Commentary on the September 2021 CKGSB Business Conditions Index

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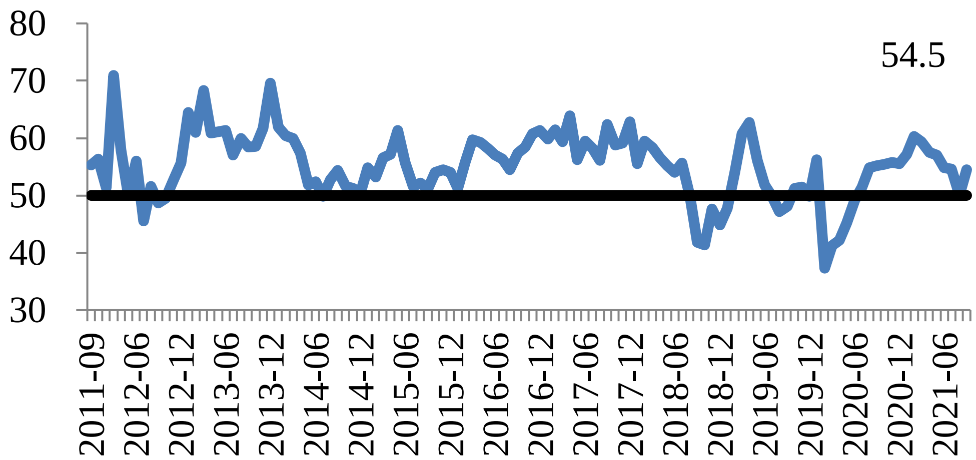
The September reading of the CKGSB Business Conditions Index (BCI) rose to 54.5 from 50.0, well clear of the confidence threshold (Figure 1).

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



Source: CKGSB Case Center and Center for Economic Research

This month marks the 10th anniversary of the CKGSB BCI. First of all, I would like to thank our alumni and CKGSB's management who have supported us over the past ten years. Without their support, the BCI would not have carried on for so long. Secondly, with the passage of time and the accumulation of data, we are close to reaching the goal we set when establishing the index – to provide China with another data-driven dimension to analyze and assess the Chinese economy. Now, the market has begun to recognize the value of the BCI, and its influence has grown at home and abroad. This is all the encouragement we in the BCI team need to carry on.

So much for the past ten years. What about the past month in the Chinese economy? Somewhat surprisingly, after 6 months of continuous decline, BCI rebounded this month, with all four sub-indexes on the rise, indicating that conditions for doing business in China have improved significantly. What is particularly important here is that both sales and profit forecasts are on the up, showing that companies' operating environments are showing consistent signs of improvement.

This month, the prices side has given us noteworthy results, with both consumer and producer price prospects significantly down on last month. The latter fell 10.3 points from 60.7 last month to 50.4 this month. As our index compares upcoming economic prospects with the same period last year, this suggests that if things carry on like this the risk of inflation in China is actually quite low.

The low risk of inflation is fortunate given that many Chinese companies are struggling with liquidity issues, notably conglomerates HNA and Evergrande. If China were facing high inflation today, it wouldn't have the scope to leverage expansionary macroeconomic policies at will. With a low risk of inflation, the leadership can afford to be more radical with its macroeconomic policies.

As in the period before the 2002 reforms that restructured state-owned commercial banks assets, bad loans amount for an alarming proportion of bank loans. Back then, the general view was that China's big four commercial banks were "technically bankrupt." To clean up the non-performing assets of the four major banks and inject new capital into them was a tough call for a central government that had, at the time, limited room for maneuver in finance. Injecting capital by re-lending from the People's Bank or using the country's foreign exchange reserves to raise funds was the equivalent of asking the People's Bank of China to issue a substantial increase in the base currency; other words starting up the printers to make more cash. We know that in the long run, currency issuance and inflation have maintained a fairly consistent growth rate relationship, but why did China not have inflation after base currency issuance was ramped up? The main reason is that China was experiencing deflation at that time, and an appropriate injection of currency had little chance of triggering inflation.

However, it should be noted that China already has a very open economy. When implementing domestic economic policies, we must take into account the international economic environment, especially major economies such as the United States, Europe and Japan. These are all now implementing extreme monetary easing, resulting in huge money inflows to China. If China had a loose monetary policy too, the two would be superimposed, and inflation would quite possibly rise. From the perspective of economic theory and practice, the best way to deal with this is to implement a floating exchange rate system, as this would be like having a pressure-reducing valve on a pressure cooker. Whenever capital inflows increase, the RMB exchange rate appreciates, and the cost of exporting goods and services from China increases. China's international trade competitiveness suffers, which has a natural restraining effect on China's macroeconomy. And as the cost of purchasing Chinese assets in foreign currencies increases, the incentive to send capital to China will also decrease.

When funds flow out on a large scale, the RMB exchange rate will depreciate and China's international competitiveness will rise, which will automatically have a stimulating effect on China's macro-economy. At the same time, an incentive for the outflow of funds will be quelled. In short, a floating exchange rate system provides relative economic in exchange for some fluctuation, acting as a natural macroeconomic regulator. In addition, a floating exchange rate creates a space for independent adjustments of the macro economy. One major shortcoming is that when the exchange rate appreciates, exports suffer. But China is a big country, and domestic demand drives the economy of all big countries. To rely on domestic demand, China must have autonomy. Second, exporters can also evade exchange rate fluctuations in the short term by purchasing derivatives, or hedge against exchange rate fluctuations through corporate internationalization and cross-border operations. In short, abandoning domestic macroeconomic stability in order to stabilize the exchange rate is likely a gain that is not worth the related losses.

This is a commentary on the CKGSB BCI report for September 2021 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.

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