Commentary on the November 2020 CKGSB Business Conditions Index

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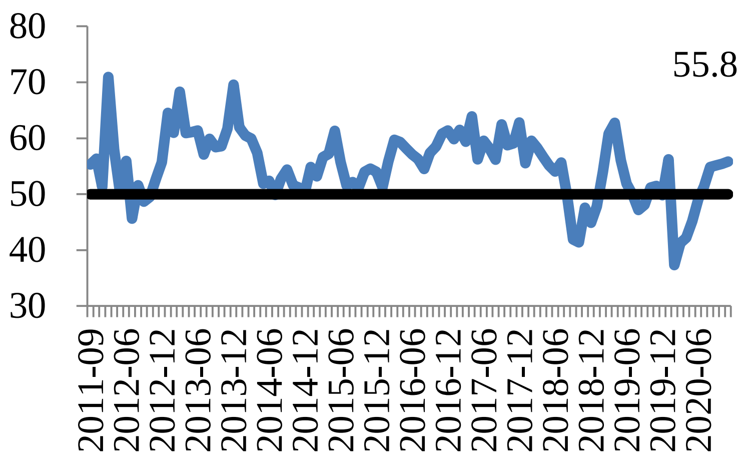
The CKGSB Business Conditions Index (BCI) reported a slight rise from 55.4 to 55.8 in November 2020 (Figure 1). With confidence above 50.0, it appears economic relief policies implemented by the government are having a decided impact on private business. There is now a fairly high probability that China's economy will finish this tumultuous year on a positive note.

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



Source: CKGSB Case Center and Center for Economic Research

The data has not altered significantly in overall terms, but there are some highlights, the most obvious of which is that the majority of sub-indices are on the rise to some extent. For example, labor cost and total cost prospects rose above 80 in November, returning to their habitual high level; the consumer prices index rose from 47.2 to 52.1, and the producer prices index rose from 50.4. to 58.8. Producer prices are ahead of consumer prices by a wide margin, which is rare for the BCI. The investment prospects index rose from 65.0 to 67.4, and the recruitment index rose from 67.6 to 69.3, indicating that most surveyed companies are expanding, and that the Chinese economy is operating at full capacity.

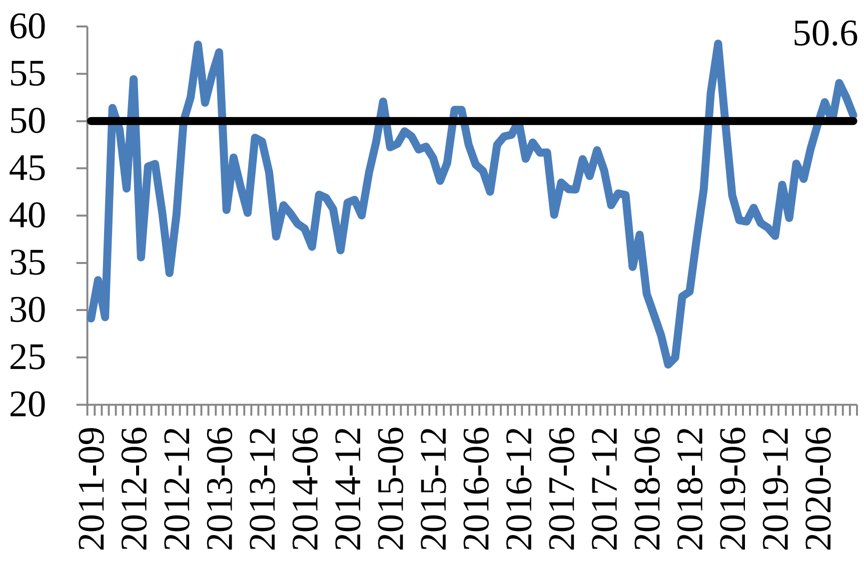
On 25th November, Liu He, Vice Premier of the State Council, wrote in the People's Daily that his main focus was on serving the real economy, making structural adjustments to the financial system, and actively increasing the proportion of direct financing in the economy. This is a very important signal, as it heralds the general direction of future financial reforms. Increasing the proportion of direct financing will likely drive the banks towards the SME market.

Big businesses have the strength, credibility, and high ratings, to push down the cost of financing to raise funds like bonds and shares. Since there is no interest and handling fee difference in bank financing, the costs of direct financing are generally lower than costs in the indirect financing market for big businesses. In other words, issuing stocks and bonds is more cost effective than hunting down a bank loan.

When large companies generally choose direct financing, banks must find new customers. At this point, small and medium-sized enterprises are in the banks' sights. Compared with large enterprises, small and medium-sized enterprises have less clout, lack transparency, and struggle to get high credit ratings. This means that financing costs in the direct financing market will be relatively high. Because of this, it is logical for SMEs to seek the support of banks. Banks come into contact with a large number of small and medium-sized enterprises every day. They not only look at the three main tables of an enterprise (balance sheet, income statement and cash flow statement), but also at the new three tables (water bill, electricity bill and customs report), to make up for information asymmetry.

So how are the banks serving business at present? Unfortunately, things are not looking great.

Figure 2 **Financing Conditions Index**



Source: CKGSB Case Center and Center for Economic Research

Figure 2 shows the financing situation of the companies we survey for the BCI. The higher the index, the better their chances of obtaining funding, and the lower the index, the worse their chances. This month the index was just over the confidence point at 50.6, which depressingly marks one of the few times since we began the survey in 2012 when it has risen above 50.0. At its lowest, the financing prospects index fell below 30.0. This is an old problem for China's economy as a whole. Poor performance here indicates that interviewed companies suffer long-standing financing difficulties and high costs. In other words, our financial institutions mainly serve large enterprises, while small and medium-sized enterprises struggle to obtain their support. This also means the market mechanism is somewhat unsound.

Apart from finding a way to increase direct financing, there is another important problem that needs resolving – the rigid payment terms given to large enterprises, especially state-owned enterprises. On November 10, 2020, Henan state-owned enterprise Yongcheng Coal and Electricity Holding Group Co. Ltd. (abbreviated to Yongmei Group) 1 billion yuan failed to repay a billion RMB ultra-short-term bond “20 Yongmei SCP003” at its date of maturity, constituting a substantial default. Since the market was caught off-guard and unprepared, the default shocked the market. The scale and significance of Yongmei Group among local state-owned enterprises triggered a chain reaction as risk spread in multiple directions.

In fact, Yongmei Group’s default was not entirely without warning, so it is interesting to consider why investors might ignore the risks. Yongmei Group is an important provincial state-owned enterprise in Henan, and investors were confident the local government would step in.

After the bond default, the ratings of Henan Yuneng and Yongmei Group were lowered from AAA to BB, and the market focused in on subsequent events. After a fierce game, under the intervention of the local government, on the evening of November 24, Everbright Bank, lead underwriter of “20 Yongmei SCP003” made an announcement to the Shanghai Clearing House that the two resolutions regarding the holder of “20 Yongmei SCP003” were passed. The holders agreed 100% that Yongmei Group should redeem 50% of the principal first, and the remaining principal loan term would be extended for 270 days with an unchanged interest rate. The principal and interest would be repaid in a lump sum, and the “20 Yongmei SCP003” contract would be considered unbreached. Yongmei Group’s debt crisis had come to a temporary conclusion.

The debt crisis was on pause but the underlying problem remains to be resolved. This is the problem of rigid payments, a concept derived from the trust sector, which means trust company must allocate principal and earnings to investors after a trust product matures. When the trust plan cannot be paid on schedule or there is difficulty in redeeming it, the trust company has to deal with the entire situation.

In fact, there is no legal provision in China that requires trust companies to instigate a process of rigid payments. This unwritten industry rule results from loose financial markets in China and capital institutions competing for funds.

Later, rigid payments spread to other industries, such as wealth management products. In the bond market, investors asking the controller behind the bond issuer to deal with everything can actually be regarded as a rigid redemption situation. When there is an expectation of rigid redemption, investors are prone to underestimate the risk of an investment product, and when something goes wrong, suspicion may reappear, leading to a large-scale revaluation of the market.

Due to the existence of rigid payments, state-owned and private enterprises are not on the same starting line, the role of the market economy is constrained, the poor financing environment of private enterprises cannot change much, and reforms and efficiency of state-owned enterprises will be delayed. Therefore, to thoroughly improve the financing environment for private enterprises, especially small and medium-sized private enterprises, removing rigid payments in the state-owned sector is an important part.

To sum up, whether by increasing the proportion of direct financing or breaking down the system of rigid payments from state-owned enterprises, it is necessary to straighten out market mechanisms, let risk correspond to return and people do what they are best suited to do. Only in this way can we overcome the two most stubborn problems of the financial market - moral hazard and adverse selection.

This is a commentary on the CKGSB BCI report for November 2020 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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29 November 2020