Commentary on the August 2019 CKGSB Business Conditions Index

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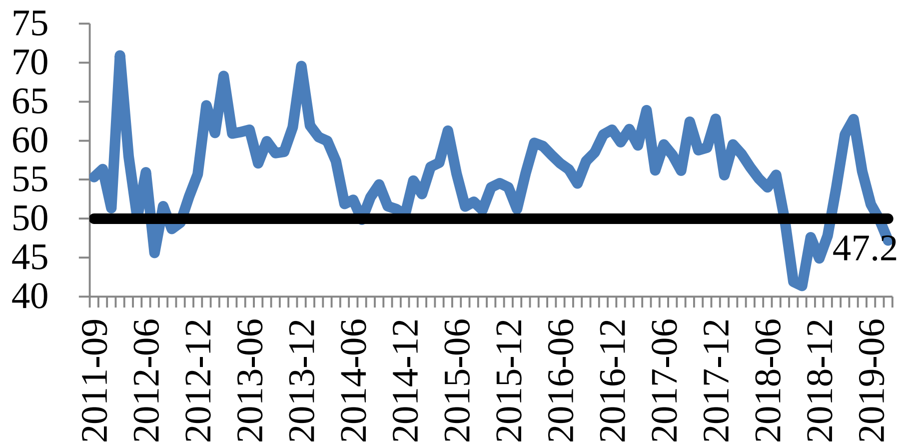
The CKGSB Business Conditions Index fell further to 47.2 in August, a slight deterioration on last month's 49.8, returning the BCI clearly below the confidence threshold of 50.0 (Figure 1).

Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

Casting an eye over this month's BCI report, the word to most likely to spring to mind is 'weak'. Why? Put simply, all indicators have fallen, whether by big or by small margins. We may not be unable to classify this trend as a recession yet, but evidence of weakness is more than enough for concern.

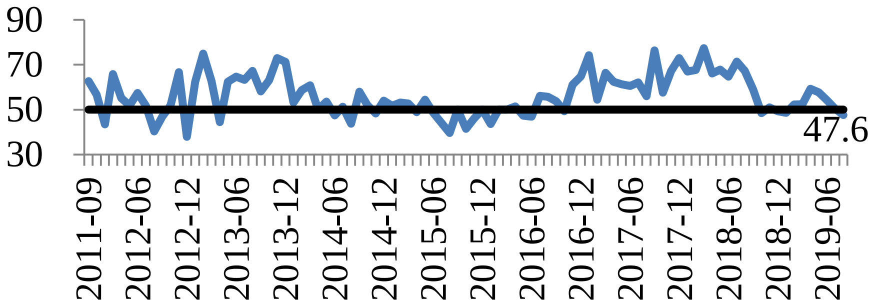
Official statistics also show this weakening trend. In the first quarter of 2018, Wind reported that year-on-year GDP growth was 6.8%. Fast forward to Q2 2019, and growth has fallen to 6.2%.

This weakness should not be underestimated, as it sets the tone for current economic trends, which determines our macroeconomic policies. If we were on the gold standard and the renminbi could be exchanged freely with gold, it would immediately become a hard currency, and the risk of inflation would be much lower, because you could not immediately obtain a lot of gold. But adopting the gold standard would be the equivalent to putting the economy in a straitjacket, because output growth may well be higher than the rate at which gold can be produced. There would be downward pressure on pricing as a whole, the economy would enter recession, and unemployment would rise. The government would be hard pressed to implement expansionary macroeconomic policies because of restrictions imposed by the gold standard. In the end, the only option would be to wait for wages and prices to fall enough so that the economy could re-adjust.

The gold standard freed us from inflationary concerns, but increased the risk of deflation and tied the hands of macroeconomic regulators. Many of the costs of the gold standard were borne by the general public, but before the Second World War, awareness was limited, and pressures on the government limited. This meant that the gold standard stayed popular for years. Post World War II, many changes have taken place. One is an awakening of public consciousness, and few governments will ignore the voice of the people for long. If a government implements a tight macroeconomic policy for too long and turns a blind eye to deflation, unemployment will rise, and the government is likely to face tremendous pressure.

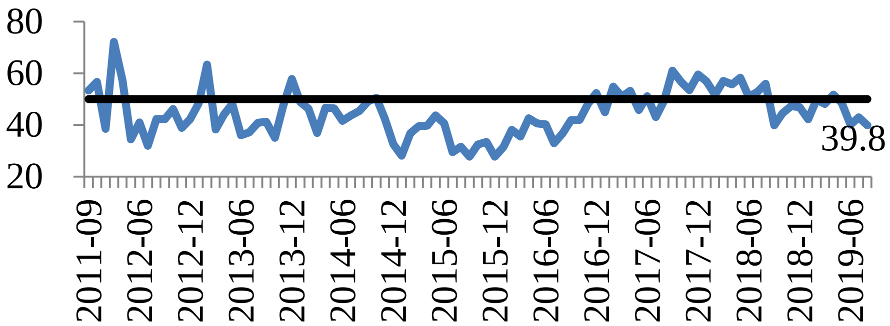
In the author's opinion, China currently faces the risk of deflation, as indicated in these two figures:

Figure 2 Consumer prices index



Source: CKGSB Case Center and Center for Economic Research

Figure 3. Producer prices index



As you can see from figures 2 and 3, our surveyed companies are pessimistic about prices in the next six months, with the index now below the threshold of 50. The economy is weak and prices are expected to fall. If this continues, the Chinese economy will soon indicate deflation. By then, corporate sales will slow, profits will fall, company failure or bankruptcy will be more commonplace, and unemployment rates will increase.

In fact, if we look at some grassroots surveys from this year, unemployment rates have already begun to rise in certain cities. Many people are frustrated by the lack of job prospects and poor salaries. At the moment, these cases are still fairly uncommon. However, we should be extremely vigilant about this trend, because even a large-scale macroeconomic expansion policy will take time to kick in.

However, there is no one need to panic. The government can apply macroeconomic policies to address these issues. If there is deflation, then the government can fully expand its fiscal and monetary policies. China's central government has a very low debt ratio and room for plenty of fiscal tweaks. In principal, as long as it does not trigger inflation and asset bubbles, monetary policy have no limits. Therefore, China's macroeconomic policy is resistant to future deflationary risks. If you have doubts, consider what happened with the "four trillion RMB stimulus package" at the end of 2008. In 2008, affected by the international financial crisis, China's economy stalled. In the first quarter of 2008, the GDP growth rate was 11.5%, and by Q1 2009, it was 6.4%. However, economic stimulus led GDP growth to a rebound back up to 11.9% by the fourth quarter of 2009.

However, macroeconomic policies are not simply anti-deflation, but also there to smooth out cyclical macroeconomic phenomena, anti-deflationary and anti-inflationary. Therefore, although we are faced with the main risk of deflation, we must also be attune to the threat of inflation. It must be an extremely delicate balancing act.

This is the author’s commentary on the CKGSB BCI report for August 2019. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei

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