Commentary on the September 2020 CKGSB Business Conditions Index

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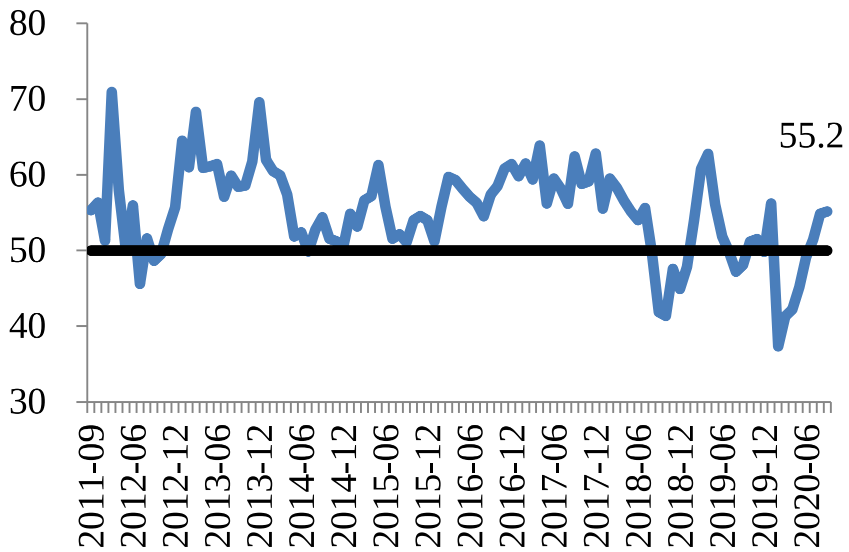
The September 2020 CKGSB Business Conditions Index (BCI) fell from 54.9 to 55.2 (Figure 1). Important to note is that with confidence above 50.0, it appears as though the government's economic rescue policies are hitting their mark. If this continues, there is now a relatively high chance that China's economy will finish this tumultuous year on a positive note.

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



Source: CKGSB Case Center and Center for Economic Research

This month's BCI data has not changed much, but does look a little brighter. First of all, the financing environment has improved four points from 50.0 to 54.0. Those who have tracked the BCI for a while will know that a negative outlook on financing has been a perennial problem, and the index has dropped as low as 20.0, and never surpassed 60.0. For our sample of mainly small and medium sized private businesses, "tough financing, high costs" has accompanied them on their journey, and our financing environment index reflects their position.

China's financing system has long been based on indirect financing. Banks are the center of the financial system, and the government is the banks' majority shareholder. This means the government has a variety of ways at its disposal to guide the flow of funds. In relative terms, state-owned enterprises have it better on the financial markets, while private enterprises are relatively disadvantaged. This means that when policies are tightened, private enterprises are the first to bear the brunt, and when policies are relaxed, private enterprises are the last to see the benefits. The BCI financing index reflects the ensuing trouble private companies have in terms of financing.

Unlike in the past, the financing environment index is currently doing well. This shows that in the face of the pandemic, while the national economy has suffered and external demand has destabilized, the government has enacted targeted measures to alleviate the “tough financing and high costs” associated with being in private business in China. It seems the Chinese government has recognized the problem and put its mind to solving it in an effective way. Although it may not be possible to develop a long-term mechanism to solve the problem, there are ways and skills to lift financing issues for a time.

Separately, each privately-owned SME is a small cog in the economy, but together they make up an important part of the overall economy, and importantly they absorb most of China’s employment supply. If they do badly, the employment market will be noticeably impacted. Employment is not simply an economic issue, but also a political issue, as it brings stability and development to society. For this reason, it must be taken seriously.

Additionally, the consumer prices index deserves our attention, as it rose from 47.8 last month to 50.0 this month, taking it above the 50.0 confidence threshold. When it comes to this index, we need to be wary of the chance of deflation in the sense of a general decline in prices. The last time China experienced deflation was twenty years ago. In a deflationary situation, companies dare not invest or recruit workers, and people dare not consume. Every country would hope to export production capacity, but trade disputes may follow. For this reason, deflation, like inflation, is a major enemy of stable economic growth. This is why so many countries like to lock their annual inflation target within 2% or 3% (rather than a negative number).

In times of deflation, companies experience sluggish sales and declining profits. For highly leveraged companies, deflation also greatly reduces a company’s ability to pay interest or debts, and increases financial risk. Therefore, it is common for companies to lay off employees during deflationary periods. Although prices will fall during deflation and the cost of living for ordinary people will fall, their income may drop faster, completely offsetting any benefits from a falling cost of living. During the gold standard era, the supply of gold often failed to keep up with economic growth, which brought down prices and caused deflation. At the time, there was such strong support for the gold standard that everyone endured this side-effect.

Following the Great Depression (the gold standard and deflation are considered to be major causes of the Great Depression), most countries abandoned the gold standard. Although the Bretton Woods system, a partial gold standard system, was established after World War II, it collapsed soon after. Deflation is now clearly viewed with horror and impossible to return to as a policy.

One of the worries with the Chinese economy is whether or not it will experience deflation, which is hard to see happening now. With the index at 50.0, on the watershed, if the positive trend can be maintained, the possibility of deflation in the future will be very small. From this perspective, there is no need to worry about excessive employment in China.

Finally, we should discuss investment and recruitment prospects. The investment index fell from

63.3 to 62.9 this month, and the recruitment index rose from 65.4 last month to 65.5 this month. The changes to these two indexes are very small this month, and they are now both above 60. This means that most of our sampled companies are willing to invest and recruit workers. The financing environment of enterprises has improved, and prices have slowly risen, giving companies more capacity to spend.

Investment in China is often driven by the government and state-owned enterprises, but the bulk of it is in the private sector and in terms of employment, the main force is private small-and-medium-sized enterprises. As long as these companies are willing to invest and recruit, the Chinese economy will not lag behind, and there will be a solid foundation for establishing strong internal circulation.

This is a commentary on the CKGSB BCI report for September 2020. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

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