

Production Continued to Increase in 2021 Q1 while Rising Costs Squeezed Corporate Profits

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Introduction

CKGSB's Center on Finance and Economic Growth surveys more than 2,000 Chinese companies from within the industrial sector every quarter to provide the most comprehensive set of independent data currently available. Led by CKGSB Professor of Finance Gan Jie, this large-scale, micro-level quarterly company survey on China's industrial economy, now in its seventh year, sheds light on how the sector is coping and what types of reforms are needed.

Described as the first of its kind, Professor Gan's survey – called the Business Sentiment Index – is based on stratified random sampling by industry, region and size from the National Bureau of Statistics' (NBS) population of industrial firms that have sales of over twenty million RMB. The survey has around 2,000 responding firms each time.

The 2021 Q1 survey sample covers 41 industries and 31 provinces and municipalities directly under the central government. According to NBS classification, the majority of the firms (96%) are small and medium companies (with the number of employees below 1000 and sales below 400 million RMB), and 17% are micro and small businesses (with the number of employees below 300 and sales below 20 million RMB).

2021 Q1 Findings

The overall industry sentiment in Q1 remained flat, with the Business Sentiment Index staying at 50 (previous quarter: 50). The diffusion indices^{1, 2} reflecting the real output, including production (55), electricity consumption (54) and domestic orders (55) are all expanding (Table 1) at a noticeable rate. 7.5% of the surveyed enterprises saw an increase production of above 10%. The diffusion index for production in foreign capital (59) and manufacturers of durable consumer goods (60) is more prominent.

However, domestic and foreign markets are still weak in demand. In Q1, products in 88% (previous quarter: 87%) of surveyed enterprises were oversupplied in the domestic market. Correspondingly the overcapacity diffusion index reflecting insufficient domestic demand rose by one point to 94, hitting a record high. At the same time, foreign orders expanded slightly (53) for the first time after shrinking for eight consecutive quarters, but the diffusion index reflecting insufficient foreign demand is still at a record high of 91 (Figure 2). Therefore, surveyed companies are still cautious about the future, with only 1% of them making expansionary investment.

¹ Specifically, the three questions underlying our Business Sentiment Index are the following: 1. How are current operating conditions – “good”, “neutral” or “difficult”? 2. What is the expected change in operating conditions during the next quarter – “up”, “same” or “down”? 3. To what extent is it now a good time to invest – “good”, “medium” or “bad?” The diffusion index is based on answers to multiple choice questions, with the choices in analog to “good,” “neutral” and “bad”, or “up,” “same” and “down.” The diffusion index is computed as $100 * \% \text{ of firms answering "good"} + 50 * \% \text{ of firms answering "neutral"}$. The diffusion index ranges between 0 and 100. A larger value indicates better operating conditions, with 50 marking the turning point between expansion and contraction.

² Our Business Sentiment Index (BSI) is the simple average of three diffusion indices, including current operating conditions, expected change in operating conditions and investment timing. Compared with other economic indices, our BSI is more forward-looking and is a reflection of the absolute level of economic activities.

The cost of raw material have risen across the board, with a diffusion index of 85, an increase of 16 points from the previous quarter, which is the highest in history. This led to a significant increase in unit costs, with a diffusion index of 84 (previous quarter: 68). Cost increases are also prominent, with more than half (53%, previous quarter: 26%) of companies' quarterly cost increasing by more than 3% (Figure 3). Against the context of overcapacity, companies lack pricing power, and the price index rose moderately to 58 (previous quarter: 54). Rising costs mean that profits are squeezed, and the proportion of companies with a gross profit margin of more than 15% fell by 5 points to 30%.

In conclusion, the industrial economy is on an upward path. However, low demands in the domestic and international markets and rising cost of raw materials hinder the full recovery of the sector. In addition, inflation risks need to be monitored closely.

Table 1. Operating Conditions of Industrial Firms**Table 1.1**

		Number of Firms		Business Sentiment Index		Diffusion Index – Operating Conditions		Diffusion Index – Expected Change in Operating Conditions		Diffusion Index – Good Timing for Investment	
		2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4
	China	2,027	2,051	50	50	55	55	50	49	46	45
By Size											
	Large	676	684	51	51	56	57	50	49	47	47
	Medium	675	683	51	50	56	56	51	49	46	45
	Small	676	684	49	48	52	52	50	48	44	44
By Ownership											
	State-owned	105	103	62	60	83	84	56	49	47	47
	Collectively-owned	7	7	50	50	50	50	50	50	50	50
	Private	1,767	1,791	49	49	53	53	50	49	46	45
	Foreign-owned	148	150	52	52	59	59	50	49	47	46
By Product Type											
	Consumer Goods – Durable	219	241	49	48	53	52	50	49	43	43
	Consumer Goods – Nondurable	661	649	52	52	60	60	51	49	46	45
	Capital Goods	111	118	52	51	57	55	50	50	49	48
	Intermediate Goods	1,036	1,043	49	49	52	52	49	48	46	46

Table 1.2

		% of Firms with Fixed Investment		% of Firms with Expansionary Investment		Diffusion Index - Production		Diffusion Index - Employment		Diffusion Index - Electricity Consumption	
		2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4	2021Q1	2020Q4
	China	6	5	1	1	55	54	50	49	54	50
By Size											
	Large	6	6	2							
	Medium	6	5	1	1	56	55	50	50	54	51
	Small	6	4	1	1	55	54	49	49	54	50
By Ownership					0	54	53	50	50	53	50
	State-owned	2	3	1	1	52	52	50	50	52	49
	Collectively-owned	0	0	0	0	57	36	50	50	57	36

Private	7	5	2	1	55	54	50	49	53	51
Foreign-owned	4	3	1	1	59	55	50	49	58	50
By Product Type										
Consumer Goods – Durable	4	2	2	1	60	57	49	49	58	51
Consumer Goods – Nondurable	8	7	2	1	54	51	49	49	53	49
Capital Goods	8	5	1	1	52	40	50	50	47	47
Intermediate Goods	5	4	1	1	55	57	50	50	54	51

Notes:

1. Diffusion Index (DI) is computed using the percentage of firms that answer "increase" (% increase) and "same" (% same) according to the formula: $(\% \text{ increase} + 0.5 * \% \text{ same})$. The index ranges between 0 and 100. A larger value indicates a better operating condition.
2. Business Sentiment Index is the average of DIs for Operating Conditions, Expected Operating Conditions and Good Timing for Investment.

Figure 1. Business Sentiment Index

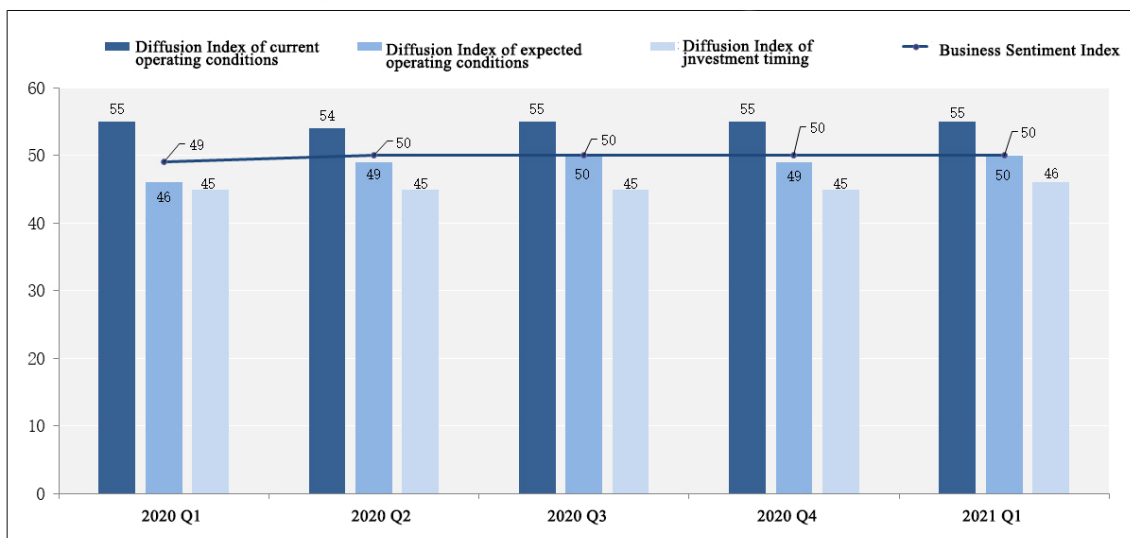


Figure 2. Excess Capacity

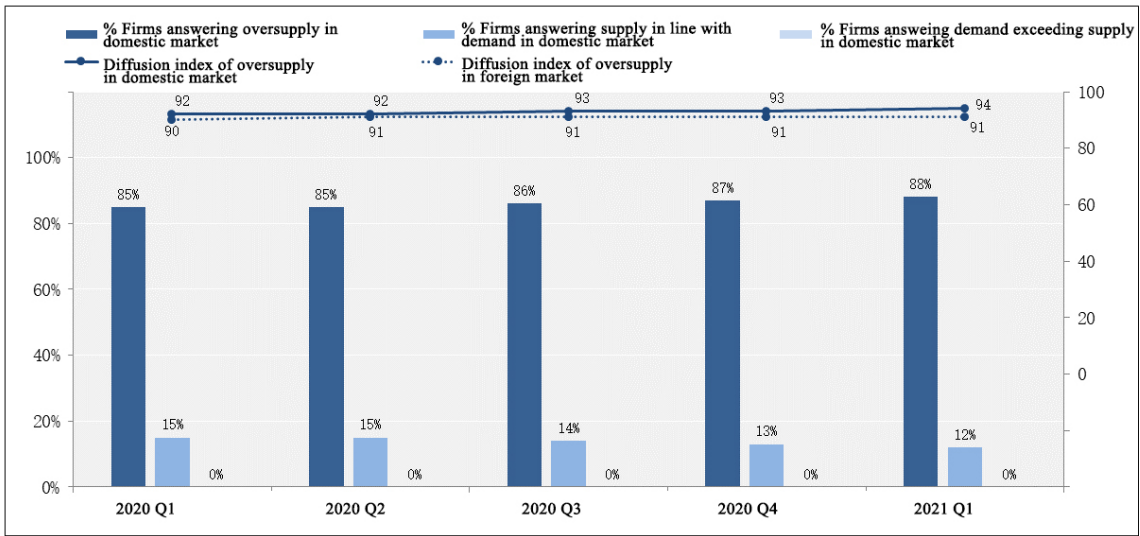


Figure 3 Costs

