Commentary on the October 2021 CKGSB Business Conditions Index

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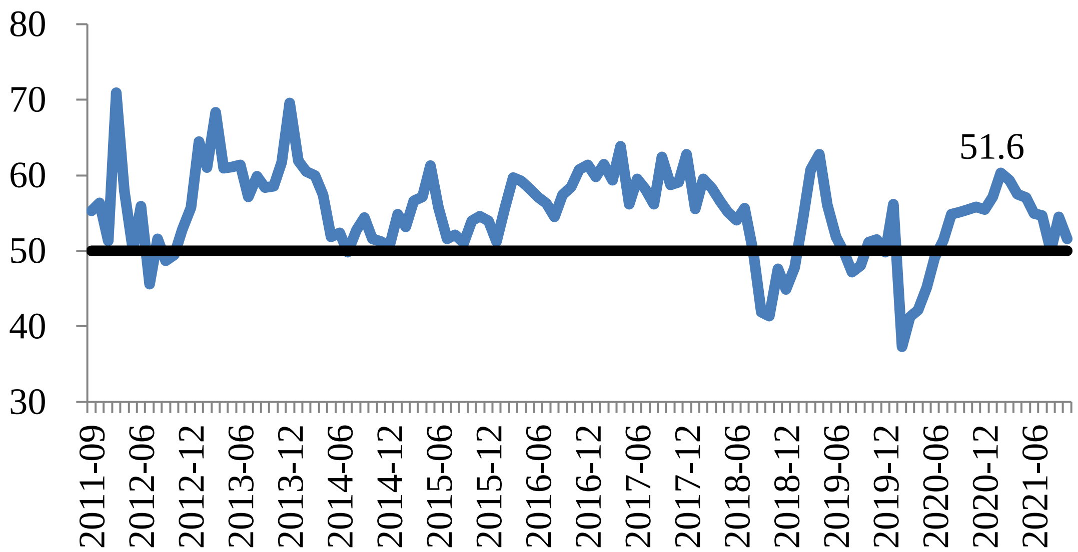
The October reading of the CKGSB Business Conditions Index (BCI) dropped from 54.5 to 51.6, not far above the confidence threshold (Figure 1).

Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

The first thing to consider is that China's GDP is on the decline. According to the National Bureau of Statistics, the GDP growth rate in the third quarter of 2021 was 4.9% year-on-year, a drop of 3 percentage points from the 7.9% registered in the second quarter. Two reasons stand out, one being a strong rebound in GDP growth in last year's third quarter, a hard act to follow this quarter, and the other being policy interventions across industries that have intensely controlled economic output, especially in education training, and in real estate. In education, the policy of "double reduction" has ringfenced school curriculum areas from private education, hitting private businesses with rounds of regulation. The policy of capping electricity and limiting production has added to the restrictive environment. It is therefore clear these reasons have dampened GDP growth.

Discussion continues on prospects of short-term GDP growth, but to take a longer perspective, it is clear which way China's economy is trending – downwards. Looking at 2007, this was the year in which the growth rate peaked, reaching 14.2%. In 2019, before the outbreak of Covid-19, this indicator was down to 6.0%. As China loses its demographic dividend, export growth and real estate boom will weaken, which makes a further fall in China's GDP growth rate next year highly likely.

As a developing country in transition, development and structural reform have gone hand in hand in China over the past 40 years. Problems have been solved in spades, but naturally, new problems have arisen. It can be said that structural reforms often promote development, and development also solves many problems caused by structural reforms. A typical example of this is the reform of state-owned enterprises in the 1990s. The problem of state-owned enterprises is not unique to China, and how to smoothly reform these state-owned enterprises is a test of the wisdom of decision-makers. Under the tide of market-oriented reforms, a large number of state-owned enterprises went bankrupt, the unemployment rate increased significantly, and the entire economy was also negatively affected. However, as the number and scale of state-owned enterprises decreased, a large amount of resources occupied by state-owned enterprises in the past, such as credit, were released. It flowed into more efficient private enterprises, which brought new impetus to economic development. With the development of the private economy, it quickly filled the gap caused by the departure of state-owned enterprises. A large number of people who used to work in state-owned enterprises are now employed in private enterprises, and the unemployment rate gradually decreased.

In recent years, while growth has fluctuated, China's economy has shown a tortuous decline as a whole. The bulk of past growth comes from structural reforms, but in the most recent decade or so, the pace of this has slowed significantly. The necessity of real estate taxes demonstrates this. In theory, the new real estate tax will give local governments a stable and sustainable source of taxes. More importantly, its introduction has a good chance of changing the behavior of local governments. It will turn people from being burdens of local authorities to being objects of desire to whom high-quality public services offer an attractive reward. This kind of reform may not only improve efficiency, but also increase living standards. It is an important part of structural reform. But let's wait for the results before acclaiming success of this real estate tax, as past efforts, widely heralded, have often come to naught.

But in all fairness, this real estate tax reform may be late to the game. Implementing a real estate tax when house prices are low has little impact on their cost, and therefore meets little resistance. As house prices are so high, the tax will have a far bigger impact and resistance will be higher too. For the government, the introduction of real estate tax may reduce its income from the sector, from land transfer fees among other things, and this squeeze will probably exceed the amount levied by real estate tax in the short term. At the very least, the introduction of a real estate tax means short-term pain for the government. The current situation is not a perfect case for the government, and it is also a suboptimal choice. Under the effect of path dependence, the government and society as a whole lack the motivation to implement the tax, an understandable outcome.

In addition to economic growth, the development of the real estate sector is another important focus. The debt crisis at Evergrande Group has gotten everyone's attention. As one of the largest developers in the country, Evergrande's fate affects the lives of countless people. The group is known for its high debt, high leverage, and high turnover game, a cutthroat business. And this is not the first time Evergrande has gotten into trouble for it. As early as 2008, the People's Bank of China implemented measures, including interest rate hikes, to control inflation, while the real estate sector was curtailed. At that time, Evergrande suffered a very serious liquidity crisis, and was said to be hanging by a thread. Later, China's "four trillion" investment plan saved Evergrande and made it, a company with significant land reserves, a big future winner. This inspired Evergrande to maintain this mode of operation.

Now we have reached a crossroads. In the face of sluggish GDP growth and bleak winds in housing estates across the country, the word "deregulation" whistles in the wind again. Some signs are already visible. But if we still follow the old path, it will undoubtedly encourage developers and speculators to take more risks, and burden our real estate market with an accumulation of danger. This will have a negative impact on the Chinese economy, and of course this is something everyone wants to avoid.

This is a commentary on the CKGSB BCI report for October 2021 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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