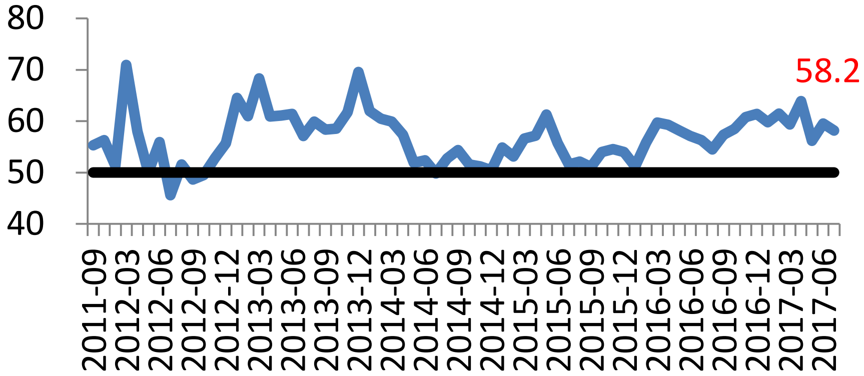
CKGSB BCI

July 2017

27 July 2017 CKGSB Case Center and Center for Economic Research

The Business Conditions Index (BCI) registered 58.2 in July, lower than last month's index of 59.5 (Figure 1). Above the confidence threshold, this shows that most sampled firms remain optimistic about business prospects for the next six months.

Figure 1 Business Conditions Index (BCI)

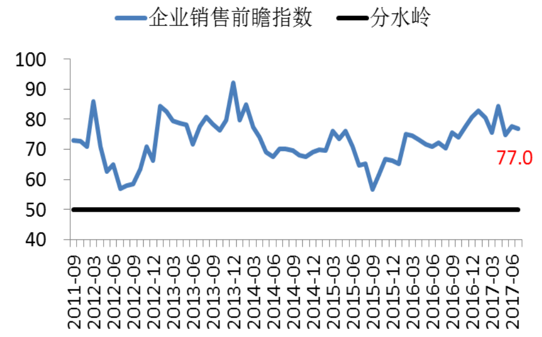


Source: CKGSB Case Center and Center for Economic Research

Without doubt the most important official data released in July was the 1H 2017 GDP growth rate. According to the National Bureau of Statistics, GDP grew 6.9% year-on-year, higher than last year's 6.7%, showing that over a short period of time China's economy has stabilized. CKGSB alumni companies are almost all private SMEs, and the BCI reflects their short-term business conditions. From Figure 1 we can clearly see that for the last six months the overall BCI index has been consistently high. In other words, the BCI confirms China's favorable short term macroeconomic operational conditions.

The CKGSB BCI comprises four sub-indices for corporate sales, corporate profits, corporate financing environment and inventory levels, all measuring future prospects except for the financing environment, which measures the current situation.

Figure 2 Corporate Sales Index



Source: CKGSB Case Center and Center for Economic Research

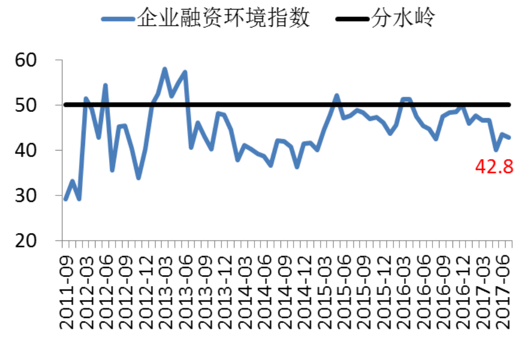
Figure 3 Corporate Profit Index

Source: CKGSB Case Center and Center for Economic Research

This month, all four sub-indices fell. Corporate sales fell from 77.6 to 77 (Figure 2) and corporate profits fell from 70.8 to 67.8 (Figure 3).

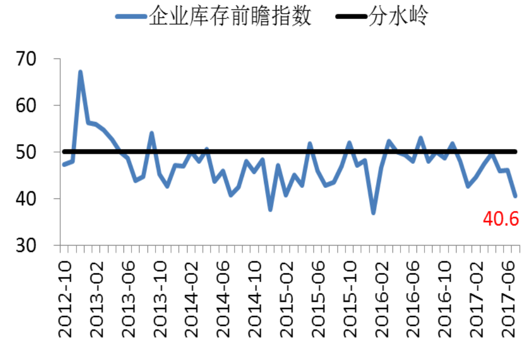
Sales are the very basis of a business's survival, and although good sales do not necessarily mean healthy operations, companies with poor sales will certainly not be doing good business. From Figure 2 we can see that sales forecasts have been quite good for our sample, especially over the last two years. Looking at the profit however, from figure 3 we can see that while our sample's recent profits forecasts have also been positive, from a long time point of view, profit fluctuations have been significantly greater than sales.

Figure 4 Corporate Financing Index



Source: CKGSB Case Center and Center for Economic Research

Figure 5 Inventory Index



Source: CKGSB Case Center and Center for Economic Research

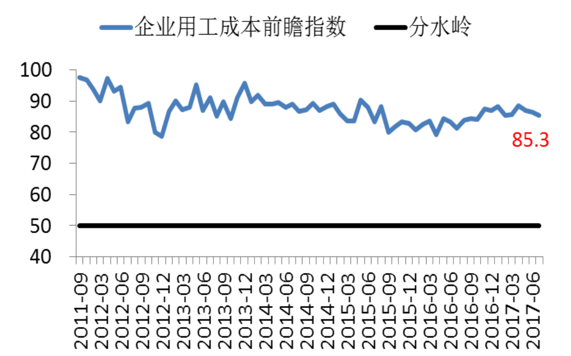
The financing environment index fell from 43.5 to 42.8 in July. We can see from Figure 4 that the financing environment index has been consistently low for our sample of CKGSB alumni, and, given that this consists mainly of China's leading private economic powerhouses, the SMEs, this is a critical issue for reformers to address.

Actually, from a macroeconomic perspective, China does not lack financial capital. According to official data, growth in social financing was in fact very high in the first half of 2017. In the first six months of the year, apart from an 11% dip in March, year-on-year social financing growth reached as high as 77% and 55% in April and May. Although financing is available, it is clear that SMEs, surveyed in our BCI, are unable to access it. This tallies with local data such as Wenzhou's private lending rates and is reflected in media reports.

Falling to 40.6 from 46.0 in July (Figure 5), the poor reading of the inventory index reflects a long term operational bottleneck for our sample. The index has mostly registered below the confidence threshold of 50 since the BCI began.

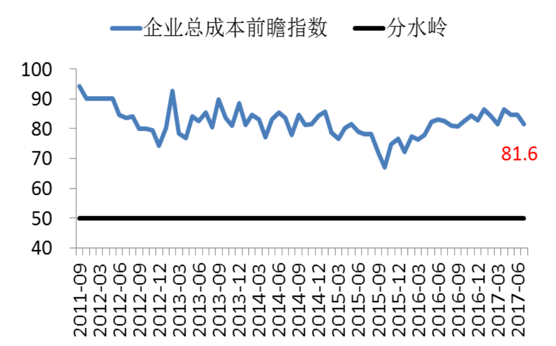
Aside from the main BCI, we also forecast costs, prices, investment and recruitment demand over the next six months:

Figure 6 Labor Costs Index



Source: CKGSB Case Center and Center for Economic Research

Figure 7 Overall Costs Index



Source: CKGSB Case Center and Center for Economic Research

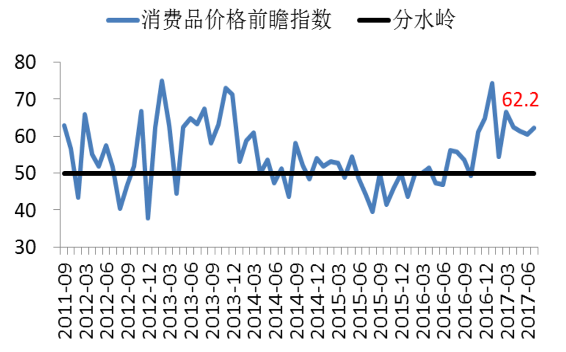
On the costs side, labor and overall costs indices remained above 80, with the former at 85.3 and the latter at 81.6. For specific statistics, see Figures 6 and 7.

Focusing in on BCI costs indices, we note that China's manufacturing cost advantage is, according to our data, rapidly disappearing. In some sense, tied to economic development, one can expect a per capita income increase to bring about cost inflation. It only really becomes a problem when cost inflation is faster than efficiency gains. After nearly 40 years of "reform and opening up", the economy has made huge leaps, but China is nevertheless still a developing country. China's productivity levels are still far below those of developed countries. According to a 2016 study by McKinsey Global Institute, China's productivity rate (hourly output) is 15-30% of the OECD global average. If China's input-output rate continues to fall, then China's economic development cannot be counted on as sustainable. Companies are currently facing multiple cost pressures, including heavy social security contributions and high land prices. How to ensure China's future economic competitiveness is an urgent question.

Turning to prices, the consumer prices index rose from 60.5 in June to 62.2 in July (Figure 8). The producer prices index fell steeply from 51.1 to 43.1, again below the confidence mark of 50 (Figure 9).

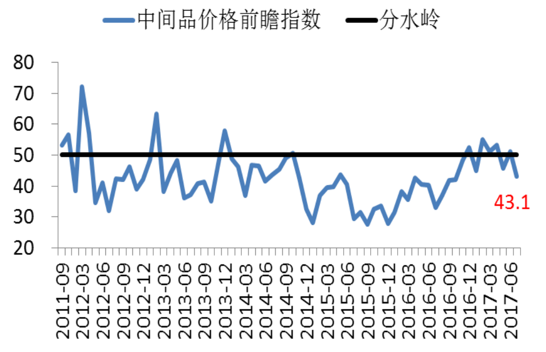
The prices side of the index reflects another problem in the Chinese economy, namely excess capacity, especially for mainly industrial intermediate goods. The consumer prices index currently rests above 60, but overall has been warming up in line with CPI figures. Producer prices had suffered a long-term downturn, corresponding to the continuing PPI malaise. Seeing the costs and prices indices together shows us that the costs of doing business have risen, but that these cannot be transferred downstream or to consumers via prices hikes. In such a situation, companies either improve efficiency, absorbing the pressure themselves, or begin to experience losses, even possibly resulting in bankruptcy. No matter how you put it, companies are facing enormous pressures.

Figure 8 Consumer Prices Index



Source: CKGSB Case Center and Center for Economic Research

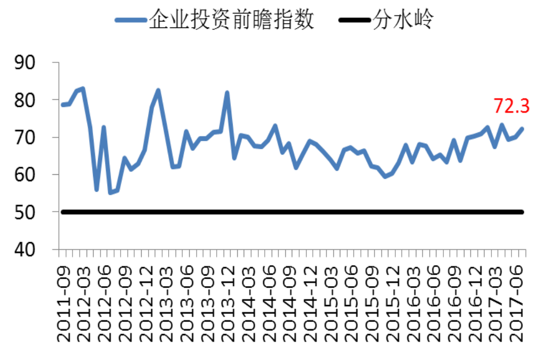
Figure 9 Producer Prices Index



Source: CKGSB Case Center and Center for Economic Research

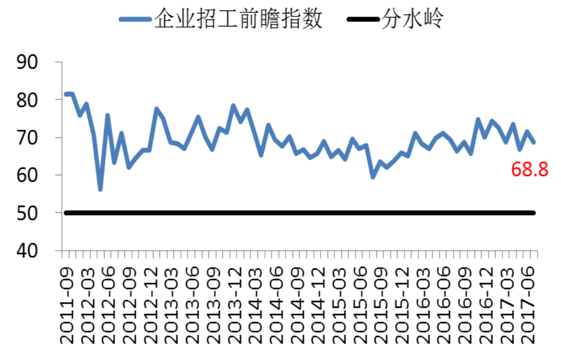
We turn now to the important topics of investment and recruitment. Although investment and recruitment confidence levels have never reached the peaks of the costs indices, they have stayed consistently at the higher end of the scale. This month's investment index was 72.3 (Figure 10), and the recruitment index 68.8 (Figure 11). These indices are interesting because no matter how macroeconomic conditions have changed since the BCI began in September 2011, while indices such as profits and inventories have fluctuated dramatically, as has the overall BCI, three indices have been stable throughout: costs, investment and recruitment.

Figure 10 Investment Index



Source: CKGSB Case Center and Center for Economic Research

Figure 11 Recruitment Index

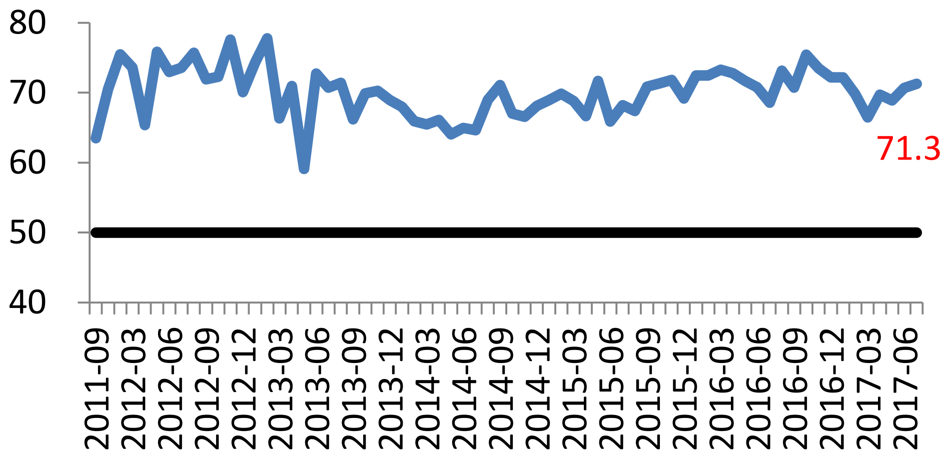


Source: CKGSB Case Center and Center for Economic Research

It is interesting that given the pressure companies face, they still chose the path of expansion. How can this be explained? We believe there are two possibilities, one being that this sample comprises high-quality companies that have improved efficiency so as to deal with external pressure, meaning that they can seize low-cost expansion opportunities; the second is the government's long-term implementation of counter-cyclical policies, bringing in stimulus policies to mitigate against falling economic growth rates. The 2008 "Four Trillion RMB" stimulus plan falls into this category. Under the influence of such policies, economic growth rebounds quickly. This creates a situation in which companies taking advantage of these contraction policies may miss their next growth point. Continued expansion is therefore a rational approach.

The industry competitiveness index shows that our sample is made up of successful companies, but given the government's past actions, we believe that these companies expand in order to keep up with the government's economic policy rhythm. In an environment of cyclical expansion, conservative companies risk falling behind, and eventually being consumed by their competitors.

Figure 12 Industry Competitiveness



Source: CKGSB Case Center and Center for Economic Research

Finally, we include an index recording our sample's relative strength in the market. Figure 12 shows our sample's level of competitiveness over time. As our sample mostly comprises the companies of CKGSB alumni, their competitiveness is consistently higher than the average (50 points) in their respective industries. This means that lower performing firms will experience worse prospects.

CKGSB BCI Introduction

In June 2011, the CKGSB Case Center and the Center for Economic Research initiated a project to gauge the business sentiment of executives about the macro-economic environment in China – called an index of business conditions.

Under the direction of Professor Li Wei, the two research centers designed and tested the BCI survey in July 2011. In September 2011, the first surveys were distributed and first results computed. Since then, from May 2012 to June 2017, 63 monthly BCI reports have been published.

Explanation of the Index

The CKGSB Business Conditions Index (CKBCI) is a set of forward-looking, diffusion indices. The index takes 50 as its threshold, so an index value above 50 means that the variable that the index measures is expected to increase, while an index value below 50 means that the variable is expected to fall. The CKGSB BCI thus uses the same methodology as the PMI index.

The survey asks senior executives of companies whether their main products are for consumers or non-consumers, and then asks how they think product prices will change in the next six months.

Based on survey responses, we have been able to report expectant changes in consumer and producer prices.

We ask companies for information pertaining to their relative competitive positions in their respective industries. Based on survey responses, we compute a competitiveness index for our sample. The higher the competitiveness index, the more competitive our sample firms are in their respective industries.

Method of Calculation

During each survey, respondents are asked to indicate whether certain aspects of their business (e.g., sales) are expected to increase, remain unchanged, or decrease over the forthcoming six months as compared to the same time period last year. The diffusion index is calculated by summing the percentage of "increase" responses and half of the “remain unchanged” responses.

Of all the indices measured for the CKGSB BCI, the overall business conditions index is an aggregate index, which has been calculated, since December 2012, by averaging its four constituent indices of sales, profit, financing environment and inventory. The aggregate BCI index before December 2012 uses a different composition of constituent indices, and is therefore not directly comparable to the current BCI index.

About Cheung Kong Graduate School of Business

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The Research Team

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