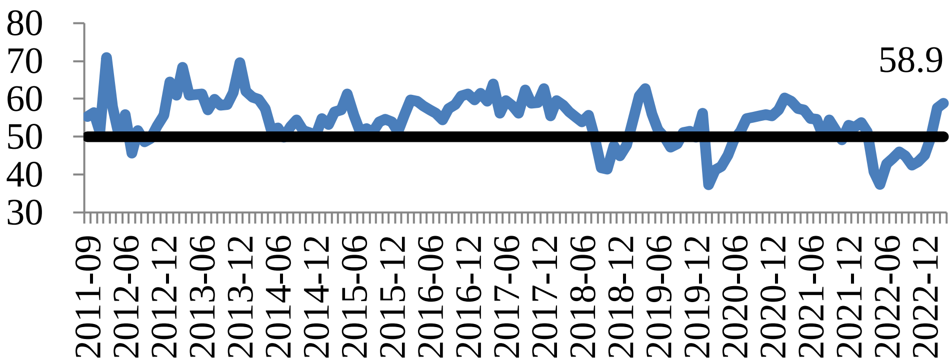
Commentary for March BCI

A Tale of Two Cities: Economy Warms Up While Warehouses Remain Cool

Professor Li Wei

We are finally making economic progress in China. Last month's data signaled a recovery, and this month's Business Conditions Index (referred to as the BCI) continued to improve, from 57.6 in February to 58.9 in March 2023. The moderate rise in sentiment can be seen in Figure 1.

Figure 1 Overall Business Conditions Index



As of March, the BCI has risen for five consecutive months and is currently close to the 60 level. This month's sales, profit and financing environment indexes have all increased to a certain extent, while the inventory index has fallen. Aside from industry competitiveness, where our sample scores well every month, only total cost prospects and inventory prospects have fallen in March. Total cost expectations are only down marginally: from 77.3 to 76.1, while inventory expectations fell from 45.1 to 41.5, far down in the doldrums.

Companies have more in stock than they would like. The increase in inventory prospects cannot tell us if operating conditions are deteriorating, because companies will sometimes actively increase inventories to cope with large upcoming orders. Only when a company produces goods it cannot sell, and funds cannot be extracted for a long period of time, does an increase in inventory show that operating conditions are tough. What is the case now?

We need to see things in light of the macroeconomic background. The short version is that we may now be facing the second situation, that is, operating conditions in terms of inventory are indeed deteriorating.

First, there is a fierce price war going on in the auto market. Anyone who understands car sales knows that this year has been all about price cutting. Whether state-owned enterprises, private firms, or foreign-funded businesses, almost the entire auto industry has joined in, and promotions of some models have skyrocketed. The industry is sitting on vast stockpiles of cars. Some businesses with high inventory cut prices, and others had little choice but to do the same. Actively or passively, consumers benefit from getting quality cars for less, and the market wins by clearing out its excess stock. It is obvious from these moves that China's auto manufacturers have had a serious problem of overcapacity for a while now.

Second, the sale of electronic products has been weak. Let's take smartphones for example. According to data from International Data Corporation (IDC), global smartphone shipments totaled 12.07 trillion units in 2022, and 13.4 trillion units in 2021, a fall of 9.9% year-on-year. In terms of smartphone shipments, Xiaomi is representative. According to IDC data, Xiaomi mobile phone shipments will amount to 152 million units in 2022, a year-on-year fall of 20% from 190 million units in 2021. In fact, even for the mighty Apple mobile phone, shipments in 2022 fell 1.3% compared to 2021.

Shipments dropped because sales did. Taking Xiaomi smartphones as an example, according to the 2022 financial report of Xiaomi Group, the average selling price of Xiaomi smartphones in 2022 was 1111.3 yuan, a record high, but this did not prevent sales dropping. The financial report shows that the sales of Xiaomi smartphones in 2022 will be 167.2 billion yuan, compared with 208.9 billion yuan in 2021.

Lackluster sales have been accompanied by a build-up of inventory. Again, taking Xiaomi as an example, according to February media reports, Tianfeng Securities analyst Ming-Chi Kuo said that Xiaomi had up to 40 to 50 million units in store, a climb from 12 to 16 weeks' worth of terminal items and components.

Third, the real estate market is in depression. In the second half of 2021, many developers, including Evergrande, experienced å financial crisis. Due to a broken capital chain, housing development shutdowns took place across the country, and homes could not be handed over on time. Real estate is a pillar industry of China's economic miracle, with deeply involved upstream and downstream industries. Land prices are deeply connected to housing. According to data from the Ministry of Finance, the revenue from the transfer of state-owned land use rights will be RMB 6,685.4 billion in 2022, a decrease of 23.3% on the previous year. As land transfers and land mortgage financing are the main sources of funding for local governments, this will impact heavily on economic development. Land market depression will affect the income of local governments, which in turn will directly affect China's investment status and the overall economy. This will have a negative impact on development as a whole.

Due to various considerations, the government reversed its regulatory controls over real estate in 2022 and restarted supporting the industry instead. Now, housing prices in first and second-tier cities have begun to stabilize, but real estate in third and fourth-tier cities, the largest component of China's real estate market, is still very sluggish. On March 21, "China's 100 Cities Residential Inventory Report" released by E-House Research Institute showed that inventory in 100 cities across the country declined year-on-year for the first time in 51 months, but the absolute number remained at a high level. Among them, the stock-to-sales ratio of new commercial housing in first, second, third and fourth-tier cities (the ratio of the stock of new housing to monthly sales, indicating the relative inventory of housing) was 13.2, 17.9, and 21.5 months, respectively. This means that without building any new homes at all, it will take nearly two years for third and fourth-tier cities to digest all the new developments they have on hand.

Moreover, these are the cities that are going through population outflow. Housing inventory is at peak levels, but populations are falling. From this point of view, the real estate market in third and fourth-tier cities may remain weak for a very long time.

From the perspective of the BCI, China's economy has rebounded significantly, but the inventory index has headed in the opposite direction, something that deserves our attention. In fact, it isn't a rare phenomenon. First, it could be due to weak external demand, which can be clearly seen from the gradually cooling export figures.

Second, China is unlikely to experience high inflation in the short term, in stark contrast to the inflation problem in developed countries. They have had to raise interest rates, which has brought up yields on most assets, but what China needs is to lower interest rates. If there are loopholes in China's capital account control (and there undoubtably are, so it's more a question of how big), then the possibility of capital outflows will be relatively high. In this case, China should de-peg the renminbi from the dollar as soon as possible and let it depreciate under market forces. Here I want to emphasize that I mean market forces rather than government regulation. In fact, the government should take this opportunity to realize the marketization of the RMB exchange rate as soon as possible and free its monetary policy from state control.

Third is that after three years of pandemic control and real estate recession, the bank balances of regular people are not looking too rosy. Under such circumstances, people's first reactions is to not consume or invest, but rather to pay off debts. Many residents are repaying mortgage loans ahead of schedule. Relevant parties who need the money and dare to borrow, such as local governments, are already heavily in debt, and banks are reluctant to lend to them wholesale. The effect of loose monetary policy is waning, as banks would prefer to lend to people who repay their loans early. From this point of view, what China needs most at present is probably not simply loose macroeconomic policy, but structural reforms to stimulate the vitality of the market and pave the way for the next round of economic growth.

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