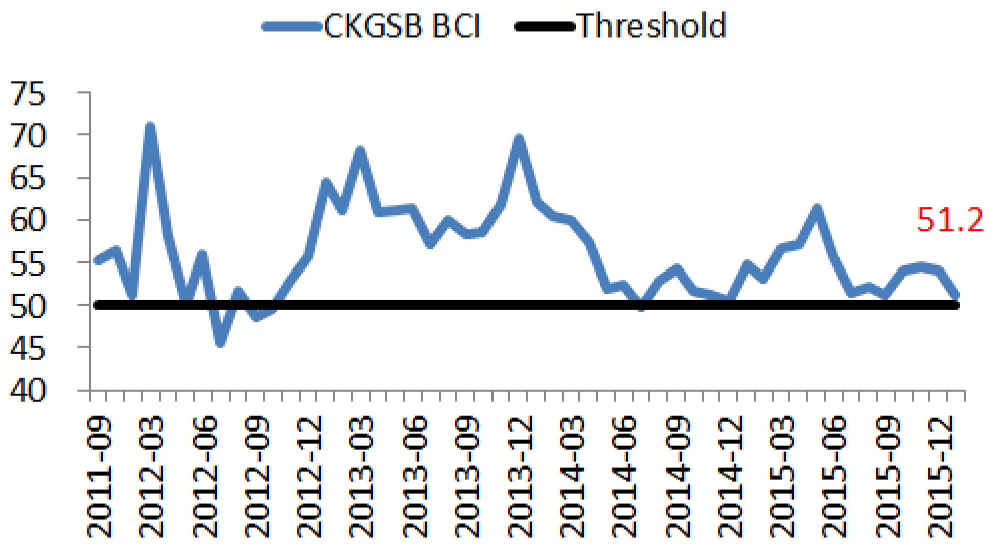
CKGSB BCI

January 2016

29 January 2016 CKGSB Case Center and Center for Economic Research

The CKGSB Business Conditions Index (BCI) registered 54.0 in December and 51.2 in January, a slightly lower overall reading (Figure 1). In May 2015, the BCI was at a considerably higher level of 61.3, but in July, August and September, it was only just above the confidence threshold of 50. From October until this month, the overall index has hovered around 54 but it has now slipped back towards the confidence threshold. This shows that for the majority of relatively successful firms in China, optimism about business conditions over the next six months is waning, and the current forecast for business operations in China is cautious optimism.

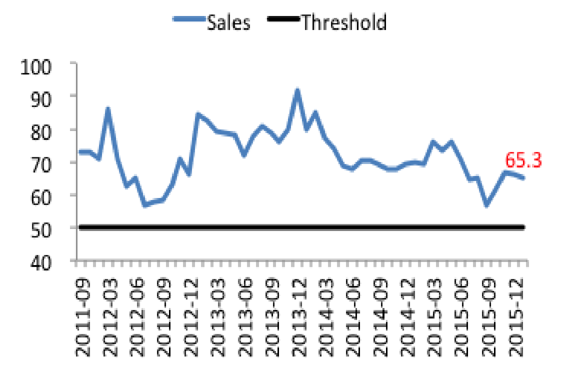
Figure 1



Source: CKGSB Case Center and Center for Economic Research

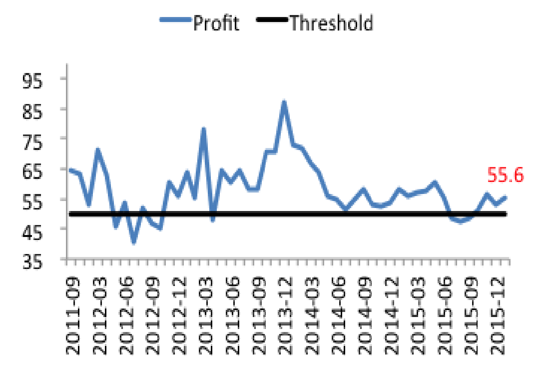
The CKGSB BCI comprises four sub-indices for corporate sales, corporate profits, corporate financing environment and inventory levels. Of these four sub-indices, three are forward-looking indicators, and one, corporate financing, measures current business sentiment. These four sub-indices for January will be discussed below.

Figure 2



Source: CKGSB Case Center and Center for Economic Research

Figure 3

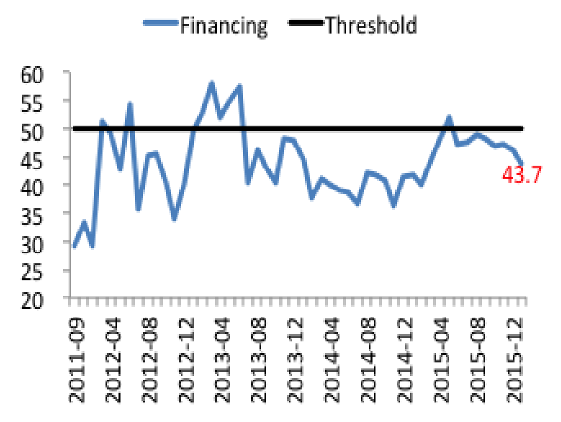


Source: CKGSB Case Center and Center for Economic Research

Of the four sub-indices, three fell and one rose in January. Starting with corporate sales, the sub-index fell from 66.3 to January's 65.3.

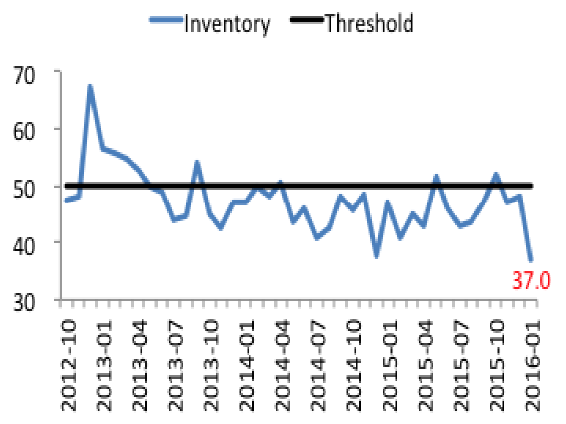
The profit index rose, from last month's 53.4 to this month's 55.6. From Figure 3, we know that in the four years since this survey began, profit expectations have rarely registered lower than 50, but in recent months, a sharp decline has been seen, beginning with 60.3 in May and veering below 50 in July, August and September. In October, profits expectations returned above 50, and this year to over 55, showing that the profit outlook is becoming more positive for the upcoming six months.

Figure 4



Source: CKGSB Case Center and Center for Economic Research

Figure 5



Source: CKGSB Case Center and Center for Economic Research

The financing index fell slightly this month from 46.1 to 43.7, remaining below the confidence threshold of 50. With the financing index below 50 over the long term, with some months even falling below 30, this shows that the financing situation for Chinese companies is far from ideal. Companies face both financing trouble and high costs. However, it is important to note that the BCI, and this reading in particular, predominantly reflect the situation for Chinese SMEs.

The central government is very clear about the current state of financing for private SMEs, and has taken a series of measures to reduce the cost of social financing. Since February 18, 2012, the People's Bank of China (PBOC) has cut the statutory reserve ratio (for large deposit-taking financial institutions) a total of seven times. Since June 8, 2012, the PBOC also cut its benchmark interest rates (on one-year deposits) a total of eight times, leaving the rate at its current level of 1.5%, the lowest since data has been collected. In addition, the central bank has repeatedly lowered the statutory reserve ratio to financial institutions that serve small and micro enterprises and agriculture-related firms. From this we can see that the central government is addressing the pain caused by financing problems among SMEs.

The central government has spent a lot of thought on ways to reduce the cost of financing for private SMEs, hoping to foster their development. However, our index has indicated that the effects of their policies have not been ideal. On the one hand, monetary policy has been loosened in 2015, with the scale of social financing now reaching 1.8151 trillion RMB, standing at 1.0224 trillion RMB in November. On the other hand, there is still a weak financing environment, and from this we can see that the problem of financing for private SMEs is structural. For example, in the case of a fall in GDP growth, the probability of default among private SMEs is greater than for SOEs. This higher default risk should be resolved by bank pricing of risk, for example, making private sector lending rates higher for SMEs than for SOEs. But the central bank controls interest rates to retain its margins, as this spread is the main source of profit for banks. The central bank is also more willing to lend to SOE funds, both to ensure bank profits and to avoid risk, because their ability to pay is assured.

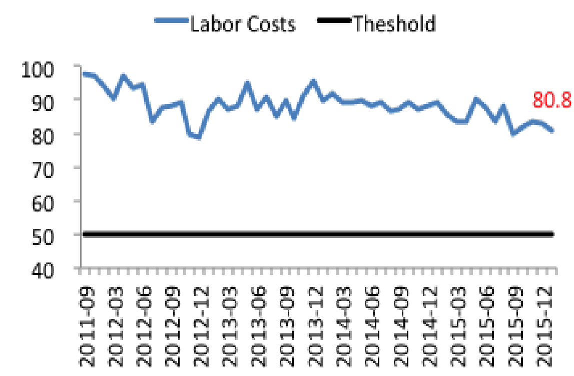
Structural problems for private SMEs in terms of financing are not easy to solve via a central policy. The problem begins and ends with those in command, and solving the difficulties of SME financing ultimately depends on a number of aspects of reform, including direct financing through the development and reform of financial markets, allowing large enterprises with high credit ratings direct financing from capital markets, and obliging banks to work with SME clients they previously refused, or were unwilling, to work with.

It is gratifying, however, that the central bank announced an interest rate cut on October 23, 2015, and declared that "for commercial banks and rural cooperative financial institutions there would no longer be a upper limit to floating interest rates on deposits". The central bank also said that the current asset side of financial institutions has been fully opened to market-oriented pricing, and the extent of market-oriented pricing on the liability side has reached more than 90%. The PBOC retained its benchmark interest rate of 1.5 times the upper management limit for deposits (including one-year deposits) and from this, it said, "the liberalization of interest rate controls is only one step away".

The inventory index fell significantly from 48.1 to 37.0 in January. In May 2015, the index briefly rose to 51.7, crossing the confidence threshold, but it has since fallen again, and in October dropped under 50, remaining in the doldrums in November and December. Hovering around the confidence threshold, inventory levels clearly show signs of instability. As to how this will play out, we will have to wait and see. But one thing is certain: from the data we have collected over the long term, the inventory situation is far from positive.

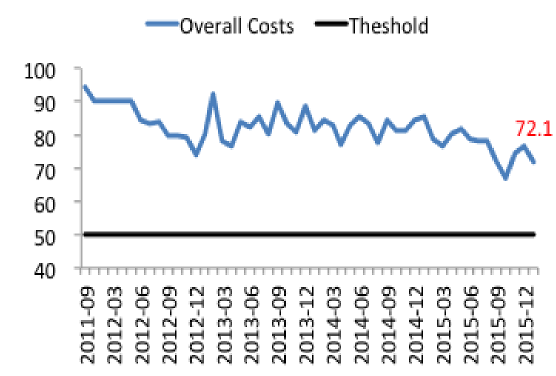
Besides the main indices, we also surveyed respondents on forecasted costs, prices, investment plans and employment conditions, to form a supplementary set of indices. First, let's consider the costs side.

Figure 6



Source: CKGSB Case Center and Center for Economic Research

Figure 7

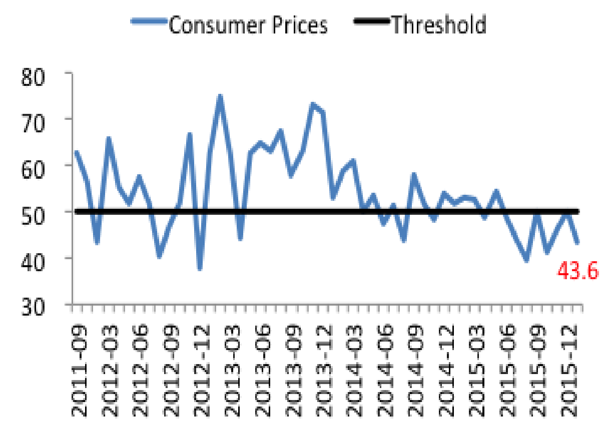


Source: CKGSB Case Center and Center for Economic Research

This month, the labor costs index fell slightly from 82.8 to 80.8, while overall costs also fell from 76.6 to 72.1. We will not say too much about this, except that this index has maintained a high level over the long term, showing that high labor costs in China are structural rather than cyclical. Rapidly-rising labor costs, despite a slowing upward trend in overall costs, indicate that other factors of production other than labor costs are expected to slow. We believe there may be two reasons, first, a drop in commodity prices, and second, excess capacity leading to sluggish prices for manufactured goods.

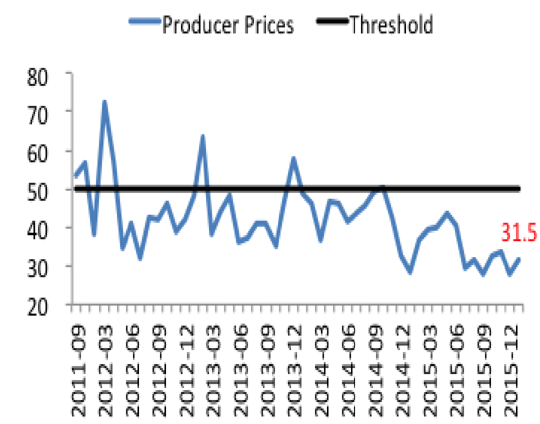
On the prices side, the consumer prices index fell this month from 50.0 to 43.6, and producer prices continued to hover at a low level, edging up from 27.8 to 31.5 in January. Since January 2014, prices have been sluggish, with consumer prices looking comparatively more healthy and mostly above the confidence threshold. However, the situation has deteriorated markedly, with the future trend unclear. The producer price index has consistently reported a poor performance, only once rising above 50 (50.5 in October 2014). This index has dropped below 30 on four recent occasions (January, July, September and December 2015 at 28.1, 29.5, 27.7 and 27.8 respectively).

Figure 8



Source: CKGSB Case Center and Center for Economic Research

Figure 9



Source: CKGSB Case Center and Center for Economic Research

From our data, the high costs/low prices combination means that companies cannot increase prices to consumers or downstream producers to steer their way out of cost pressures, meaning that despite acceptable sales, the profit index is performing poorly (despite two months of rebound in the profit index, compared with 2013 and the first half of 2014, the index is at a low level). This echoes an earlier point about one of the biggest structural problems facing the Chinese economy – manufacturing overcapacity. This does not indicate that Chinese people are now so well off that they do not need as many goods or services. On the contrary, for a middle income country, China's domestic demand is healthy, but there are countless sectors in dire need of investment, including healthcare, education and pensions. Overcapacity is a result of misallocation of resources: placing resources in low return sectors such as the steel industry. Overcapacity means we need to carry out economic structural reforms, allowing the market to guide an outflow of resources that has become stagnated, and configure a way to put valuable resources to better use. In the short term, such reform may trigger a greater slowdown with rising unemployment likely to damage vested interests, and this causes the resistance to such a plan. However, for the long term health of the Chinese economy, this is an unavoidable step.

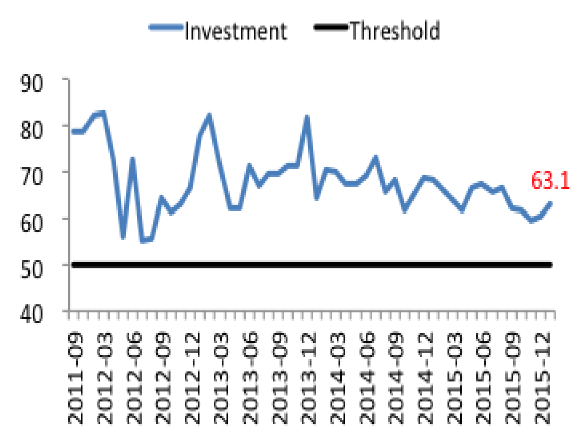
The CPC Central Committee has a clear perspective on this, and has promoted its views publicly. At the recent Central Economic Work Conference, the Central Committee made clear the importance of tough structural reforms in economic and social development in 2016. Five key areas were highlighted, namely production capacity, inventory levels, leverage, efforts to reduce costs, and making up for systemic shortcomings. Mentioned first in this list of government tasks, it seems that the central authorities are well aware of the issue of production overcapacity.

Overcapacity and the growth of debt are linked. In fact, they are two sides of the same coin. Inefficient industries are unable to gain sufficient profit or cash flow from operations alone, so in order to function, survive and even expand, burgeoning debt is accumulated. As debt increases, so economic pressure builds up and when the debt burden spills over, economic and social unrest may result. We need to monitor debt, but, as of today, there is little cause for optimism in this regard.

According to the Chinese Academy of Social Science (CASS), from 1996 to 2014, China's total debt-to-GDP ratio rose sharply from 113% to 235.7%. The highest proportion was in non-finance sectors, and in 2014, the total non-finance corporate debt-to-GDP ratio was 123.1%.

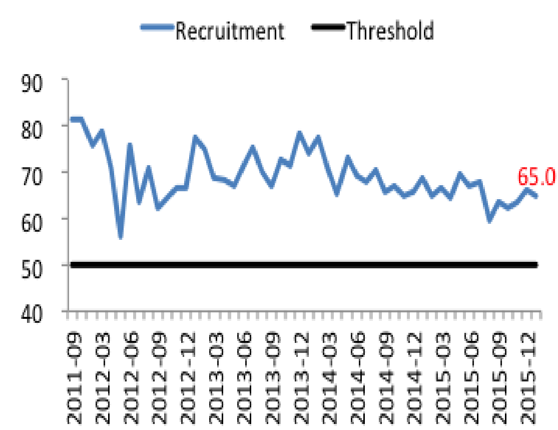
Following the discussion of costs and prices, investment and recruitment will be considered. The corporate investment index rose from 60.3 to 63.1, with the labor demand index falling from 66.0 to 65.0. These two indices are interesting: while other indices, including profit and inventory and the overall BCI, have fluctuated since September 2011, these two and the costs index have remained consistent.

Figure 10



Source: CKGSB Case Center and Center for Economic Research

Figure 11



Source: CKGSB Case Center and Center for Economic Research

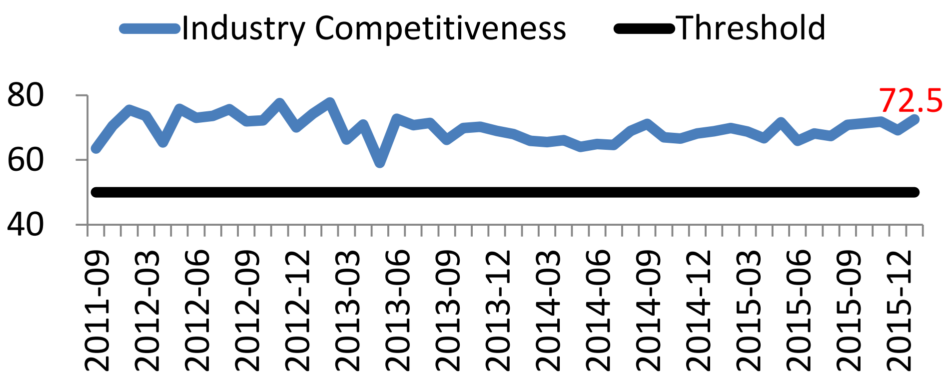
The investment index and labor index have both been above 50 overthe long term, and comparatively high at that. Taking investment as an example, since September 2011, the index has been between 50 and 60 four times, and the rest of the time above 60, even topping80 on four occasions. The labor demand index has only been between 50 and 60 twice, and has remained above 60 for the rest of the time, twice registering above 80.

While sales are still good, cost pressures are mounting, long-term financing conditions are poor and prices and profit performance are weak. But what is most interesting is that firms are still in expansionary mode, ploughing more money into investment and recruitment. With such poor short-term business prospects, why are businesses making such counter-cyclical decisions?

Perhaps, for good quality companies, a time of adversity is indeed the right opportunity to expand. But there is another possibility, that for some companies “expansion is the only way” sums up how industries such as real estate, and the related sectors of steel, glass, and cement feel under the government’s favorable policies. Whenever there is an economic downturn, the government applies the logic it first used in 2009 and then again more recently, leading companies to expect an expansionary period to follow a contraction. From this perspective, reverse-cycle business operations make sense. But what about for the economy as a whole?

Finally, the BCI is generated wholly on the basis of statistics gathered from leading enterprises whose executives have studied or are studying at Cheung Kong Graduate School of Business. In the questionnaire, we ask respondents to indicate whether their firm is more, the same, or less, competitive that the industry average (50), and from this we derive a sample competitiveness index. Consequently, as our sample firms are in a relatively strong competitive position in their respective industries (a reading of 72.5 in January, Figure 12), the CKGSB BCI indices are higher than government and industry PMI indices and the conditions for most companies are even more difficult.

Figure 12



Source: CKGSB Case Center and Center for Economic Research

CKGSB BCI Introduction

In June 2011, the CKGSB Case Center and the Center for Economic Research initiated a project to gauge the business sentiment of executives about the macro-economic environment in China – called an index of business conditions.

Under the direction of Professor Li Wei, in July 2011, the two research centers designed and tested the BCI survey. In September 2011, the first surveys were distributed and results computed. From May 2012 to January 2016, the research team has published 45 monthly BCI survey reports.

Explanation of the Index

The CKGSB Business Conditions Index (CKBCI) is a set of forward-looking, diffusion indices. The index takes 50 as its threshold, so an index value above 50 means that the variable that the index measures is expected to increase, while an index value below 50 means that the variable is expected to fall. The CKGSB BCI thus uses the same methodology as the PMI index.

The survey asks senior executives of companies whether their main products are for consumers or non-consumers, and then asks how they think product prices will change in the next six months. Based on survey responses, we have been able to report expectant changes in consumer and producer prices.

We ask companies for information pertaining to their relative competitive positions in their respective industries. Based on survey responses, we compute a competitiveness index for our sample. The higher the competitiveness index, the more competitive our sample firms are in their respective industries.

Method of Calculation

During each survey, respondents are asked to indicate whether certain aspects of their business (e.g., sales) are expected to increase, remain unchanged, or decrease over the forthcoming six months as compared to the same time period last year. The diffusion index is calculated by summing the percentage of "increase" responses and half of the “remain unchanged” responses.

Of all the indices measured for the CKGSB BCI, the overall business conditions index is an aggregate index, which has been calculated, since December 2012, by averaging its four constituent indices of sales, profit, financing environment and inventory. The aggregate BCI index before December 2012 uses a different composition of constituent indices, and is therefore not directly comparable to the current BCI index.

About Cheung Kong Graduate School of Business

Education for a New Era of Global Business

Established in Beijing in November, 2002 with generous support from the Li Ka Shing Foundation, CKGSB is a private, non-profit, independent educational institution and the only business school in China with faculty governance. The school offers innovative MBA, Finance MBA, Executive MBA and Executive Education programs. In addition to its main campus in the center of Beijing, it has campuses in Shanghai and Shenzhen and offices in Hong Kong, London and New York.

Thought Leaders on Business in China

CKGSB faculty, through their on-the-ground research and close relationships with leading domestic executives, provide global thought leadership on both the theory and the practical reality of real-life business in China. They consistently generate important insights into areas that are poorly understood outside of China, such as the globalization strategies of Chinese companies and competition and collaboration among state-owned enterprises, private businesses and multinationals.

World-Class Faculty with a Global Perspective

CKGSB is the only business school in China with the reputation and resources to attract faculty from top business schools such as Wharton, Stanford, NYU, and INSEAD. The majority of CKGSB faculty members were born and raised in China before leaving to study and teach abroad. Their bicultural backgrounds have endowed them with a valuable capacity to interpret global business in the context of both China and the West.

The Research Team

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