Commentary on the September 2019 CKGSB Business Conditions Index

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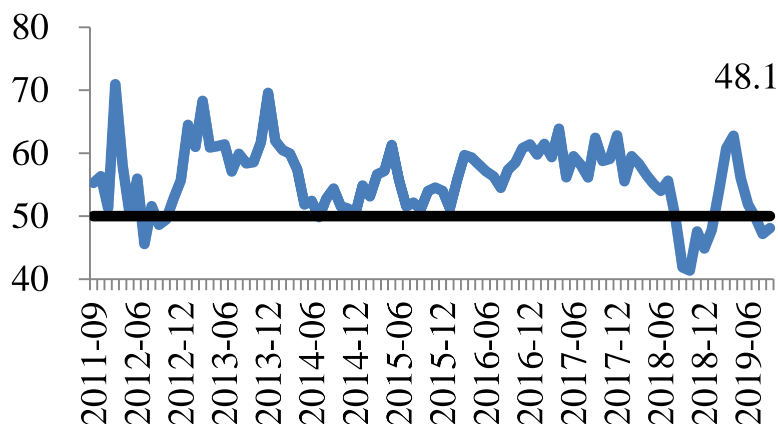
The CKGSB Business Conditions Index rebounded slightly to 48.1 from 47.2 in September. Currently, the BCI remains below the confidence threshold of 50.0 (Figure 1).

Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

This month's BCI shows fairly differentiated results across the board. Costs forecasts dropped, but consumer product prices also dropped. A major feature of this month's BCI is actually that with only small increases and limited decreases, it appears to show relative macroeconomic stability.

We must not forget that this seeming stability has weak foundations. Chinese macroeconomics continue to be in weak situation. Hidden concerns over economic growth have led the central bank to lower the statutory deposit reserve ratio by 0.5 percentage points. Some may ask why not cut interest rates instead? There are two likely reasons. First, there is a fairly wide space for manoever in terms of RRR reduction. Even after the latest move, large deposit-taking financial institutions still have to keep 13% in reserve. Even the PBOC holds large excess deposit reserves. According to Wind, as of June 2019, this excess equates to as much as 2% of total deposit value. The central bank may have opened the money taps, but financial institutions have not been filling the market. Instead of putting money into the market, they have been returning it to the central back as excess reserves, and all these efforts have been in vain. Given what is happening, if the economy continues to weaken, it is unavoidable that the central bank will continue to lower RRR.

Conversely, there is not much room for interest rate cuts in China. The benchmark interest rate for on-demand deposits is now 0.35%, practically zero. The benchmark interest rate for one-year deposits (full amount) is 1.5%, significantly lower than the yield on Yu'ebao and other trendy funds. The risk is about the same, and Yu'ebao investments come with far higher liquidity. More rate cuts means more deposits will seep out of the banks, with a knock-on effect on the operations of financial institutions.

Is it possible to only reduce interest rates on loans then? At present, the benchmark interest rate for RMB loans from 6 months to 1 year (inclusive) is 4.35%, which seems to give space for a cut. But for the reasons mentioned above, with no room for lowering deposit interest rate, lowering the loan interest rate means reducing spread. For Chinese banks, the spread is where they earn their profit, and a

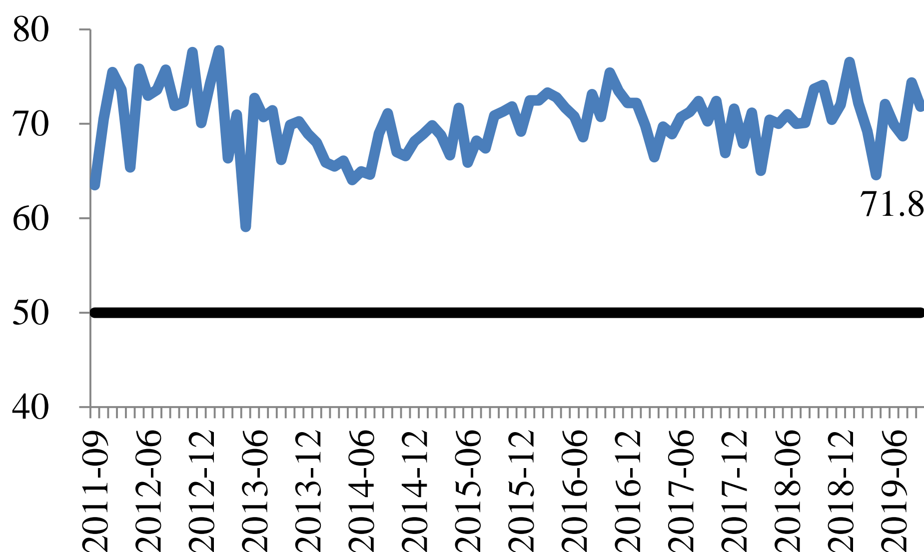
reduction in spread is like asking banks to contribute to national macroeconomic regulation. How can the banks agree to that? Even if the banks were willing, profits would fall and they would likely lose money, so how could they face shareholders? Although China's banks are mainly state-owned, the big ones are now almost all listed, including overseas, so reducing spreads, a move that would clearly damage shareholder interests, is unlikely to be attempted by private investors in China's domestic A-share market or overseas investors in Chinese banks. So at the moment, although there is some space to cut interest rates, it is highly constrained.

In fact, if we combine our data with that of the government, we will find a major structural issue in the Chinese economy, that is, resource misallocation caused by financial inefficiencies.

The government has repeatedly lowered the RRR threshold, hoping to inject more money into the economy and reduce the cost of capital, so that the most efficient private enterprises receive cheaper funds. However, after the RRR cut, many funds returned to the central bank as excess deposit reserve.

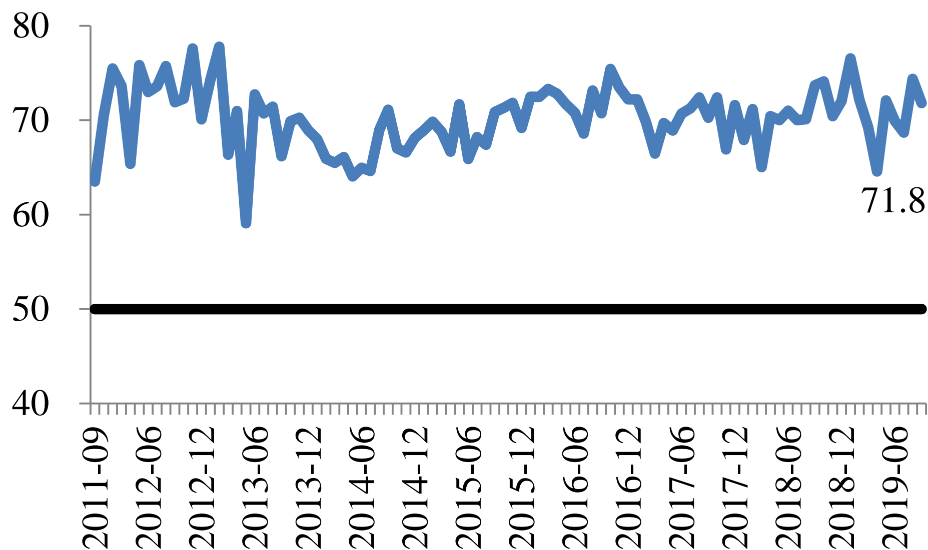
The BCI sample is made up of China's leading private firms (Figure 2). Their financing troubles have long been a source of woe (Figure 3).

Figure 2 Industry competitiveness index



Source: CKGSB Case Center and Center for Economic Research

Figure 3 Corporate financing index



Source: CKGSB Case Center and Center for Economic Research

Finance is the brain of the economic system, responsible for the allocation of resources. Its raison d'etre is to supply the most efficient parts of the economy at the expense of those parts that underperform. At macroeconomic level, an inefficient brain means resources lie idle while excess deposit reserves mount. It also means excellent companies are increasingly starved of capital. This is a classic structural problem. The central bank's opening of the taps may alleviate the problem to some extent, but an overhaul of the system must be taken. Without such reform, it will not be long before economic growth in this country will experience an irreversible decline, conditions will become severe, and the trickiness of implementing reform will only grow.

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

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