Commentary on the April 2018 CKGSB BCI

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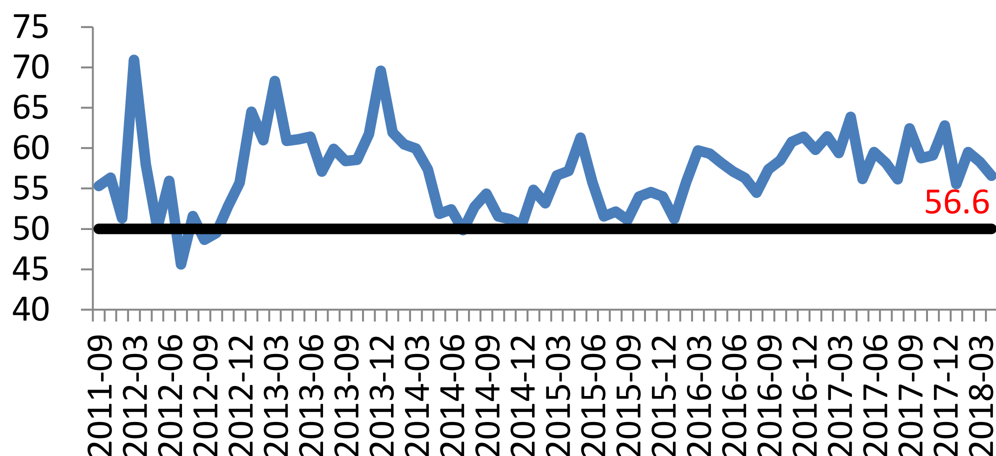
In April, the CKGSB Business Conditions Index (BCI) fell slightly from 58.3 to 56.6, but remained above the confidence threshold of 50 (Figure 1).

Figure 1 Business Conditions Index (BCI)

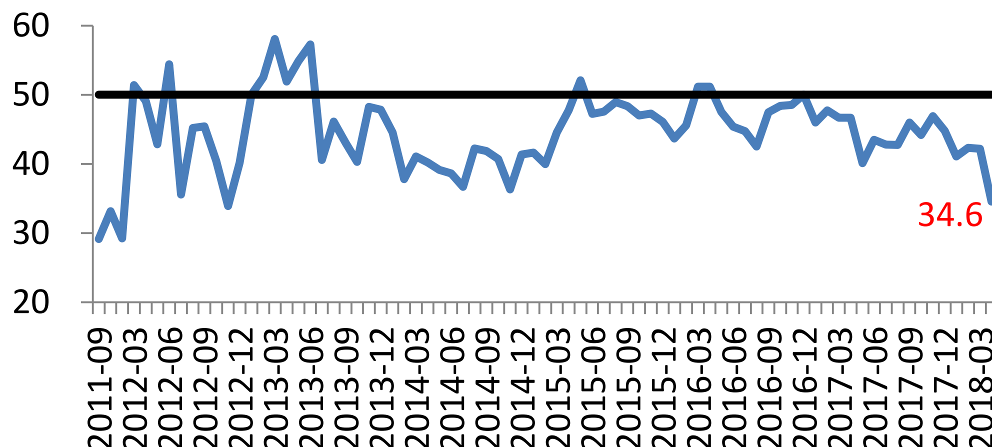


Source: CKGSB Case Center and Center for Economic Research

Some of month's indices have not changed much, namely those on the cost side, and some have changed to a certain degree, namely those on the prices side. For specific content, please refer to the April BCI report. This month's index points to particularly interesting results for one indicator in particular, the financial environment index. The commentary on this month's data will therefore center on financing conditions.

First, let us look at the data. This month, the corporate financing index registered 34.6, much lower than last month's score of 42.2 (Figure 2). It's important to note that this is the lowest figure since November 2012 (33.9), and if this trend continues, it is not impossible to imagine that the index will fall below the lowest figure recorded since the BCI began (29.1, September 2011).

Figure 2 Corporate Financing Index



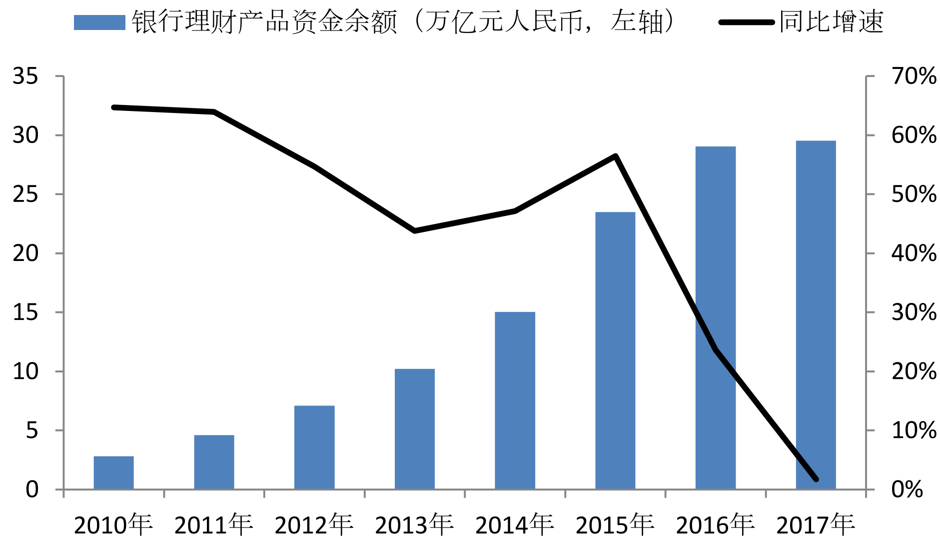
Source: CKGSB Case Center and Center for Economic Research

Our survey respondents are leaders of CKGSB alumni companies. These firms consist mostly of Chinese SMEs. In the current financial markets, they are in a relatively weak position, and have suffered from “financing difficulties and high costs.” Why have conditions deteriorated recently? We believe this is possibly related to recent fiscal consolidation by the financial supervisory authorities.

When it comes to fiscal consolidation, we should first consider the background. In recent years, there has been rapid development of the shadow banking sector. This generally refers to financing taking place outside the mainstream banking system. In China, it includes such financial vehicles as trusts, entrusted loans, and bank promissory notes. According to PBOC data, from 2002 to 2017, the scale of social financing grew from 2 trillion RMB to 19.44 trillion RMB, with an average annual growth rate as high as 17.6%. At the same time, sources of funding changed significantly. In 2002, new RMB loans accounted for 91.9% of the increase in scale of social financing. By 2017, this had dropped to 71.2%, but from 2010 to 2014, this figure was actually below 60% for five consecutive years and reached its lowest value of 51.4% in 2013.

In a sense, shadow banking in China acts in the shadows of the banks. Pressure from regulatory policies and other aspects have given banks a strong desire to list their assets in recent years. Moreover, banks have customers, channels, and credit. In shadow banking, earnings from intermediate services have inherent advantages, so we can see that everywhere, bank networks have added large number of finance service counters. Published data also demonstrates this:

Figure 3



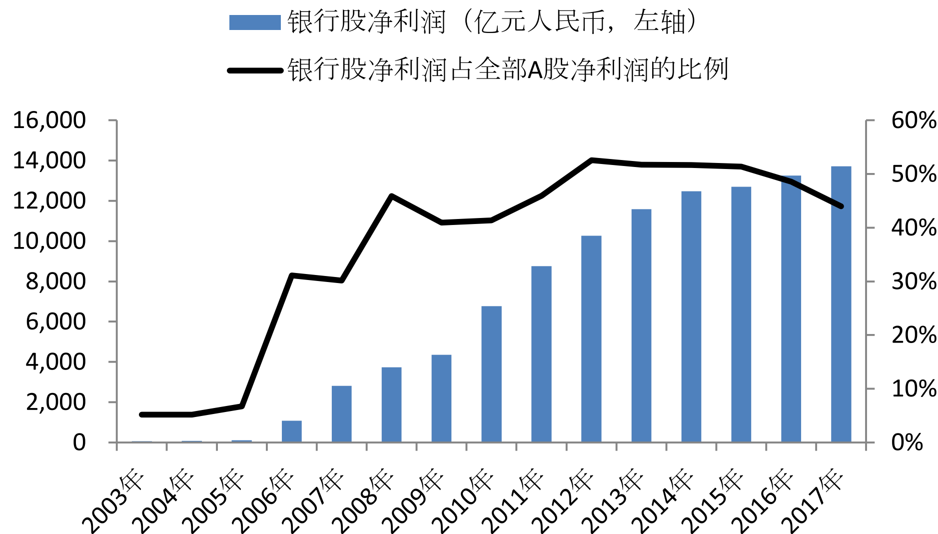
Blue bars = total bank finance product revenue (trillion RMB, left axis); black line = year-on-year growth

Source: Wind database

From Figure 3, we can clearly see that until 2015, the balance for bank wealth management products was growing rapidly. The year-on-year rate of this indicator began to decline sharply in 2016, albeit ending the year on 23.6%. Since 2017, due to massive fiscal consolidation actions by regulatory authorities including China Banking Regulatory Commission, the year-on-year growth of the bank's balance of wealth management products plummeted to 1.7%.

Interestingly, banks’ net profits (seen as part of their parent company’s shareholders net profits) appear to have also been affected by this.

Figure 4



Blue bars = bank share profit (trillion RMB, left axis); black line = bank's net profit as a percentage of total A share's net profit

Source: Wind database

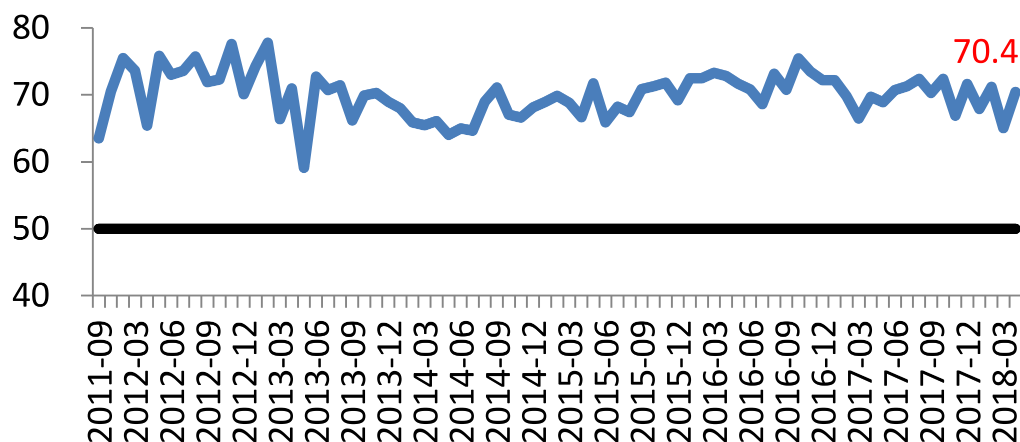
According to the data in Figure 4, from 2012 to 2015, net profits of A-listed banks as a proportion of all A-listed company profits exceeded 50% for four years in a row. The highest percentage was 52.6% in 2012. By 2017, the indicator fell to 44%, 8.6 percentage points lower than in 2012.

It must be said that the concern shown by financial supervision departments and their actions in cleaning up the shadow banking sector is right to a certain extent. Shadow banking is far from transparent, payments are rigid, and risks are hard to estimate. But in another sense, shadow banking has inadvertently promoted the marketization of interest rates in China. It could be said that shadow banking has even become the “marketization of interest rates with Chinese characteristics.”

For a long time, the Chinese government has been controlling the benchmark interest rate, and has often suppressed interest rates at a low level. Interest is the price of financing. If the price is too low, then some projects with low returns will be easier to launch, which will result in a waste of funds and accumulation of debt. More importantly, China actually has a two-track interest rate system. State-owned enterprises and local governments are strong players in the capital markets, and can easily borrow money at relatively low rates. Private enterprises, especially private SMEs, exist on the weaker end of the capital markets, beset with “financing difficulties and high costs”.

In contrast to this, private enterprises are comparatively efficient, and give investors good rates of return. Our data also proves this point (Figure 5). In this way, financial allocation of this critical resource in the Chinese economy is mismatched. More efficient companies cannot get funded, and can only get hold of financing at high cost, while low efficiency companies have an easier time securing financing.

Figure 5: Industry competitiveness



Note: This measures surveyed companies compared with their industry's average level of efficiency. A higher value in the index represents a company's higher level of efficiency in the industry.

Source: CKGSB Case Center and Center for Economic Research

As a matter of fact, in recent years, the Chinese government has taken regular action on the issue of interest rate liberalization. For example, the Central Bank fully liberalized interest rate controls in July 2013, and in October 2015 removed the upper interest rate limit on deposits. On paper, the Central Bank has handed decision-making on interest rates over to the banks, but in reality this is not quite the case. After interest rate controls ended, the banking industry formed a national self-regulatory mechanism for market interest rate pricing in 2013, which in fact was a new way for banks to determine their own interest rates. According to media reports, the current general deposit rate can only rise 1.5 times the benchmark rate. At present, one-year fixed deposits (total deposit and withdrawal) have a benchmark interest rate of 1.5%, and even with a 50% increase, the rate is only 2.25%. Even if it is a three-year fixed deposit (total deposit and withdrawal), the benchmark interest rate is only 2.75%. After increasing 50%, it is just 4.125%, although this comes with low risk. However, a no-penalty easy access current exchange fund may have an annualized return rate of more than 4%. Bank savings have no interest rate advantage over this. Therefore, not only is the borrower market a two-track interest rate system, but the capital provider market is also a two-track system. The benchmark interest rate is controlled by the government and is relatively low. The yield of wealth management products (including wealth funds) is determined by the market and is relatively high.
On the surface, wealth management products seek higher rates of return, which makes corporate lending more expensive. But for SMEs, although capital costs less at the benchmark interest rate, it is hard for private enterprises to get a share, so they have to take the higher cost private financing options. Therefore, private enterprises find themselves in a difficult situation. The requisite rate of return for wealth management products is much higher than the benchmark interest rate. If state-owned enterprises and local governments and other departments fail to make interest payments, they will not be funded in this way. This has increased the possibility of private enterprises getting funding via this channel, as compared to private financing interest rates, costs for wealth management products are lower. Objectively, the financial product market has alleviated private industry's problem of "financing difficulties and high costs." This has helped correct a misallocation of capital market resources, and been conducive to improving economic efficiency and the quality of China's economic development.

Private enterprises currently contribute more than 60% of China's GDP, provide 80% of urban jobs, absorb more than 70% of rural migrant labor, and private firms provide 90% of new jobs. They pay more than 50% of taxes. These may be approximate percentages, but there is no doubt that since reform and opening up, private enterprises in China have seen tremendous development, and played a pivotal

role in the economy. Despite this, in the capital markets, they have long been discriminated against, and each time the money supply shrunk, private firms were hit first. Now it seems with the fiscal consolidation process, the finance industry is experiencing a similar phenomenon. The author does not oppose the cleaning up of the financial industry, and believes many of the regulatory authorities' policies are necessary, but could we at least open some front doors while closing these back doors and give the market more of a chance to determine interest rates?

CKGSB Professor Li Wei

April 24, 2018