

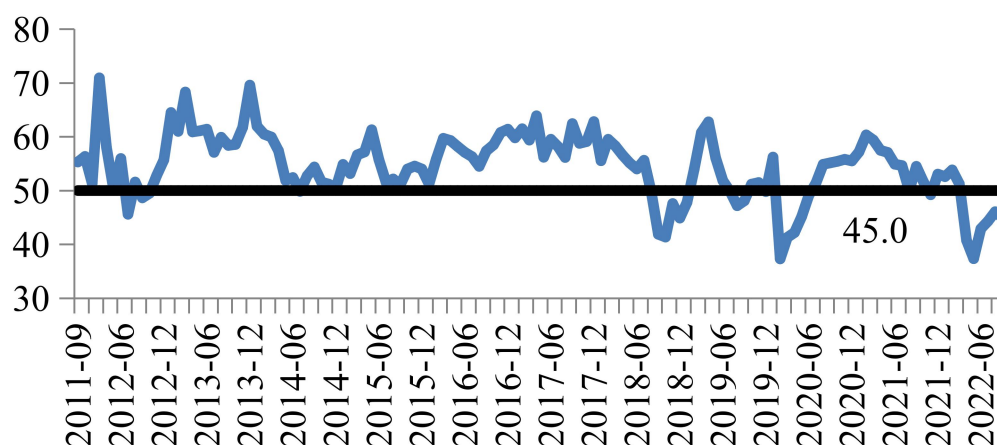
Commentary on the September 2022 CKGSB Business Conditions Index

Professor Li Wei

China's economy is in a particularly weak state this month.

In September, the “CKGSB Business Conditions Index” (BCI) fell another point to 45.0 from 46.1, well below the confidence threshold of 50.0. Although this month's fall in the index is itself small, we can see from the charts that it has put pay to a three-month rebound.

Figure 1 Business Conditions Index (BCI)



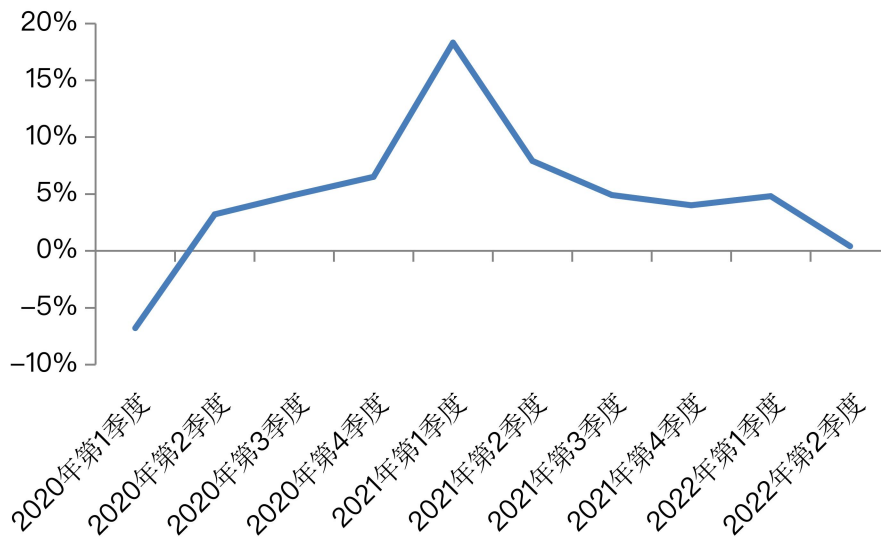
Source: CKGSB Case Center and Center for Economic Research

In the 11 years in which we have conducted the BCI survey, its lowest point of 37.31 was reached in February 2020. This was at the beginning of the pandemic when uncertainty reigned. Since then, the BCI rose for nine months straight before dropping slightly in December 2020, and rising again to a high of 60.3 in February 2022. The BCI made China's recovery look like a beautiful V-shaped rebound.

The BCI then fluctuated, but mainly above the confidence threshold of 50. It dropped under this line to a trough of 40.8 in April 2022, having recorded 51.3 in March 2022. In May 2022, the BCI recorded its second-lowest value in history — 37.34. Subsequently, the BCI rose for 3 consecutive months, but remained below 50. This month's data reversed the promising trajectory, showing that this year's rebound was a weak version of the hearty 2020 uptick. Moreover, it is uncertain what the economy has in store for our survey respondents next year, and how this will be reflected in future BCI survey results.

This is also reflected in government data.

Figure 2 China's quarterly year-on-year growth rate from Q1 2020 to Q2 2022



Note: Blue: GDP growth rate

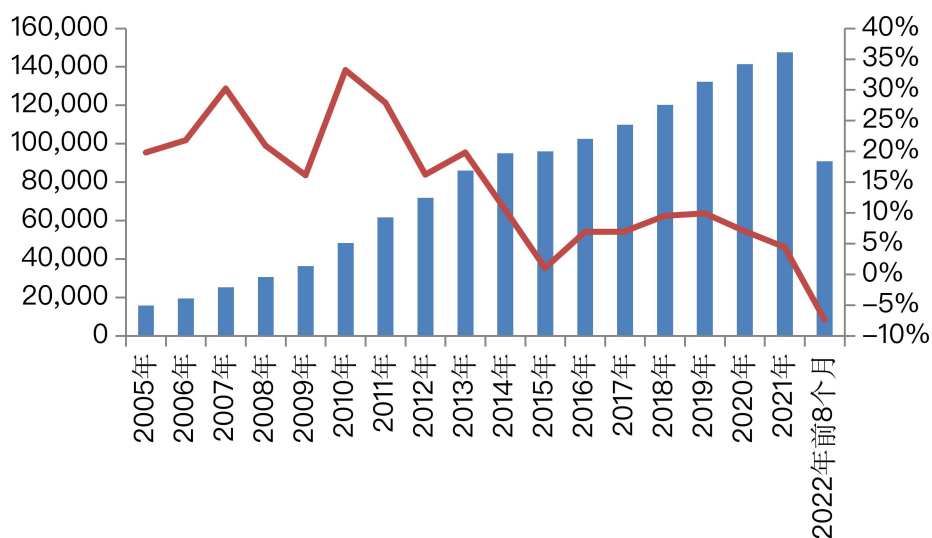
Source: Public information

From Figure 2, when we take the past two and a half years, China's quarterly GDP growth rate displays a typical inverted V-shape, from negative growth when Covid-19 first hit the country to a peak of 18.3% in the first quarter of 2021 once the virus was deemed in check. Of course, a big reason for the peak was how far it had fallen in the first quarter of 2020.

However, since the highs of early 2021, GDP growth has done nothing but fall, and by the second quarter of 2022, indicators show a growth rate of just 0.4%. Observing the data over the past two and a half years, we find that the ups and downs of China's economy are explicitly connected to the course of the coronavirus, with sporadic outbreaks curbed with considerable intensity. As with the negative growth rate in the first quarter of 2020, the downturn in the second quarter of 2022 is closely connected to deflated economic activity due to outbreaks of the omicron strain in China.

Aside from Covid-19, we cannot ignore the fact that economic growth has fallen because the real estate industry is in deep trouble. In this regard, there is plenty of data to sift through. We pick two important aspects:

Figure 3 Investment in real estate

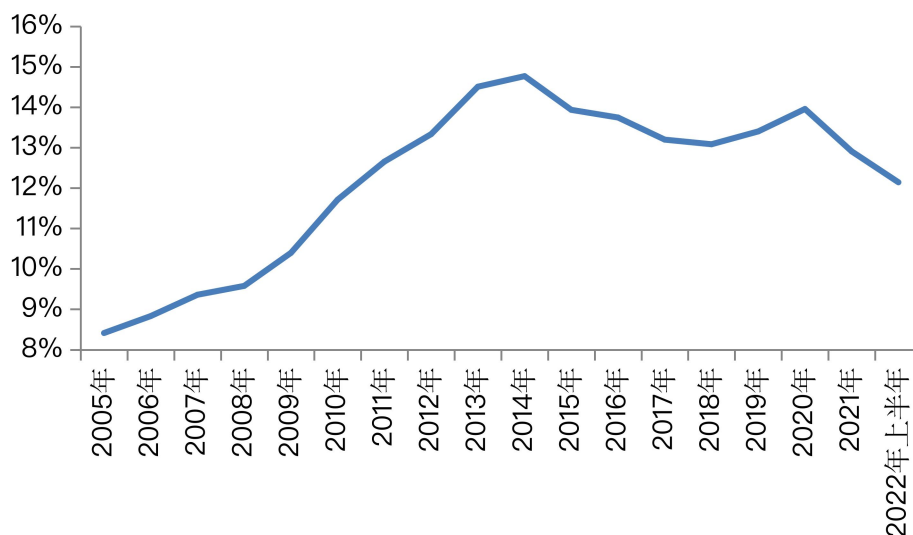


Blue: real estate investment (100 million yuan) on the left axis; Red: GDP growth rate (on the right axis)

Note: 2022 comparison is between the first eight months of 2022 and the first eight months of 2021

Source: CEIC

Figure 4 Investment in real estate/GDP growth rate



Source: CEIC

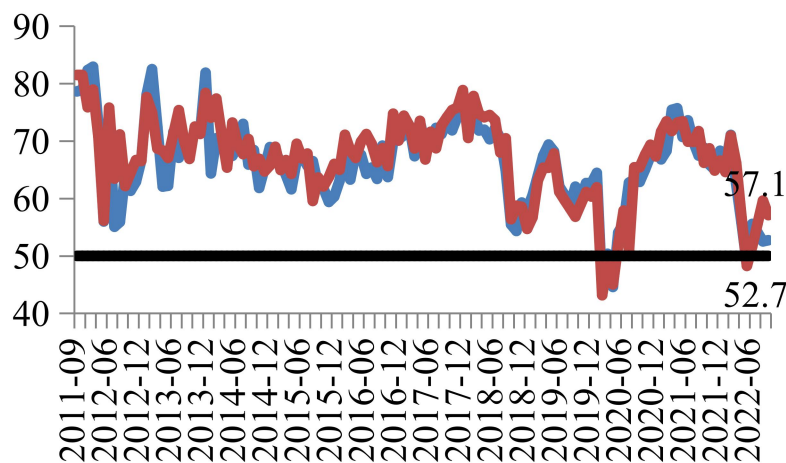
Figure 3 shows that the first eight months of 2022 bucks the trend of growing real estate investment every year since 2005. In the first eight months of 2022, year-on-year growth of real

estate investment was negative 7.4%. Since 2015, the year-on-year growth rate of real estate investment can be characterized as an inverted U-shape.

Figure 4 shows the contribution of real estate to the Chinese economy. According to the World Bank if upstream and downstream sectors like steel are added, the housing market’s contribution to GDP would be as much as 30%, broadly speaking. This would make real estate a veritable pillar of the Chinese economy.

As we all know, China is an investment-driven economy. When investment loses momentum, the entire economy weakens, and this has a knock-on effect on employment. Our data clearly shows this:

Figure 5 BCI Investment and recruitment indices



Note: Blue: corporate investment index; Red: recruitment index

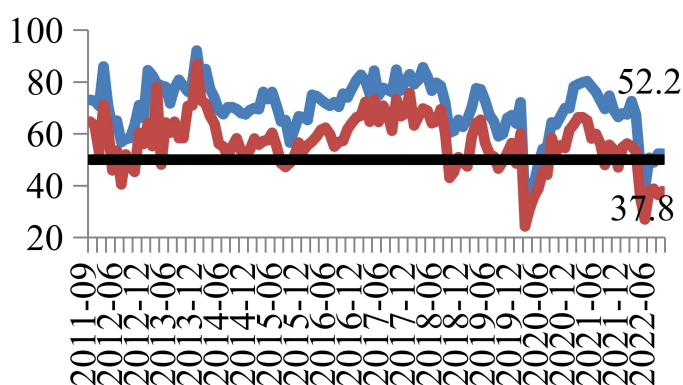
Source: CKGSB Case Center and Center for Economic Research

In Figure 5, the indices for corporate investment and recruitment mainly overlap, and the reason for this should be apparent to the reader. When companies have a strong desire to invest, they will also want to recruit new staff to take on more work, and the economy will flourish amid all the activity. The BCI’s investment and recruitment indices have been generally high, so although recent records are not historic lows, their sluggishness is keenly noted.

So why would companies break a habit and press pause on their spending plans? Perhaps the BCI sales and profit indices will give us a clue. Figure 6 compares how survey respondents view the next six months in terms of corporate sales and profits. From this figure, we can see that although

there is not a total overlap as with investment and recruitment scores, the trend is similar. The BCI sales forecast is a bit higher than the one for profits. Indeed, the first indicator we should look at with a company is sales, and the second is profit. These two indicators are not only connected to indicators such as scale and cash flow, but also to the roots of business operations, the lifeblood of a company.

Figure 6 BCI indices on sales and profit



Note: Blue: corporate sales index; Red: corporate profit index

Source: CKGSB Case Center and Center for Economic Research

Poor business operations will naturally affect government functioning. A typical example of this is income from land sales. According to data from the Ministry of Finance, in the first half of 2022, revenue from the sale of state-owned land use rights was 2.4 billion yuan, down 31% on last year. The income from land transfers belongs to local funds, which are all owned by local authorities. Land transfers generate about 90% of government funds' income. It can be said that the income of government funds is roughly equal to the income from land transfers.

Because many private developers are trapped in tight capital chains, notably Evergrande Group, they are not as active in land acquisition as they used to be, which has led to downward pressure on land sale prices. To hold the market, some local governments have asked local state-owned enterprises, city investment companies in particular, to do their part by buying land at a higher-than-market price. But as soon as such land is put out to tender, it will lose money, so the local government does not make these state-owned enterprises pay land transfer fees, and the land is left undeveloped. With that in mind, a local government revenue fall of a third may even be an underestimate.

So why do local governments feel obliged to prop up the market? First, this can have a stabilizing effect on land prices, which helps future land sales. But this is only one reason, and not the main

one. The biggest issue is land financing. Second, what does it have to do with local governments? Land financing mainly refers to the fact that local governments obtain income by selling land, but their real aim is to use the land as collateral to raise funds on the financial markets. Taking bank loans as an example: when local governments and local state-owned enterprises borrow money from the bank, they tend to use land as collateral. So here comes the question: how is this collateral valued? The higher the valuation, the more money can be raised and vice versa. Land finance brings revenue to local governments, and more importantly, higher land valuations, which is why local governments continue to think the higher the value of land, the better.

Local governments have received large sums of money from land financing, and used these funds to build infrastructure and conduct other government business, as well as attract investment, a cycle that has greatly contributed to urbanization and industrialization across the country. But there are obvious drawbacks. Local authorities tend to raise housing prices, and with this comes a series of social issues, but this is not the most important problem. More important is China's economic growth rate itself. The growth rate is inevitably going to fall gradually, as China has passed peak urbanization and industrialization. This will lead to a slow reduction in demand for land across the country. At present, land valuations can still hold up, but in the long run, a fall in land prices is inevitable. So many financing deals use land as collateral. When this shrinks, financial institutions will be left to prop up the edifice and obviously can't do this alone. When they are dragged into the game, the risk to the whole economy grows.

So what should be the next step? The oft-spoken word "crisis", comprising of risk and opportunity in Chinese, is apt. Times of danger are often full of opportunity. Lessons from the reform and opening up period go to show this. If Chinese policymakers in 1978 had not recognized how much China was lagging behind the rest of the world, they would not have felt the impetus to enact a swathe of reforms in the decades that followed. In the past, local governments have been doing well by relying on land finance and financing, and it is hard for them to find the motivation to reform. But with money from land transfers drying up, their drive to reform has naturally grown.

The author believes that local governments in China must make the switch from relying on land to living off property taxes. This may exert a downward pressure on house prices in the short term, which local governments do not want to see, but in the long-term, property taxes are a less volatile source of fiscal revenue than land sales. It is worth bearing temporary discomfort to reap the benefits later.

More importantly, the implementation of property taxes will change local governments' behavior. For a long time, local governments have not welcomed population inflows, especially of people with lower levels of education, because of all the costly public services they would need to offer their new citizens. Many people suggest the reason for their reluctance is that after reforms of the

tax-sharing system, local governments' financial and administrative powers are not in balance, with high expenditure and low income, so there is no extra money to provide public services. In fact, although the central government now takes the bulk of tax revenue, a considerable part is returned to local authorities in the form of transfer payments. People in contact with local government officials know that seeking investment and accelerating local economic development are high on their agenda. Why don't they make public service provision a priority? As we've said before, public services cost money. The most important part of China's official evaluation mechanism is the development of the local economy. More investment means faster economic growth. In such a situation, investment comes first, and public services are ignored, intentionally or otherwise.

The author believes that property tax can change local governments' incentive mechanism. At the moment, their tax revenue comes mainly from the manufacturing process, which has led to a focus on investment, and the dire situation for public service provision. After property taxes are rolled out, the more residents there are, the more money local governments will bring in. Once people are the way to make money, authorities need to find a way to attract out-of-towners, and a key incentive is better public services. As people are mobile and their needs are different, the introduction of property taxes will not only shift local government targets to providing public services, but also prompt them to offer services according to local conditions, giving rise to diversified offerings.

However, it must be said that the property tax is likely to bring down housing prices in the short term, which will trigger a revaluation of real estate-related collateral, whether for residential mortgage loans, loans from developers, or from the local government. This could cause a valuation crisis, and financial institutions represented by the banks may suffer a greater impact. But this is a hurdle that China's economy needs to face up to sooner or later. Even if the property tax is not introduced, a valuation crisis may still be ahead of us. Trying to introduce a long-term mechanism such as the property tax while avoiding a financial crisis is something that would test even the wisest of policymakers.

In short, the property tax will turn people from "heavy load" to "sweet pastry" in the eyes of local authorities. With the economic downturn, the central government as repeatedly told local authorities to tighten their belts, spend frugally, and protect peoples' livelihoods. The idea is fantastic, but it doesn't solve the issue of local authorities' incentive mechanism. This is something a property tax will largely resolve.

No matter what perspective we take, China's economy is at a crossroads. If we actively embrace change and work as hard as we did in 1978, our prospects are bright for making progress and setting out renewed on a journey to high-quality national development.

This is a commentary on the CKGSB BCI report for September 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.

CKGSB Professor Li Wei

28 September 2022