Commentary on the July 2018 CKGSB BCI

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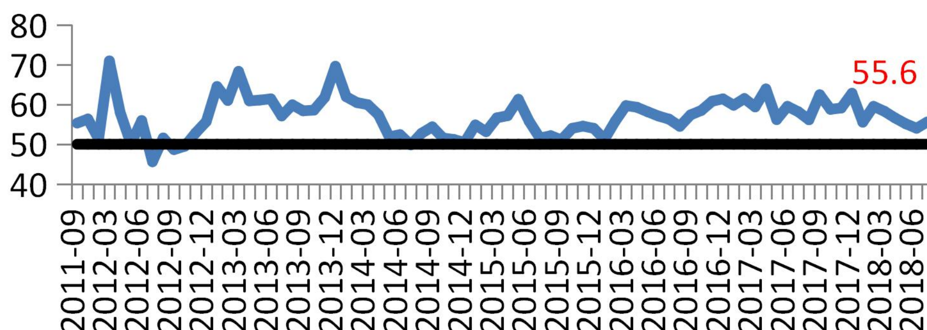
In July, the CKGSB Business Conditions Index (BCI) rebounded slightly to 55.6 from 54.0, but stayed not far off the confidence threshold of 50 (Figure 1).

Figure 1 Business Conditions Index (BCI)

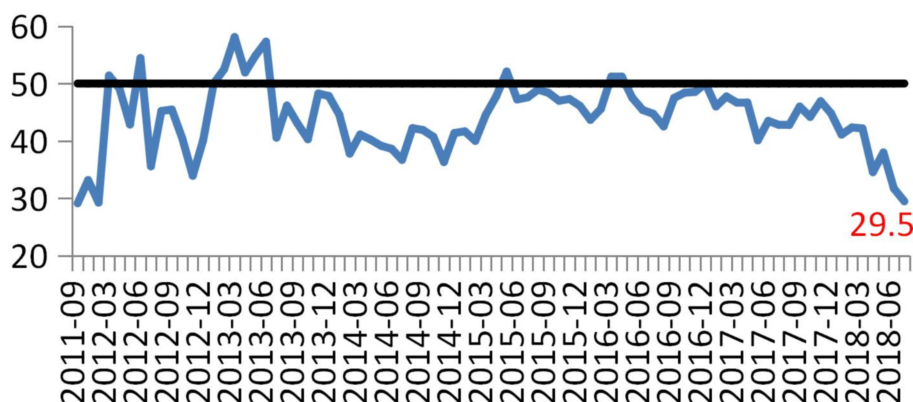


Source: CKGSB Case Center and Center for Economic Research

Trends this month stayed on course for the most part, with costs as an example. Other indices did show clear shifts. The consumer prices forecast jumped from 64.8 to 71.4. For more details, see the July BCI report in full.

This month, particular attention should be paid to financing. Following a sharp drop in June, the index has fallen again, and is now only a short step away from its historic low point (Figure 2).

Figure 2 Corporate Financing Index



Source: CKGSB Case Center and Center for Economic Research

July’s financing environment index is 29.5, the third lowest since the survey began, with the other two

lowest scores being 29.1 (September 2011) and 29.2 (December 2011). In nearly seven years since the survey began, it has registered under 30 just three times, and is this month just 0.4 points away from the lowest it has ever been.

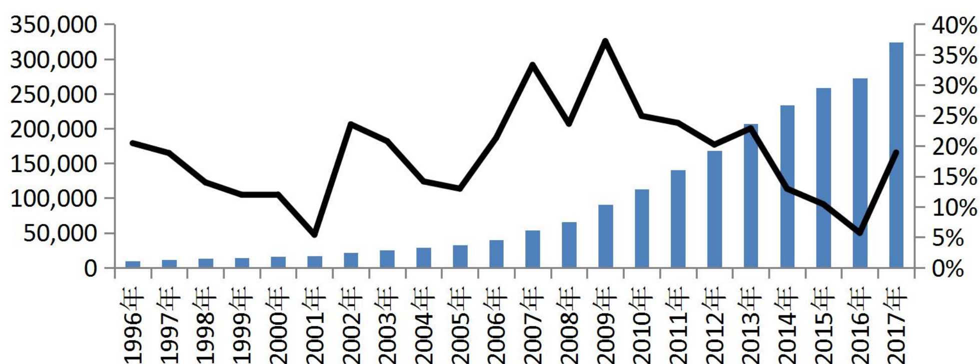
BCI respondents are mostly CKGSB alumni, whose high performing private SMEs have been hardest hit by the ever more restricted funding opportunities. Even knowing this, the level of deterioration of the financing index is rare. While private SMEs have never had it easy on the capital markets, a little disputed fact among economists, why have it all of a sudden got even worse?

In 2016, total savings to GDP in China were as high as 47%, making China the saving champion of the world among major economies. A high savings rate and a group of excellent companies that have financing trouble? How could this happen? The author’s view is that China's financial system structural problems mean it cannot meet the needs of the real economy.

In the author’s opinion, changes in the domestic financial environment are to blame. Specifically, the current situation largely results from a deleveraging campaign. First of all, leverage is a neutral word and modern economies are essentially credit economies. Economic development is inseparable from leverage. In other words, the availability or lack thereof of leverage is not in itself a measure of national economic and financial health.

When talking about China's leverage ratio, we inevitably come to the 2008 global financial crisis and subsequent RMB 4 trillion stimulus package. One of the biggest outcomes of the RMB 4 trillion deal was that China was soon awash with credit. According to data from Wind, new loans issued by financial institutions in 2008 totalled around RMB 4.2 trillion. In 2009, this indicator soared as high as RMB 9.6 trillion. Although it later dipped, in 2015 it rose again to around RMB 12 trillion. Taking the RMB 4 trillion stimulus package as a dividing line, China’s credit supply shifted pace dramatically. This has had a clear impact, leading to a rapid rise in China's leverage ratio (Figure 3).

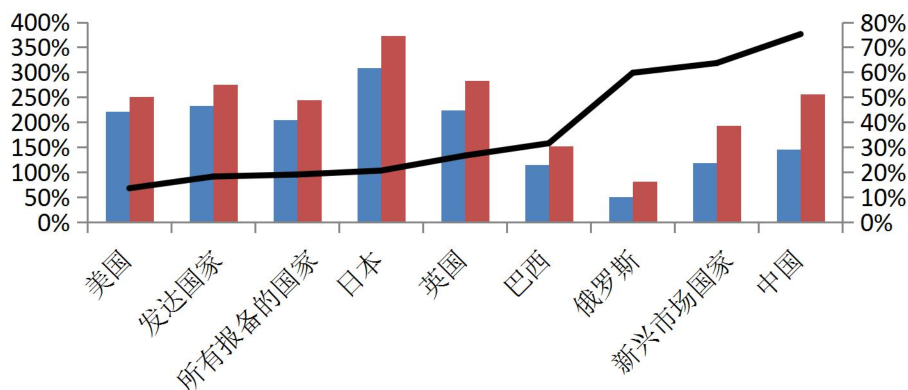
Figure 3 Total Non-Financial Sector* Debt (in USD 100 m)



NB: bars on the left, y-y growth on the right
*The non-financial sector comprise non-finance firms, government and private firms
Source: Bank for International Settlements (BIS)

Even from an international comparative perspective, the growth rate of China's leverage ratio. Figure 4 shows total non-financial sector liabilities of various economies as a percentage of GDP and their rate of increase. China's non-financial sector's total debt to GDP ratio is by no means the highest, but its rate of increase is undoubtably the fastest.

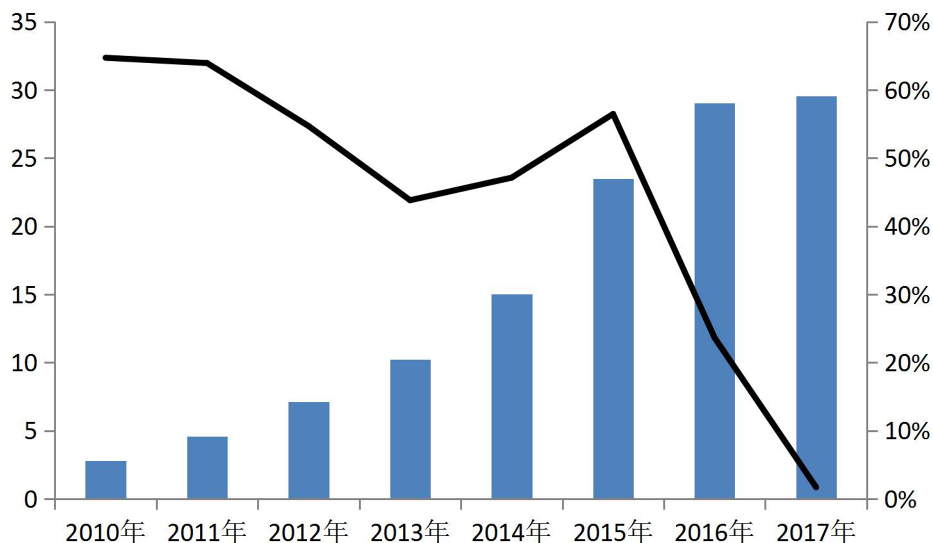
Figure 4 Non-Financial Sector Debt to GDP (by country)



Blue is Q1 2017; Red is Q4 2017; Black (right axis) is growth rate
(Bottom axis L-R) US; Developed Countries; All Countries; Japan; UK; Brazil; Russia; Emerging Market Countries; China
Source: Bank for International Settlements (BIS)

The fast rate of increase of China's leverage ratio has also helped with the growth of shadow banking in recent years, taking wealth management products as an example. The sector was worth just 2.8 trillion RMB in 2010 and has risen to a massive 30 trillion in 2017 (Figure 5).

Figure 5 Bank wealth management products (Billion RMB); Growth y-on-y



Source: Wind

The author's view on shadow banking has always been divided. On the plus side, shadow banking has provided a realistic financing path for many SMEs, has alleviated their trouble obtaining low cost funding, and has helped push financial reforms to some degree. From a negative perspective, shadow banking only exists because of weak regulatory control, in an environment of rigid payments and opaque funding pool operations. In the context of a move to control financial risk, the financial regulatory authorities' tolerance for shadow banking has fallen in recent years. Since 2017, the CBRC and other financial regulatory authorities have initiated a heavy-handed rectification campaign. The effects have been seen immediately, and a heavily pruned shadow banking sector is left today. The proportion of RMB loans in the new social financing package was as high as 91.9% in 2002, plummiting by 2013 to just 51.35%. In 2017, the indicator rebounded to 71.2%.

Judging from the current situation, the determination and strength of the financial regulatory authorities to straighten out the sector is likely to continue for a long time, and some policies will be gradually standardized and legalized. For example, asset management regulations are currently being extended. It is likely that launching new rules will not be able to curtail the growth of shadow banking altogther but will at the very least provide a bridle, shining a light on practices in a previously dark corner of finance.

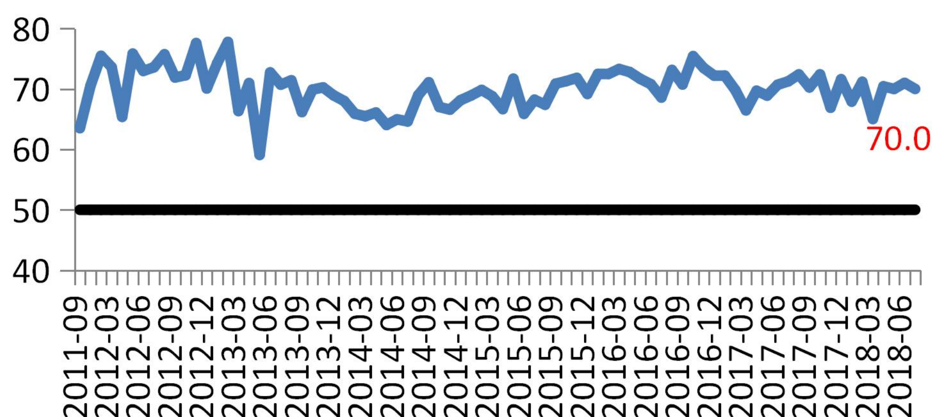
In the last few years, various institutions have made predictions about China's leverage ratio. They may have arrived at different figures, but the general trend has been consistent. The leverage ratio is rising rapidly, and China's financial system is accumulating risk. Corporate default incidents are cropping up more frequently. The Chinese government attaches great importance to financial risk, and is implementing measures in an attempt to control it. To date, research by a number of institutions has shown that leverage rates have begun to stabilize.

About controlling financial risk, the author is in full agreement with the attitude taken by the government. As the core of the modern economy, financial efficiency largely determines the level of efficiency of the economy as a whole. At the same time, finance is always accompanied by risk. Failing to tred carefully may lead to disaster. In 2008, despite having the world's most developed financial system, the US experienced a serious financial crisis. Of the five major investment banks on Wall Street, three disappeared in a flash. The other two survived only with Federal Reserve relief (at the cost of becoming commercial banks, so from this perspective, all five major investment banks disappeared). In 1997, financial crisis swept across Asia. Thailand's rapid development has come to an abrupt end. Social unrest broke out in Indonesia, and South Korea's per capita GDP fell by 40% in the wake of the crisis. No such financial crisis has hit modern China to date, but in the 1990s, China's four major commercial banks had huge non-performing assets on their books and were, according to some, "effectively bankrupt."

It makes sense to take a cautious approach to finance, but it should not be taken to extremes. Measures to protect against financial risk should avoid "throwing the baby out with the bath water." In fact, the essense of finance is managing rather than avoiding risk. In the case of banks, deposits can be withdrawn at any time, but the same cannot be said of business loans. Bank balance sheet have a perennial risk of mismatch. But if banks simply decide not to lend money to companies because of this risk, perhaps they should not be in the bank-running business in the first place. Measures should be put in place to control repayment and liquidity risks that arise in the course of doing business, but do not limit efficient companies' chances of obtaining capital, and producing more goods and services. At the same time, these measures should benefit depositors and the banks themselves, for an ultimately acheivable win-win situation.

Financial regulators' emphasis on reining in excessive leverage warrants praise, but current practices also hold a risk of setting in motion counterproductive actions. Why would we say this? Quite simply, one of the indicators in our BCI measures company quality. Respondants who rate their company's performance higher than 50 believe their level of efficiency is higher than their sector's average. The higher the index, the better the survey respondents' business quality. This month's industry competitiveness index is as follows:

Figure 6 Industry Competitiveness



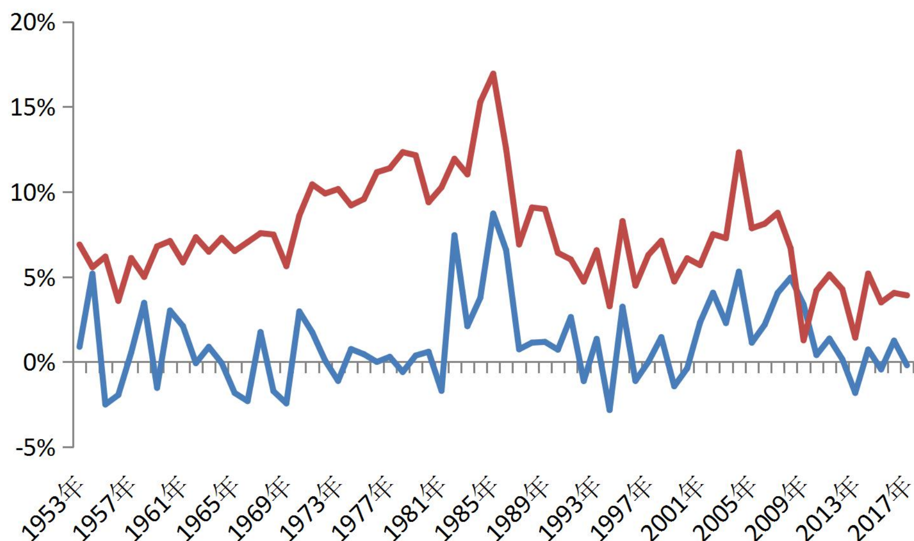
Source: CKGSB Case Center and Center for Economic Research

Clearly, the BCI surveys a group of excellent companies, but the results show that this group of excellent companies still has difficulties obtaining funding. National economic growth is made up of several components: labor, capital and land. But there is also a component called Total Factor Productivity (TFP). TFP is a measure of productivity that includes but is not limited to factors such as technological advancement, organizational innovation, specialization, and production innovation. In other words, economic growth that cannot be explained by factors such as labor, capital, and land, can be attributed to TFP. Economic research has found that the sustained and benign development of a country's economy must rely on the development of TFP. That is to say, production factors such as labor, capital and land are more limited. Economic growth obtained by increasing inputs of these production factors is hard to sustain. Only TFP growth can enable a country with limited investments to continuously increase output.

One of the best ways to increase TFP is to preferentially allocate resources to the most efficient companies. For example, financial institutions can allocate funds based on efficiency. Although current practice has managed to bring total debt levels under control, financial reforms have had a lag effect which has put SMEs in a weak position in the capital markets. If monetary policy is tightened again, they will be first to fall victim. As a result, although financial supervisory authorities control total leverage, there is a risk that funds are mismatched and it will be harder for highly efficient companies to obtain financing. The deterioration of the efficient corporate financing environment will inevitably affect its development and ultimately undermine economic development as a whole.

We need to pay attention to the fact that the leverage ratio is composed of total debt and GDP. The damage to GDP is not conducive to de-leveraging. In this respect, the historical experience of the United States may be referenced:

Figure 7 Blue: Non-Financial Sector Debt to GDP year-on-year growth/
Red: Non-Financial Sector Debt Totals year-on-year growth



Source: Bank for International Settlements (BIS)

Figure 7 shows that year-on-year growth of total liabilities in the US non-financial sector is significantly higher than year-on-year growth of total non-financial sector liabilities to GDP. In terms of calculation, the non-financial sector total liabilities growth rate ÷ GDP year-on-year growth rate = non-financial sector total liabilities as a percentage of GDP growth. Therefore Figure 7 means that the US GDP growth rate has remained at a relatively high level during this period.

In fact, the Chinese government is well aware that deleveraging measures may incur collaterol damage and any policy effect may be in diametric opposition to the intended outcome. Therefore, while deleveraging, the government has recently introduced policies to solve SME funding problems. On June 24, 2018, the PBOC website released a report that from July 5, 2018, RMB deposit requirements for large state-owned commercial banks, joint-stock commercial banks, postal savings banks, city commercial banks, non-county rural commercial banks, and foreign banks would be reduced. The reserve ratio is 0.5 percentage points. Among them, small and medium-sized banks such as the Postal Savings Bank, the City Commercial Bank, and the Non-County Agricultural Commercial Bank have been requested to use these RRR cuts to lend to small and micro enterprises, and focus on alleviating SME funding issues.

Adding to this, the author would like to point out that, at present, there are two ways to solve the problem of financing difficulties for SMEs. One is to relax conditions in which shadow banks operate and let the system serve SMEs. The second is to strengthen supervision of and limits placed on shadow banks. At the same time, targeted policies and administrative orders should be used to alleviate the funding difficulties of SMEs. The author's problem is, if you consider the risks and benefits, which method is more suitable for solving the above-mentioned funding plight?

综上所述，笔者认为从大局上来说去杠杆是必要的，但在去杠杆的同时，更重要的是进行金融和财政等方面的改革，让各项措施相辅相成，解决一些结构上的老难题，至少要有所缓解。一些效率低的企业要去杠杆，一些效率高的企业反而要加杠杆，不能简单的将降低总杠杆率作为政策目标，不然的话我们可能会重复过去的问题——总量问题的缓解是以结构问题的恶化作为代价而实现的。最后在市场中是劣币驱逐良币，良好的政策愿望与其结果相去甚远、甚至背道而驰，徒留一声叹息。

In summary, the author believes that deleveraging is absolutely necessary from an overall perspective, but that it should take place alongside financial sector and finance policy reforms, so that various measures can complement each other to solve structural problems, or at least offer some relief. Some inefficient companies need to be deleveraged. Other high-efficiency companies should add leverage. Simply reducing total leverage cannot be the goal, or past mistakes risk being repeated. The reduction of the overall problem should not be realized at the expense of a deterioration of financial structural issues. Otherwise the market will be full of bad money being thrown after good. Seeing the results of well intended policies fall so far short, even sometimes running contrary to them, leaves those of us watching no choice but to let out a long sigh.

This is the author’s commentary on the CKGSB BCI report for July 2018. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei
July 24, 2018