Commentary on the November 2022 CKGSB Business Conditions Index

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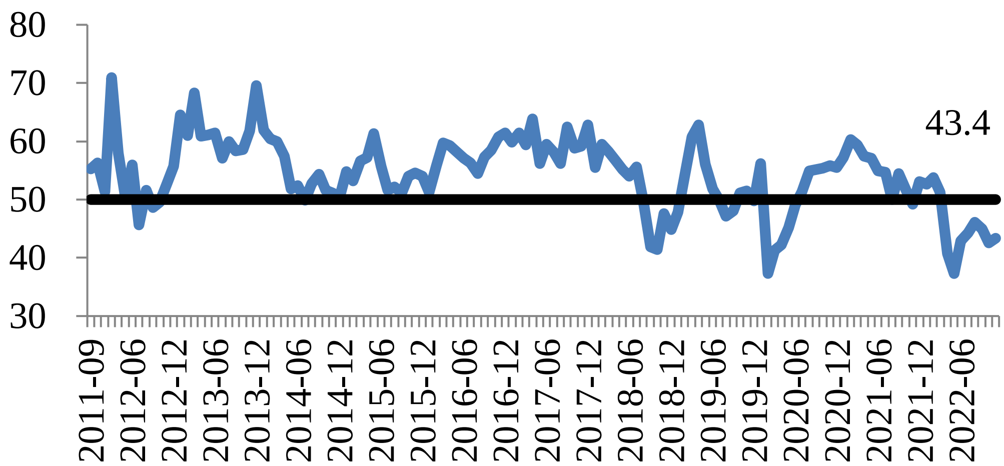
China's economy is in a very fragile state this month.

In November, the "CKGSB Business Conditions Index" (BCI) notched up to 43.4, slightly above last month's score of 42.5. Below the confidence threshold of 50.0, this is still extremely weak, indicating that miserable statistics will continue to toll the bell for a weakened Chinese economy for some time to come.

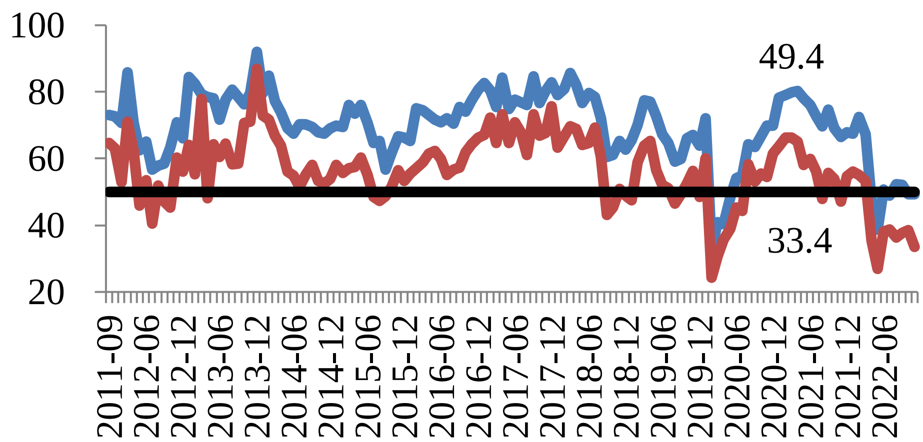
Figure 1 **Business Conditions Index (BCI)**



Source: CKGSB Case Center and Center for Economic Research

Our data shows that the macroeconomic picture of China is far from healthy, with sales and profits expected to stay at a low ebb (Figure 2).

Figure 2 **BCI Sales and Profits Forecasts**



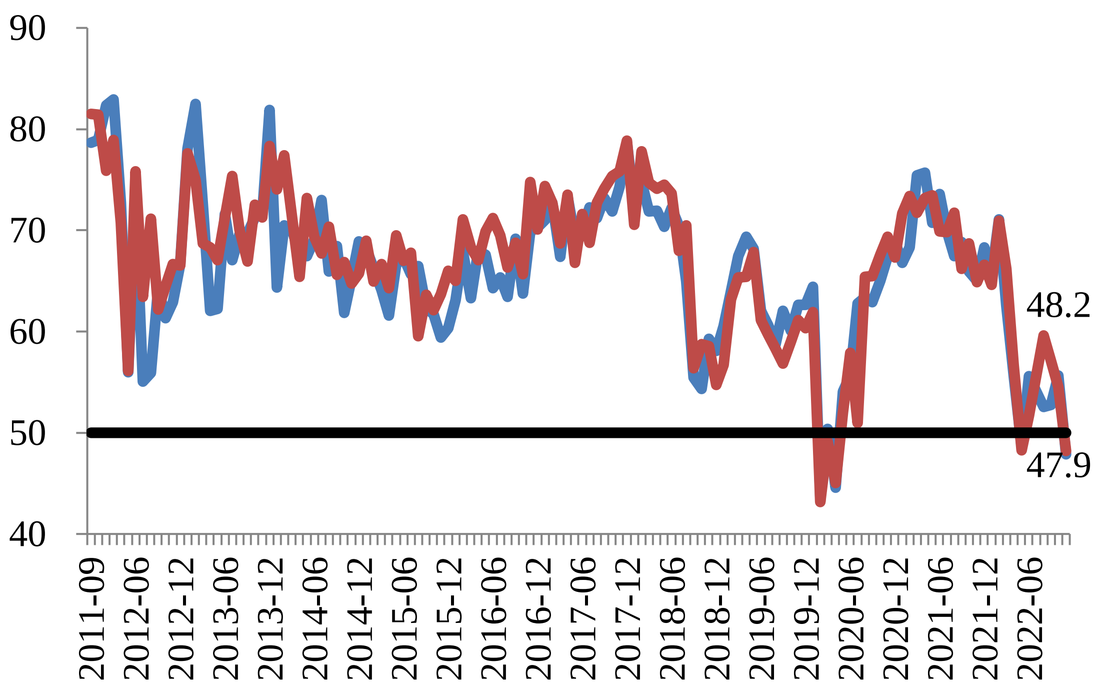
Source: CKGSB Case Center and Center for Economic Research

CKGSB's confidence index includes four sub-indices: sales, profits, corporate financing, and inventory, each offering a view on the upcoming six-month period in business. Of these, only financing measures current conditions, while the others ask entrepreneurs for their expectations on how aspects of their business are expected to play out in the 6 months to come.

Sales is a key business indicator. A company with a large sales volume isn't necessarily a good company, but one with a small sales volume has hardly any chance of becoming an eye-catching enterprise. "Fortune 500" picks its featured companies by their sales volume. Profit however is the net income of an enterprise, and whether the enterprise makes money or not determines the outcome of that enterprise. From Figure 2, we see that current sales and prospective profits are, for the majority of our sample, plummeting to their lowest level since the BCI began, which is clearly a bad sign.

Besides sales, investment and employment indices are the two indicators of the Chinese economy with most acuity. Figure 3 is a chart of what they show this month:

Figure 3 Investment and Employment Prospects



Red: investment; Blue: employment

As can be seen from Figure 3, both investment and recruitment prospects have fallen below 50, which has rarely happened in all 12 years we've been conducting this survey. China's economy is largely driven by investment. With this at a low ebb, a decline in the growth rate is inevitable, and this will lead to worse employment figures. In fact, this has long been known. Companies have been putting a freeze on hiring, people are losing their jobs or having their salaries cut. Others have had new housing projects halted: all manifestations of economic downturn. In the first three quarters of 2022, the actual growth rate was just 3%, making the original government target of 5.5% well beyond reach.

Regarding next year, there are some who are relatively optimistic. From this year's low base, 5% growth looks possible. Others are less optimistic. The real estate slump may not be so temporary. It will take a while to fix, and with exports down too, China's regular engines of growth are missing in action. On top of this, if Covid is not handled optimally, it will be very hard for China to reach 5% year-on-year GDP growth in 2023.

China's short-term economic growth is sluggish, and structural problems are surfacing. This is a phenomenon that everyone has on their front of mind, but what exactly are the structural problems we're talking about? Everyone can probably point to lagging consumption, an extremely high savings rate, an overly strong investment rate, and the fast growth of debt. These issues are very important, but the following three are most critical. The future of China's economy depends on how they are tackled.

First, housing and land prices. Housing is an old problem, but there's a new side to it now: falling prices. As apartment prices fall, so do land prices. Real estate developers have no money in their pockets, and are having trouble handing over properties to buyers. For example, how can Evergrande find the money to pay for land? With fewer institutions bidding for land, local governments are either letting land prices fall, or find another body to cover their bottom line.

Falling land prices will affect the economy in two ways. First, once they've dropped, local governments will get less from land transfer fees. According to government data, in the first three quarters of 2022, revenue from the sale of state-owned land use rights across the country was RMB 3,850.7 billion, down 28.3%. As revenue from land sales plummets, local government revenue has been stretched very thin. Local state-owned enterprises are being pushed forward to buy land to help put a bottom on the price slump. Despite this being noticed in Beijing, and the Ministry of Finance has issued a document specifically prohibiting such practices, it is still going on. The bank loans most in demand are mortgage loans, and most collateral is land. If land prices fall, the value of this collateral will fall with it. If it is done according to market rules, debtors will either add new collateral, or banks will find themselves with more non-performing loans. More than 20 years ago, China's commercial banks were deeply involved in non-performing loans. According to international standards, the non-performing loan ratio of China's four major banks was as high as 50% of total loans. In other countries, these banks would have gone bankrupt ten times over. Now we have come to the same old crossroads. The drop-off in land prices may bring more non-performing loans to banks, which may cause banks to shrink their accounts, pushing the entire economy yet further into the mire.

Based on this situation, while the government is sticking to “housing is for living in, not for betting on”, it has also adopted real estate development stimulus policies to keep housing and land prices from falling sharply. The government’s ambivalence towards property means policy tends to swing violently, leading to heavy fluctuation in the market. The unpredictable real estate market stops developers from having stable expectations. This is an industry that has little focus on improving efficiency while it spends all this energy on policy tricks. You might say this is a lose-lose game for developers and for the government.

To best manage the real estate market, short-term policy adjustments are good, but long-term systemic development is better. Only a system that operates in accordance with the laws of the market can truly assist the real estate industry to become a stable part of the economy; one that levies property taxes that ultimately benefit China’s people.

Second, low levels of consumption among citizens. We all know that the proportion of Chinese residents’ consumption to GDP is very low. Economic development has made it possible for people to consume more and live a better life. People work hard to make money, so why don’t they spend, instead of saving it for a rainy day? There are many reasons for this, but real estate is an important reason often overlooked.

The logic is this – China's state-owned land is mainly divided into three types according to use: industrial, commercial and residential. In order to develop the local economy, local governments often give out very low-cost, or even free, land to bring in investment and get factories or commercial properties built in the area. Local governments, unable to generate enough revenue from industrial and commercial land, begin to think of acquiring residential land. According to China's policy, commercial housing can only be built on state-owned land, and rural collective land needs to go through land acquisition procedures before it can be converted into residential land. As a result, local governments monopolize the supply of city land. The problem with monopolies has long been studied in economics. If one party has a monopoly on the supply side, it will inevitably reduce supply to maximize its benefits, and this is exactly what we see in real estate.

Industrial and commercial land prices are low while residential land prices remain high. This is an act of price discrimination, and its essence is to let the money earned from residential land subsidize industrial and commercial developments. The price of residential land is directly related to land pockets owned by local governments, so the higher the housing prices, the happier local level officials. In order to buy houses at ever-growing prices, residents can only save and save. With this situation, how on earth can spending increase?

In essence, the current real estate structure is there to collect a tax on residents. This kind of tax is not easy to detect, so it has received relatively little opposition, but the economic and social problems it has brought with it are substantial.

In fact, China's land policy came from Hong Kong, with the island's land being owned by the government from the beginning. Hong Kong's land system is rare among developed economies, so why does Hong Kong have such a land system? This goes back to the American War of Independence. The direct cause of this war was the British government imposing heavy taxes on its colonies, eventually triggering strong resistance. After a struggle, the North American colonies gained independence, and Britain lost a very important overseas colony. Move over to Asia, and following the Opium War between China and the U.K., the latter acquired Hong Kong as a trading port. In order to avoid repeating its mistakes, the British government declared Hong Kong a free port immediately, and gave up the notion of tariffs altogether. Instead, the British declared that the land belonged to the government, making land transfers an important source of state revenue. The system didn't stop after Hong Kong was returned to China in 1997. The Hong Kong government monopolized land supply, so the Hong Kong government increased land and housing prices by reducing supply, damaging residents' interests in the meantime. Today, although Hong Kong is a developed economy, living conditions for residents, as attested to by dwellers in overpriced undermaintained apartments, leave much to be desired.

Third, soft budget constraints of state-owned enterprises. This economic concept refers to assistance offered by external forces when an economy encounters difficulties, which means an economy is not fully responsible for its own actions. Such a situation allows the economy to maintain operational inefficiencies.

In China, these soft budget constraints are a prominent fallback for state-owned companies (SOEs). State-owned enterprises have government endorsement, can get low-interest loans from banks, and can ask the government for help when they encounter operational difficulties. Private enterprises basically have no advantages in these aspects, so state-owned enterprises are often inferior to private enterprises in terms of efficiency. Since reform and opening up, China's economy has achieved leapfrog development, the biggest reason for which is the rise of private enterprises. This has meant that the front line of state-owned enterprises has been shrinking day by day. During Zhu Rongji's era, a large number of state-owned enterprises were streamlined, through a process of bankruptcy, mergers and reorganizations. A common saying is "the state retreats and private interests move forward". The reforms left many workers unemployed, and caused a series of social problems, but also alleviated the soft budget constraints of state-owned enterprises, improving operating efficiency in the economy as a whole, laying good foundations for economic development over the next 20 years.

Unfortunately, SOEs are on the rise again. This kind of expansion means the deepening of the soft budget constraints, which will affect the speed and quality of China's economic development, and lead to more financial and economic risks. How to reverse this trend, from "state advances and private interests retreat" to "state retreats and private interests advance" again, is a major issue for the Chinese economy and requires the attention of society as a whole.

This is a commentary on the CKGSB BCI report for November 2022 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.

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