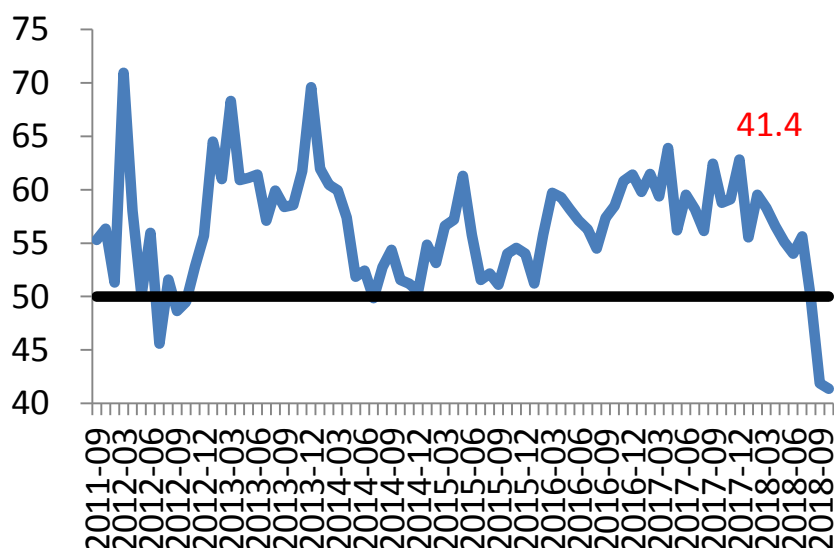


Commentary on the October 2018 CKGSB BCI

Professor Li Wei

In October, the CKGSB Business Conditions Index (BCI) dropped slightly from the worst reading to date in September, from 41.9 to 41.4 (Figure 1). Although not quite as dramatic a reading as last month, the deterioration of conditions for doing business in China should not be underestimated. It shows that the majority of sampled companies, some of the most competitive private businesses in China, are pessimistic about their prospects for the next six months.

Figure 1 Business Conditions Index (BCI)

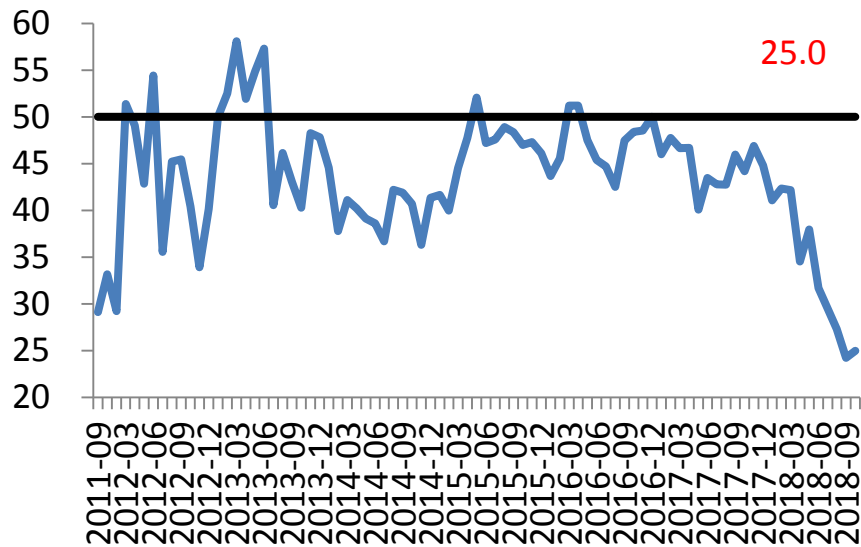


Source: CKGSB Case Center and Center for Economic Research

The BCI comprises four sub-indices. In October, the financing environment, corporate sales and profits indices rose slightly. The inventory index, on the other hand, fell (Figure 2). As for other indices, costs are still at the high end, while consumer prices have fallen sharply and producer prices have rebounded somewhat. Both prices indices remain below the confidence threshold of 50. The investment index fell and the recruitment index climbed marginally, but compared with pre-September data, both figures are relatively weak.

Having given readers a general picture of business conditions, we will focus on financing. Addressed in previous commentaries, this is an important topic, as restricted funding access continues to plague sample companies. Targeted measures to mitigate funding shortages are needed urgently.

Figure 2 Corporate Financing Index



Source: CKGSB Case Center and Center for Economic Research

This month's corporate financing environment index was 25.0, slightly higher than last month's 24.2, but still very low. It shows that issues with financing and high costs have not been alleviated in a substantial way.

Seen from recent measure put in place by decision makers, it is crystal clear they are aware of the financing difficulty and high costs private enterprises face, especially privately-owned micro, small and medium-sized enterprises. On October 7, the People's Bank of China (PBOC) stated that on October 15 the RMB deposit reserve ratio will drop by one percentage point for certain financial institutions. Except for funds to facilitate the repayment of medium-term loans, the adjusted deposit reserve ratio would release about 750 billion RMB in capital. At the time, the PBOC stated they would "guide financial institutions to increase support for micro, small, private and innovative enterprises."

In another example, on October 19, Vice Premier of the State Council, Liu He, said: "We are seeing some misunderstandings and deviations in implementation. Some employees are of the opinion that it is always safe to provide loans to state-owned companies, but it is politically risky to lend money to private companies – they would rather do nothing than commit political mistakes. Such views and practices are completely wrong. We must talk about policies and recognize the systemic aspects of the problem. The private economy plays an important role in the entire economic system, contributing more than 50% of tax revenue, more than 60% of GDP, more than 70% of technological innovation, more than 80% of urban employment, and more than 90% of new jobs and businesses. Without the development of private enterprises, there will be no stable development of the entire economy. Without a high-quality private enterprise system, there will be no modern industrial system. Supporting the development of private firms is to support the development of the Chinese economy as a whole. Behavior that prioritizes 'private safety' does not support the development of the private sector, is politically problematic and must be rectified." The fact that private lending has become such a high-level political issue, demonstrates how serious policy makers take the current predicament.

However, policies and calls by decision makers have proved somewhat ineffective. They are examples of the Keynesian notion of "Pushing on a String." This metaphor is widely used to describe the asymmetric impact of monetary policy. When a central bank tightens monetary policy, growth will dampen, demonstrating monetary policy's power, but when monetary policy is relaxed, the reverse is not true. Monetary easing cannot transmit the same power, just as pushing on a string is useless. Examples abound in economic history. Japan has implemented large-scale quantitative easing measures

over the course of many years, investing heavily into the base economy, but growth is still sluggish, and prices are far from reflecting levels of input.

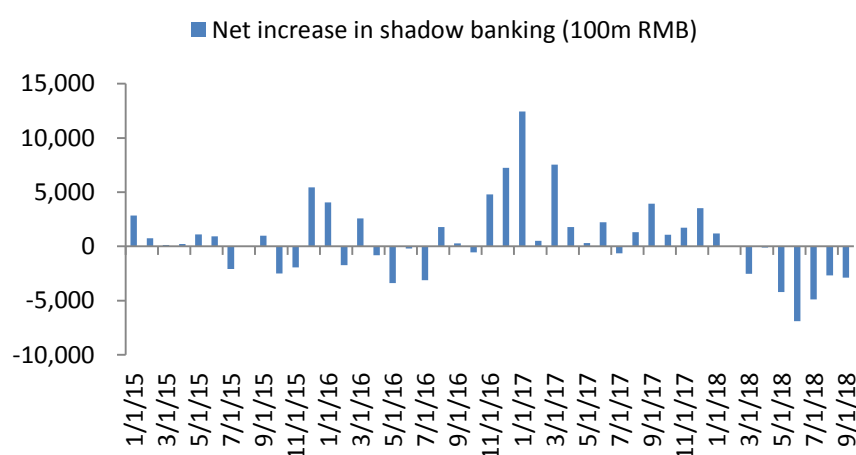
China and Japan have different national conditions, with different specific problems. However, as in Japan, China has a failed monetary policy. Although the Chinese government has tried many ways to solve the financing and high costs bottleneck for private enterprises, and has loosened monetary policy, the data shows that private enterprises may only obtain limited support. In other words, the way the monetary policy in being implemented has become “fragmented”, and while the central bank has been working overtime, end user benefit is negligible.

Why is this happening? There are many reasons, and one of them is the relationship between SOEs and private firms. In Vice Premier Liu He’s words, “Some employees are of the opinion that it is always safe to provide loans to state-owned companies, but it is politically risky to lend money to private companies.” He sees this as a matter of understanding. Although there is some truth to this, there are deeper institutional factors. From a lender’s perspective, borrowing to a private enterprise comes with the suspicion of receiving benefits, while funding a SOE does not. And if a private firm cannot service its debts, the risk of bankruptcy and liquidation is immediate, and the loan officer may be held accountable for putting a “bad asset” on the books. With SOEs, because of the nature of ownership, the government is more likely to offer protection or even a bailout if something goes wrong. This is the equivalent of free insurance for banks, and makes lenders’ behavior unsurprising.

In the current environment, private enterprises, especially small private enterprises, are in a relatively weak position in the capital market. If they need a small loan, they have a greater chance, but when the amounts increase, banks will set more restrictions, especially collateral, which small businesses are hard-pressed to acquire. So it is naturally difficult for them to pass a loan review.

In the past, private enterprises that could not access loans through regulated routes could make a detour through “back door” routes and borrow money from shadow banks. However, since 2017, China has implemented a policy of deleveraging, which has rectified the shadow banking sector. As a result, the size of the shadow banking sector has shrunk considerably (Figure 3).

Figure 3 Industry Competitiveness



Source: Wind

Notes: Net increase in shadow banking = net increase in trust loans + net increase in entrusted loans + net increase in undiscounted bank acceptance bills.

The shadow banking sector means rigid returns and unknown risk for borrowers, and has indeed been ripe for rectification for a long time. It has also, however, been one of the only realistic solutions for private firms in need of financing. Both these aspects need to be taken seriously. It would be best to

open up new financing channels for private enterprises while rectifying shadow banking, and open regulated financial institutions to allow private firms to compete equally with SOEs on the capital markets. However, some significant structural reforms need to be enacted before this can happen. If local governments stop propping up SOEs, banks no longer have that insurance policy which prioritizes lending to SOEs and offering low cost repayment options. If such problems are not resolved, China's broken monetary policy will never be healed. And while structural reforms are hard, this should not be an excuse for us to evade them. Of course, as a compromise, we could allow shadow banking to carry on, while carrying out structural reforms and controlling financial risks, so as to avoid the impact of a private enterprise financing drought in the interim.

This is the author's commentary on the CKGSB BCI report for October 2018. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

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