Commentary on the March 2022 CKGSB Business Conditions Index

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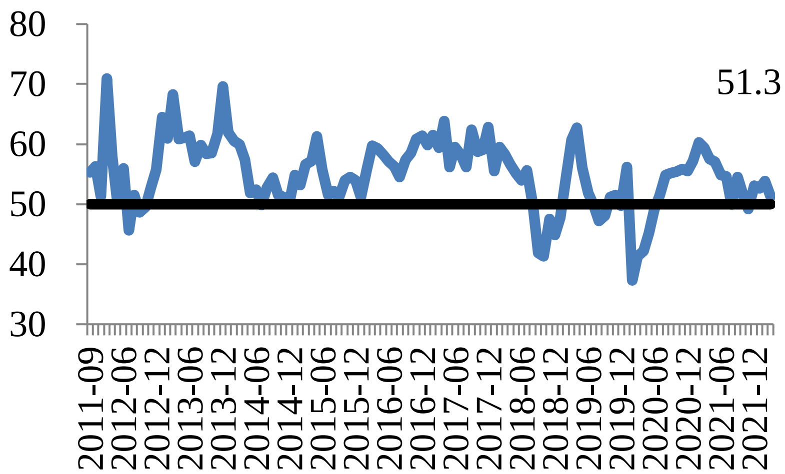
In March, the CKGSB Business Conditions Index (BCI) dropped to 51.3 from 53.8, just above the confidence line of 50.0 (Figure 1). According to our sample comprising of successful business owners in China, company prospects remain positive for the next six months.

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



Source: CKGSB Case Center and Center for Economic Research

As the BCI and its related indices have not changed much this month, the author will offer his views on debt dollarization. Debt dollarization refers to the fact that on the balance sheet of a company, the assets are mainly denominated in local currency, while the liabilities are mainly denominated in foreign currencies (largely U.S. dollars). This currency mismatch gives rise to risk. We do not disallow debt dollarization because of this risk. On the contrary, we need to manage it well.

One of the obvious risks we face right now is a Fed rate hike. Recently, the Federal Reserve raised interest rates by 0.25%, the first raise in several years. In view of serious inflation in the United States, we have to expect the Fed will keep tightening its monetary policy in the foreseeable future. Past experience shows that when the US raises interest rates, the return on US dollar assets will rise, capital will work its way into the US from abroad, and foreign currencies will face greater depreciation pressure. One of the triggers of the Mexican financial crisis in 1994 was Federal Research interest rates going up.

Currency devaluation is not without benefits. For example, a depreciated currency will make a country's export commodities cheaper, which will help it gain more market share, driving exports and economic growth. But for an economy, the combination of currency devaluation and debt dollarization is often a fatal combination. The logic behind this is that dollarizing debt means that companies have currency risk on their balance sheets, especially for those companies whose sales are denominated in their own currency. For most enterprises, when the local currency depreciates, the assets of the enterprise do not change, but the liabilities increase, and the interest expenses settled in the local currency also increase, and many of the assets of the enterprise are long-term assets that are not easily realized, such as machinery and equipment. In this way, the company has the equivalent of a large increase in its debt and financial costs, and eventually, such debt might be overwhelming. When a country has a large number of such bankrupt companies, trouble for the economy is around the corner.

In addition to this, there is a more dangerous combination, namely a fixed exchange rate and debt dollarization. A fixed exchange rate is equivalent to the government providing companies with free insurance against the risk of changes to the exchange rate, which may encourage companies to borrow dollars, especially when the interest rate on dollar loans is low. Historically, there have been many examples of the combination of a fixed exchange rate and debt dollarization leading to currency crises, such as the Mexican financial crisis in 1994, the South Korean financial crisis in 1997, and the Argentine financial crisis in 2001. Before these financial crises, these countries each had a loose or tight fixed exchange rate policy, especially Argentina, which directly bound the peso to the US dollar at 1:1, and implemented the currency board system, which is a very strict fixed exchange rate system.

Why is fixed exchange rate and debt dollarization such a dangerous combination? The reason is that when a country's economy is in trouble, the government's resources to maintain a fixed exchange rate will be in trouble. When the market realizes this, there will be speculative forces attacking the currency, and shorting the currency will come first to mind. In order to maintain the certain exchange rate level, the central bank of the attacked country generally has three options: using foreign exchange reserves to buy local currency, raising interest rates, or implementing capital controls. The weakness of the first method is that foreign exchange reserves are limited, and it is impossible for a country to hold a large amount of foreign exchange reserves for a long time for temporary needs, and the opportunity cost of doing so is extremely high. The problem with the second method is that high interest rates will hit companies' domestic operations, because they will have to pay more to borrow. Many countries try their best to avoid this kind of economic self-harm. The problem with the third method is that it breaks the It reduces policy continuity, creates uncertainty for investors, and capital controls themselves distort markets, resulting in a net loss of welfare. Over time, people will find more and more loopholes in capital controls, and more and more ways to circumvent them, so capital controls, while not entirely unhelpful, are not the best option either.

On a side note, fixed exchange rates and debt dollarization are a dangerous combination for most companies, but not for some, typically exporters. At present, most export enterprises settle their income in US dollars. When the local currency depreciates, the assets and liabilities of the enterprises will change in the same direction, so the risks brought by the exchange rate can be hedged to a large extent.

China had a fixed exchange rate system for a long time, and its exchange rate is nowhere near fully liberalized today. Although China has huge net exports -- 4.36 trillion yuan-worth last year -- as long as this trend is maintained, structurally speaking, the yuan should appreciate. However, domestic asset prices are already quite high. Once the free flow of capital is loosened, a large amount of funds may flow out of China to buy assets abroad. Therefore, in the short term, there may be obvious depreciation pressure on the yuan. Once it depreciates significantly, Chinese companies that dollarize their debt will suffer an immediate impact. If you don't believe it, you can ask Evergrande, a company that has issued a large number of US dollar bonds in Hong Kong.

In short, the United States has entered a cycle of raising interest rates, and China's asset prices are high. Many Chinese companies (real estate developers in particular) have borrowed US dollar bonds abroad. Once the yuan depreciates significantly, these assets will be worth less and their balance sheets will suffer. With the domestic economy impacted badly by Covid-19 measures in recent months, the dollarization of debt may push companies into bankruptcy, which will be even worse for the Chinese economy.

This is a commentary on the CKGSB BCI report for March 2022 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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