

# **China's Industrial Economy in 2019 Q4 Highlights and Annual Report<sup>1</sup>**

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<sup>1</sup> This report is based on a nationwide quarterly survey of industrial firms, which is implemented by Beijing Allinfo Co., based on the questionnaire and sample provided by Professor Gan Jie, Director of the Center on Finance and Economic Growth. We thank Beijing Allinfo for its hard work and professionalism. We acknowledge the able research assistance of Harry Leung and Jessy Yao who provided support to the data analysis.

## **Executive Summary**

The Business Sentiment Index stood at 50, the turning point between expansion and contraction, and thus ending a 7-quarter mild expansion. Private firms, however, were in a slight contraction. Real output, as reflected in production, electricity consumption and both of domestic and foreign orders were also in a slight contraction. Besides, investment was still sluggish and overcapacity hit a historical high.

Although firms' confidence about their economic outlook over the next 3-5 years declined markedly, still there are more than half remained either "optimistic" or "cautiously optimistic." The top concern was competition and overcapacity, whereas macro conditions came the next.

With the coronavirus outbreak, both domestic and international demand are severely affected. The government policies are expected to aim at helping the firms, especially small private firms, through fiscal spending, tax reliefs, and monetary policy, so that employment and thus social and economic stability can be maintained.

## **Introduction**

This report is based on data collected from our quarterly surveys of around 2,000 industrial firms in China. Conducted through telephone interviews, this survey, launched in 2014 Q2, is now in its fifth year. Our results are important in understanding the Chinese economy, because, if we exclude real estate and finance, the industrial sector now accounts for about 50% of China's non-agricultural GDP.

Our survey design ensures that our sample fully represents industry, region and company size. As a result, we are able to construct business indices that are, to the best of our knowledge, the most informative ones available. Furthermore, our survey questions allow us to understand the underlying mechanisms behind the data and analyze why the economy is doing well or not.

### **I. 2019 Q4 Key Findings**

#### **I.1 The Industry Ended a Seven-Quarter Mild Expansion**

In Q4, the Business Sentiment Index<sup>2</sup> stood at 50, the turning point between expansion and contraction, and thus ending a 7-quarter mild expansion (Figure 1)<sup>3</sup>.

Private firms – the vast majority of industrial firms – were in a slight contraction (49). Real output, as reflected in production and electricity consumption were in a mild contraction, with diffusion indices both being 48 (Q3: 46-48). Intermediate goods and durable consumer goods were affected the most, with diffusion indices between 46 and 47.

Investments were still weak and the proportion of the firms making expansionary investments was 2%, similar to last quarter (Q3: 1%).

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<sup>2</sup> Our 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.

<sup>3</sup> 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.

## **I.2 Impact of Trade War Stabilized**

The impact of the Sino-US trade war was similar to that in Q3. The proportion of affected firms was 19% (Figure 4), whereas the proportion of firms reporting a significant impact was 4%, the same as the last quarter. Moreover, 4% of firms expected to be affected significantly by the trade war within the next two years.

Affected firms were mainly export firms, which accounted for 31% of our sample. Among these export firms, 38% were affected in Q4 and 10% reported a significant impact.

The five industries with the highest proportion of firms being affected are Processing of Wood Products, Textile, Electric Equipment (Computers and Communications), Textile Wearing & Apparel and Cultural & Sports Products. 35% to 43% of firms in these industries were affected. The top two industries based on the proportion of firms reporting a “significant impact” were Textile Wearing & Apparel (12%) and Cultural & Sports Products (13%).

In addition, the decline in foreign orders in Q4 eased slightly with a diffusion index of 49 (Q3: 45). This contraction is mainly concentrated in private firms (49) and intermediate goods producers (48). Besides, the reduction in the share of foreign markets is mild in Q4, with a diffusion index of 49 in Q4 (Q3: 45).

## **II. 2019 Annual Review**

### **II.1 Overall Conditions and Industry & Regional Distribution**

In 2019, the Business Sentiment Index indicates a slight contraction for the first 3 quarters but stayed flat in Q4. This slight expansion during the year was mainly driven by state-owned (58-61) and foreign firms (54-56). Real output, as reflected in production (46-48), electricity consumption (46-48), and domestic & foreign orders (45-49) were in a slight contraction throughout the year.

Fixed investment remained sluggish throughout the year of 2019. The proportion of firms making fixed investment decreased from 13% in 2018 Q4 to 8% in this quarter. Meanwhile, the proportion of firms with expansionary investment dropped from 7% in 2018 Q4 to 2%.

Inflation is contained in 2019, with the diffusion index of product prices in a 49-50 range.

## **II.2 Challenges**

Overcapacity was still at historically high levels throughout the year. The diffusion index rose from 83 in 2018 Q4 to 87 in 2019 Q4 (Figure 2), hitting a record high. Notably and related to the trade war, overcapacity for foreign market rose from 74 in 2018 Q4 to 81 in 2019 Q4. In Q4, 37% of the firms reported that their excess capacity was above 10% (2018 Q4: 31%), while 16% (2018 Q4: 12%) reported that their excess capacity was above 20%. Capacity utilization declined significantly in 2019. The proportion of firms with capacity utilization above 90% dropped from 60% in 2018 Q4 to 51% in 2019 Q4. Overcapacity was most prominent in intermediate (90) and durable consumer goods (87).

Cost rises have been the second biggest challenge facing the industrial economy. The rising costs continued in 2019, but to lesser extent, with the diffusion index ranging between 56 and 61 (2018: 61-69)

Our survey has consistently found, since its inception in the second quarter of 2014, that financing is not a bottleneck for the industrial economy. In each quarter of 2019, only 1-2% of firms cited financing as a constraining factor (2018: 1-2%). In Q4, 15% of firms said they had “sufficient” funds, 83% answered “neutral”, while only 2% reported “insufficient” funds.

In line with the overall tightening of liquidity, however, the diffusion index reflecting an “accommodating” bank lending attitude declined during the year, from 55 in 2018 Q4 to 52 in 2019 Q4, hitting a historical low. Notably, for small firms and intermediate goods producers, the index was 48, below the turning point of 50, indicating that lending altitude is in the realm of “being tight.”

## **III. Going Forward: Outlook, Institutions and Innovation**

### **III.1 Economic Outlook**

There was a notable drop in firms’ confidence about their economic outlook over the next three to five years, although there are still over half of firms (59%) were either “optimistic” (9%) or “cautiously optimistic” (50%) (2018: 21% and 63%) (Figure 5). Among those who were “not optimistic”, 48% said their top concern was competition and overcapacity, consistent with 2018. 37% and 10% of firms cited concerns over macroeconomic environment and environmental issues respectively (2018: 23% and 21%).

### **III.2 Innovation**

The proportion of firms without any R&D spending decreased from 70% in 2018 to 65% in 2019. However, 1% of firms reported R&D spending over 5% of sales, substantially lower than the 6% in 2018.

### **III.3 Institutions**

Contrary to the skeptical opinions of some in the west, the legal institutions in China have provided reasonably good protections for business operations. In answering the question “On a scale of 0-10, what is the likelihood that the legal system will uphold your contract and property rights in business disputes (0 being the worst)?”, the firms’ average rating of the legal environment increased from 6.3 in 2018 to 7.7 in 2019. The proportion of firms which gave a rating above 7 increased significantly from 61% to 84%, whereas those who gave a rating below 5 dropped substantially from 31% in 2018 to 6% in 2019. These changes suggest that the government’s effort to promote private firms has taken effect. There was not much variation in the rating across regions.

The Chinese government plays an active role in promoting economic growth. The proportion of firms receiving support from the government increased from 20% in 2018 to 22% in 2019. This is at least partially attributable to the fact that the proportion of firms receiving tax reduction increased, from 12% in 2018 to 17% in 2019. The second common form of support was funding for innovation, which was cited by 5% of firms in 2019 (2018: 6%). Other forms of support included project-based funding, guarantees for loans, etc., and accounted for 5% of firms in total.

## **IV. Conclusion**

The Business Sentiment Index stood at 50, the turning point between expansion and contraction, and thus ending a 7-quarter mild expansion. Private firms – the vast majority of industrial firms – however were in slight contraction. Real output, as reflected in production, electricity consumption and both of domestic and foreign orders were in a slight contraction. Besides, investments were still weak and the proportion of the firms making expansionary investments was 2% in Q4. Overcapacity hit a historical high.

Although firms’ confidence about their economic outlook over the next 3-5 years declined markedly, still there are more than half remained either “optimistic” or “cautiously optimistic.” The top concern was competition and overcapacity, whereas macro conditions came the next. Firms’ average rating of the legal environment increased markedly from 6.3 in 2018 to 7.7 in 2019.

With the coronavirus outbreak, both domestic and international demand are severely affected. The government policies are expected to aim at supporting the survival of firms, especially small private firms, through fiscal spending, tax reliefs, and monetary policy, so that employment and thus social and economic stability can be maintained.

**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			
		Q4		Q3		Q4		Q3		Q4		Q3	
		Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3
<i>By Size</i>													
Nation	2,037	2,035	50	51	56	56	49	51	45	45			
Large	679	679	51	52	58	59	48	51	47	47			
Medium	679	678	50	51	56	56	49	50	46	46			
Small	679	678	48	49	53	54	49	50	43	42			
<i>By Ownership</i>													
State-owned	107	100	59	58	80	78	50	48	47	47			
Collectively-owned	11	13	50	53	59	65	45	50	45	42			
Private	1,738	1,731	49	50	53	54	48	51	45	45			
Foreign-owned	181	191	54	55	64	65	51	53	48	47			
<i>By Product Type</i>													
Consumer Goods - Durable	286	259	49	50	54	56	49	52	45	44			
Consumer Goods - Nondurable	606	607	52	52	60	60	51	52	45	45			
Capital Goods	137	152	53	54	59	61	50	51	49	49			
Intermediate Goods	1,008	1,017	49	49	53	54	47	49	46	45			

**Table 1.2**

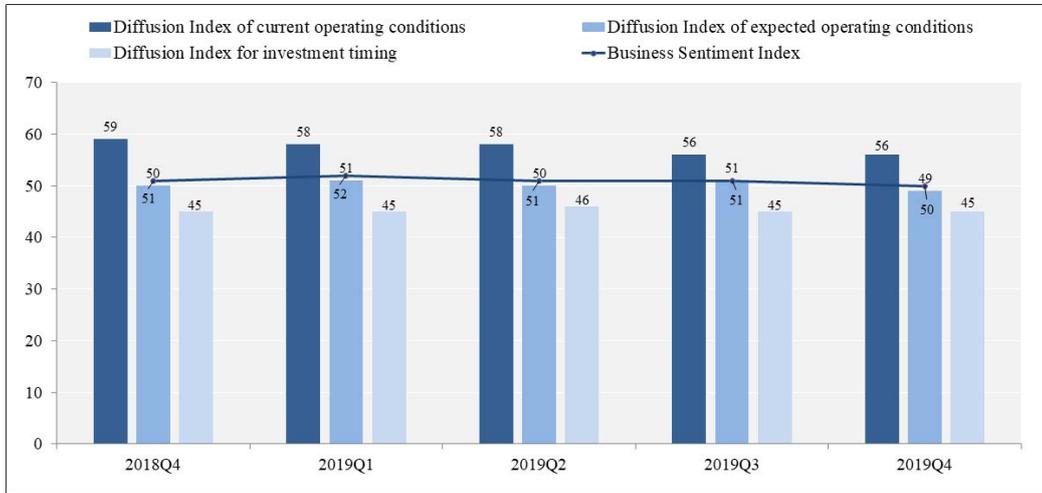
	% of Firms with Fixed Investment		% of Firms with Expansionary Investment		Diffusion Index - Production		Diffusion Index - Employment		Diffusion Index - Price			
	Q4		Q3		Q4		Q3		Q4		Q3	
	Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4	Q3
<i>By Size</i>												
Nation	8	6	2	1	48	46	50	49	50	49		
Large	10	8	3	1	47	47	51	50	49	49		
Medium	10	6	2	1	49	47	50	50	50	50		
Small	6	5	2	1	48	44	49	48	50	48		
<i>By Ownership</i>												
State-owned	7	3	1	0	48	53	50	51	50	50		
Collectively-owned	0	0	0	0	45	42	45	46	45	50		
Private	9	7	2	1	48	46	50	49	50	49		
Foreign-owned	9	6	2	2	49	47	50	51	49	48		
<i>By Product Type</i>												
Consumer Goods - Durable	10	5	4	0	47	45	49	49	49	48		
Consumer Goods - Nondurable	10	6	2	1	51	50	51	49	50	50		
Capital Goods	11	5	1	0	53	44	51	49	50	50		
Intermediate Goods	7	7	2	2	46	45	50	50	50	48		

Notes:

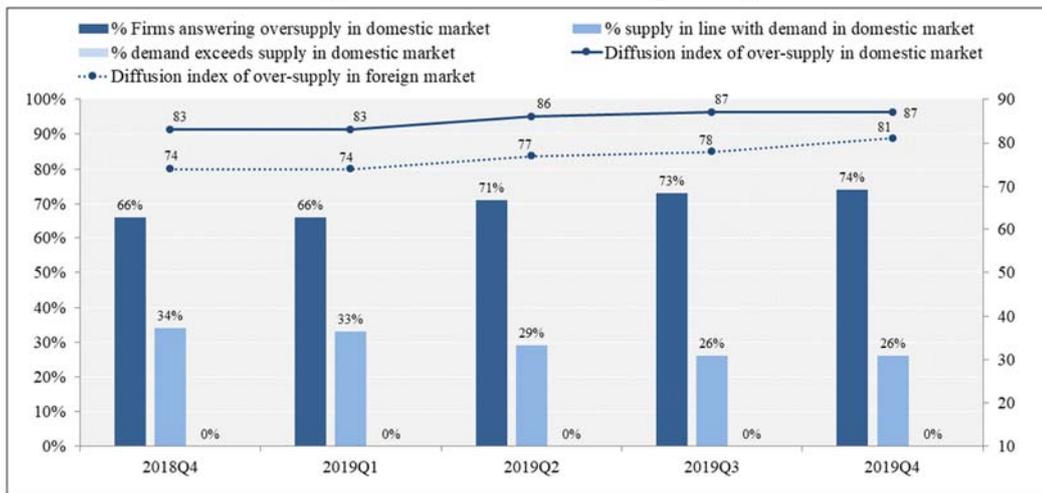
1. Diffusion Index (DI) is computed using the percentage of firms that answer "increase" (% increase) and "same" (% same) according to the formula: (% increase + 0.5 \* % same). The index ranges between 0 and 100. A larger value indicates a better operating condition.

2. Business Sentiment Index is the average of DIs for Operating Conditions, Expected Operating Conditions and Good Timing for Investment.

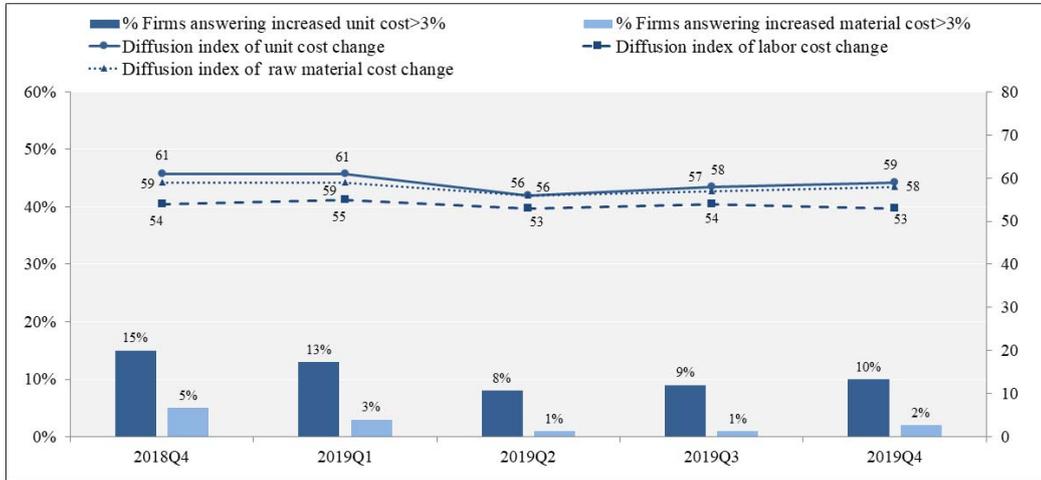
### Figure 1. Business Sentiment Index



### Figure 2. Excess Capacity



### Figure 3. Costs



### Figure 4. % of Firms Affected by Trade War

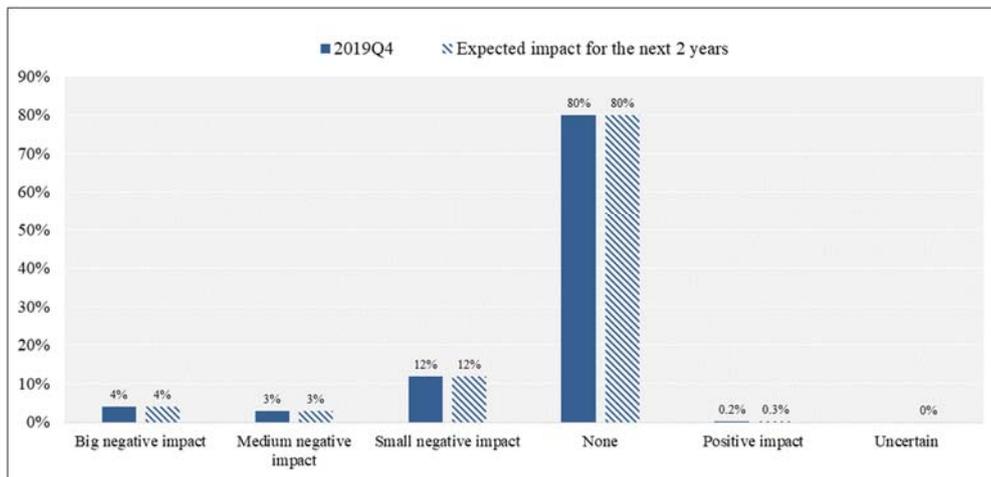


Figure 5. Business Outlook in 3-5 Years

