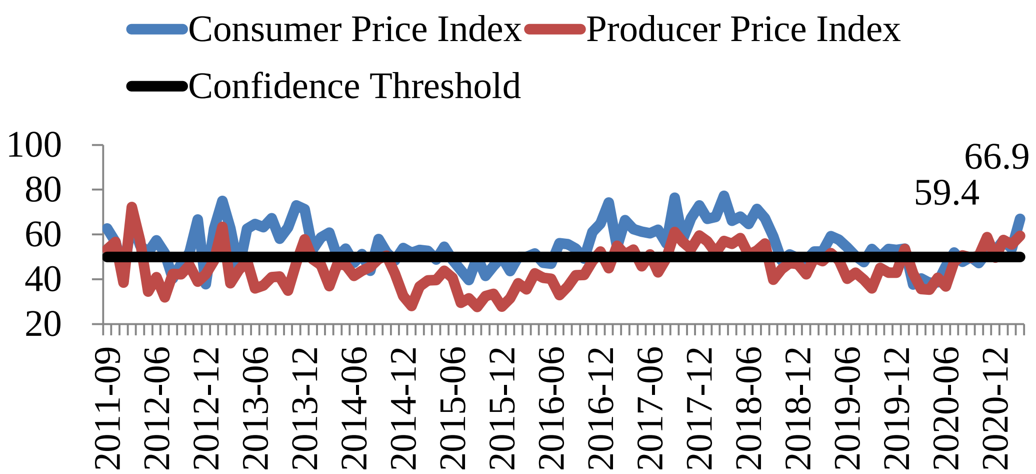
Our index data remains at the confident end of the scale, which is in sharp contrast to data from other sources.

The National Bureau of Statistics, for example, puts February's PMI at 50.6, falling for a third consecutive month. Moreover, this leaves the official PMI just 0.6 points from the contraction or expansion threshold of 50, leaving it vulnerable to any slight disturbance which would take it below the line.

So why does our BCI data look so different? I believe that the main reason is the sample. Most of the companies we survey are outstanding private companies, and their level of efficiency puts them at the top of their respective industries. It's not surprising that the CKGSB BCI performs well. On the other hand, the National Bureau of Statistics' PMI primarily surveys conditions at state-owned enterprises (SOEs). Despite their policy advantages, China's SOEs are inefficient and trapped by institutional perplexities, leading to a poorly performing PMI.

Another reason for the difference is changes taking place in China's financial sector. As we all know, China's financial institutions, mainly banks, act very much like pawnshops, focusing on collateral rather than corporate credit. Therefore, private enterprises that lack collateral generally suffer the most. However, from information obtained recently, it appears that banks are set on changing the situation, and will now be more willing to lend to private businesses, especially those with an outstanding record. Our sample of private companies is about to be on the receiving end of more funds, which will allow them to climb to new heights. A very good thing, this will improve a financing environment that has been difficult for private business for a long time. Policymakers have made a start in solving this problem. I believe this will be immensely helpful in shifting to a national high-quality growth model.

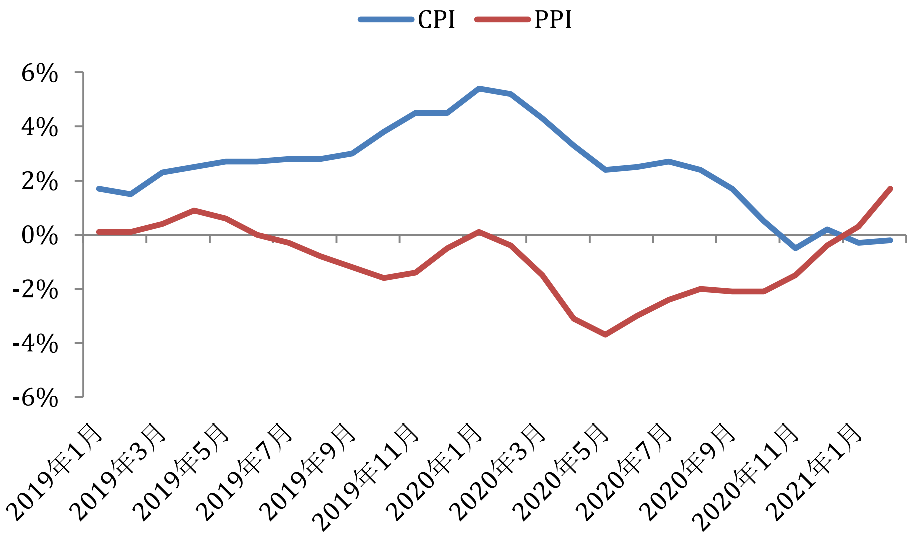
Figure 2 **Rising Price Indices (BCI)**



Source: CKGSB Case Center and Center for Economic Research

This month, consumer price prospects rose as high as 66.9, registering a 13.2 percentage leap from last month. Consumer price expectations rose to 59.4, which is 3.8 percent higher than in February's BCI. Our data is very different from the official statistics.

Figure 3 **CPI and PPI - Changes over Time (%)**



Data until February 2021
Source: CEIC

Official data (Figure 3) shows that February's CPI was -0.2%, and the PPI was only marginally higher, at 1.7%. From the official data, there can be no doubt that China is still a long way from experiencing inflation. But our index is forward-looking, with data that considers the upcoming six months. It shows that China is highly likely to experience strong inflation.

In fact, China is not the only place expecting inflation. According to official forecasts, the U.S. is also expecting inflation in the coming months. When interest rates were raised during March's Federal Reserve meeting, the U.S. economy's year-on-year growth had reached 6.5%. For a developed country like the U.S., even if the base effect of last year is taken into account, this level of growth is highly significant. The unemployment forecasts for 2021, 2022 and 2023 are 4.5%, 3.9% and 3.5% respectively, gradually falling over time. Inflation forecasts for 2021, 2022 and 2023 are 2.4%, 2.0% and 2.1% respectively. According to the Fed's standards, the U.S. inflation target is generally set at 2%. When it exceeds 2%, it is necessary to consider sustainability. At that point, it is only a matter of time before loose monetary policy is withdrawn. My prediction is that by this fall, U.S. interest rates will rise. Next year, an interest rate hike is highly probable. In fact, when the Fed released the latest economic forecast data, the market reacted immediately. The yield on the long-term 10-year Treasury bond rose significantly, which increased the attractiveness of U.S. assets and may cause some funds to flow out of China and return to the U.S. The United States can in turn put pressure on Chinese asset prices.

Once the Fed starts raising interest rates, funds that return to the U.S. from China may give China three main options. One is to also raise interest rates and maintain a Sino-US interest rate differential. However, many Chinese companies rely on low interest rates to survive. Once rates are increased, these companies may suffer a negative impact. Second, devaluing the renminbi will not only prevent capital outflows, but also encourage exports. This is a relatively good approach, but it also has problems. Companies have taken advantage of the cheap dollar and have a lot of dollar debt. This has caused a currency mismatch on the balance sheet. Once the currency depreciates, their debt will increase significantly, which may then trigger a chain reaction. Caution should be applied. The third option is capital control. For a long time, China has welcomed two-way capital flow, and now has rich experience in this area. It may not be hard, but capital control can easily cause market distortions and reduce efficiency, and over time, it will begin to lose impact. This is a no-brainer. To sum up, once the Fed raises interest rates, China may encounter a series of difficulties to which there is no perfect answer, only pitfalls.

This is a commentary on the CKGSB BCI report for March 2021 to which you are welcome to refer for detailed statistics. Do not hesitate to contact the BCI team by email for the accompanying BCI data report.

CKGSB Professor Li Wei

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