Weak private sector financing supply and demand makes it difficult to translate financing into effective investment, thereby reducing the interest rate elasticity of investment. Despite reasonable and ample liquidity in China’s financial market and sufficient funding supply in commercial banks, as well as the stable growth of the social financing scale and broad money supply since the outbreak of the COVID-19 pandemic, China didn’t see a significant increase in investment growth (around 5%).

From the perspective of financing demand, private and small to medium-sized enterprises (SMEs) hold relatively smaller assets and are less resilient to risk shocks. Therefore, they’re more likely to suffer from shrinking financing demand during economic downturns as their investment decisions are driven more by risk considerations rather than profit. In contrast, state-owned enterprises (SOEs) possess relatively larger asset sizes and are more resilient to shocks. The interest rate level is not a core consideration for SOEs’ investment and financing decisions; hence, their loan decisions are not sensitive to interest rate levels.

In terms of funding supply, economic downturns are often accompanied by asset price adjustments, which reduce the willingness of funding providers (especially banks) to provide funds to businesses based on mechanisms such as collateral channels and financial accelerators. Compared to SOEs with ample financing channels, these mechanisms tend to be more definitive in determining the business operations of the private sector.

Distributional effects of continued interest rate cuts deserve closer scrutiny. Due to low interest rate elasticity, sustained policy interest rate cuts would not strongly impact consumption, savings, or the scale of investment and financing, but will instead manifest itself in the redistribution of profits among economic entities. On the one hand, commercial bank loans currently mainly flow to SOEs. On the surface, interest rate cuts will reduce interest expenses and increase the profits that SOEs contribute to the government’s coffers. However, a continuous interest rate cut would drag the loan prime rate (LPR) down, narrow the interest rate spread for commercial banks, leading to a decline in their profits and an increase in the potential financial risks. This means that continuous interest rate cuts could result in a situation where money is transferred from one pocket to another within the government’s finances. On the other hand, to maintain a certain interest rate spread, commercial banks tend to gradually reduce deposit rates, shifting the pressure of decreasing interest income onto households, which in turn reduces their deposit returns. This runs counter to stimulating household consumption, especially at a time when households have a strong inclination to build precautionary savings, and it could further hinder the willingness of businesses to increase investment.

Given the current low interest rate elasticity of investment and consumption in China, further interest rate cuts will have limited effect in stimulating consumption and investment in the short term. Therefore, sustained interest rate cuts for the time being may not necessarily produce positive policy results, but could instead lead to certain distributional issues and side effects.

How are foreign companies doing in China?

Multinational corporations (MNCs) have been operating in the Chinese market for more than three decades. There are at least two distinct dimensions of their activities in China, both of which are now experiencing headwinds for different reasons.

First, China has long been considered “the world’s factory” – that is, MNCs have been manufacturing and processing products in China and exporting them to foreign markets since the 1980s. Second, MNCs have long regarded China as an essential consumer market. Around the beginning of the 21st century, foreign brands started to sell products in China (some of which were also manufactured here).

From the 2000s to the late 2010s, foreign consumer brands continued to grow in China, demonstrating the willingness of Chinese consumers to purchase foreign products during that period. Over the past 30-plus years, foreign companies in China have experienced ups and downs, while witnessing the country’s growing integration into the world economy. Despite the fact that China has evolved from being “the world’s factory” into a market for multinationals, however, the passion of foreign companies for doing business here seems to have cooled. So, how will they weigh the new Chinese market in their future expansion strategies? And, what impact will such changes bring to China?
Strategic transformation in Chinese companies

While MNCs in China are now struggling with rising costs and declining margins due to slowing market growth, many don’t see emerging Chinese players as a critical challenge yet since they possess organisational and management capabilities that are more effective, efficient, and sustainable for their targeted customer segments. Chinese companies, even the most successful ICT giants, for example, still suffer from structural, organisational, and management issues that hinder their ability to compete directly with MNCs for middle and high-income customers, though they are making progress.

China should focus on encouraging MNCs to increase their commitment to the Chinese market and attract new MNCs. China should allow them to use its production base and market to compete with mature MNCs and local Chinese companies as a way of promoting development.

Daniel Han Ming Chng
CEIBS Professor of Strategy and Entrepreneurship

Who will stay in China?

In short, foreign companies such as Siemens, ABB and other non-high-tech manufacturers with well-established China-based production facilities and ongoing business needs in China and Asia are more likely to stay here. Although their operating costs in China are growing, they continue to benefit from an efficient and established manufacturing ecosystem that ensures high productivity. In addition to factories, this ecosystem also includes logistics infrastructure (such as ports and roads), as well as well-trained workers.

Luxury and strong global brands can continue to do well in the Chinese market, while those that fail to provide differentiated products and meet local customer needs (such as H&M and GAP) will lose ground. Brands with unique IPs and high-quality, reliable products and services (such as Coca-Cola) or those that offer more comprehensive solutions than those of Chinese manufacturers (such as Phillips Lighting) can also succeed.

While foreign tech and internet, consumer goods and electronics companies whose shares in China’s consumer market have declined over the past decade will likely leave, in the short term, their departure may not have much impact on China’s manufacturing industry, which will soon be harnessed by other companies or industries.