Commentary on the March 2018 CKGSB BCI

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In March, the CKGSB Business Conditions Index (BCI) fell slightly from 59.5 to 58.3, representing a minor deterioration of business conditions in the past month. This month's BCI indices include some interesting changes, one being that the prices indices have risen significantly. The second is that investment and recruitment prospects have weakened. For comprehensive figures, please refer to this month's data report.

This month's data brings up two points of discussion:

First, the recent rise in the prices indices should to be noted. Reflecting on past BCI data, the consumer prices index has been on the rise from the second half of 2016. Between 2015 and the first half of 2016, the consumer price index fell below 50 several times, and now this month's index has reached a very noticeable peak of 77.3.

The producer price index was later to rise than the consumer price index, by around a year. However, since then, the index has showed steady growth. Albeit consistently lower than the consumer price index, it should be noted that over the course of our six-year-long survey, the producer price index dwelt below 50 for the majority of the time. It has now crossed the confidence threshold of 50, and has reached 57.1 this month.

At the same time, China is experiencing relatively serious overcapacity in the industrial sector, posing a strong downward pressure on producer prices. Taking this into account, recent changes in the outlook for producer goods prices should not be ignored.

According to our problem set, the BCI prices indices are all about our sample companies' expectations regarding product prices in the next half year, so they are naturally the leading indicators of future price levels. The current situation is like this, but the forecast will really take effect in six months' time.

Our data is showing this, but what about the official data? According to Wind database, the February Consumer Prices Index (CPI) grew 2.9% year-on-year, much higher than January's 1.5%. This may be due to Spring Festival falling in February this year, as over the holiday period consumer products such as food often see a short term price hike. Therefore, making a comparison using February and January figures is not completely satisfactory. Nevertheless, we note that February's 2.9% y-o-y growth rate is the highest since November 2013 (CPI y-o-y 3%). Between 2014 to 2017, there have been four Spring Festivals, yet the monthly CPI has not risen as high as this year's February. We believe this may mean that recent inflation is going through a new set of changes.

The February 2018 producer price index (PPI) rose by 3.7% year-on-year. On the surface, the PPI is higher than the CPI, but looking at the trends, the current PPI seems to be on a downward path. A few short months ago in October 2017, the PPI was still at a high of 6.9%. However, considering that the PPI has shown negative growth for a long time in the past few years, the current index of 3.7% is not insignificant.

In terms of sectors surveyed, the CPI is closest to the BCI consumer price index, and the PPI is closest to the BCI producer price index. Taken together, they suggest that China's economy may experience a pattern of rising inflation in the short term. From this perspective, China may need to plan ahead and increase interest rates, and it would be advantageous to do this now, as the US Federal Reserve is raising interest rates at present. As the RMB is still closely linked to the US dollar, the Fed's interest rate hike will exert some pressure on the People's Bank of China to follow suit (see the author's BCI commentary from last month for details). Following the trend and taking action may be the better choice.

The second point is about US-Chinese trade relations. This month's headline news has been the Trump administration's provocation of a trade war with China. As soon as the Trump government announced sanctions, China countered them, with repercussions felt in falls in global stock markets. However, in fact, from the data, China's current dependence on exports has fallen sharply compared with a few years ago. According to the World Bank, China's current account surplus as a proportion of GDP was considerable ten years ago. For example, in 2006, 2007 and 2008, the percentages were 8.4%, 9.9% and 9.1% respectively. Since then, this has gradually declined, to just 1.8% in 2016.

Conversely, although China has a large surplus with the US, China is in deficit with many other economies. An important reason is that China often plays the last role in the international production chain. For example, there are many suppliers for Apple cell phones. South Korea's Samsung produces their screens. These supplies are exported to China, where the phones are assembled for shipping overseas, including the US. On the surface, China has created surplus by exporting Apple cell phones to the United States. However, in reality, China earned only a small percent of hard earned money in this process. Most of the surplus should actually count as other countries' surplus with the US.

However, China is currently the world's largest exporter. Exports not only bring economic growth to China, but also create a massive amount of jobs. Therefore, if the trade war gets worse, resulting in economic decline, its ultimate impact on the Chinese economy carries a degree of uncertainty. But we can also think about this issue from another perspective. If China exports so much and has a current account surplus, is this actually a good thing?

Two concepts need explaining: First, the balance of payments: current account surplus = net capital outflow; Second, net capital outflow = unofficial net capital outflow + official net capital outflow. Although China's unofficial net capital outflows have long been in the red, only turning positive in recent times, official net capital outflow has been consistently positive. In other words, Chinese companies and individuals have long accepted incoming foreign investment greater than their own investment overseas. However, China's officialdom, mainly the People's Bank of China, is an increasingly large foreign investment player. China's growing foreign investment can be mainly put down to large foreign exchange reserves created by the central bank's large-scale purchase of foreign national debt.

From 1994 to 2017, China had a current account surplus every year, totaling over USD 3 trillion. We exported goods and services in exchange for foreign exchange, and used this foreign exchange to invest overseas. Even the US Treasury holds just USD 1.1682 trillion (US Treasury data point of January 2018), ranking first among all foreign investors. Total combined foreign investment is USD 6,260.4 billion, of which China accounts for 18.7%.

China's rapid economic growth and high capital return rate mean that it should be a country of net capital inflow. The international balance of payments should be reflected as a current account deficit. For developed countries, economic growth is slow, and returns on capital investment is low. This means they should be net capital outflow countries. In terms of balance of payments, they should show current account surpluses. In actual fact, the current situation is completely opposite. While we save reasons for another discussion, at the very least this is clearly unreasonable. China's per capita GDP is still lagging behind that of developed countries. We borrow money yet receive very low interest rates (financial bonds and other financial products are safe and liquid, but yields are very low). What is the logic to having poor people lend money to the rich, at low interest rates? Therefore, even if Trump's government does not initiate a trade war against China, China should take measures to change the current situation, at least to gradually reduce the size of its current account surplus, even to the point of deficit, and even over the long term. Being in deficit is not something to worry about.

This is the author's commentary on the CKGSB BCI data for March 2018. Do not hesitate to contact the BCI team by way of the email addresses provided in the February BCI data report.

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