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Business surveys and
inflation forecasting in China



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Contents

Abstract.....	5
Tiivistelmä.....	6
1 Introduction	7
2 Data and methodology.....	8
3 Results	10
4 Conclusion.....	11
References	12
Tables and figures.....	13

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Juuso Kaaresvirta and Aaron Mehrotra*

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Abstract

We use business survey data collected by the People's Bank of China for inflation forecasting. Some survey indicators lead to enhanced forecasting performance relative to the univariate benchmark model, especially for a period of moderate inflation. However, the estimated models do not do a good job of tracking the recent pickup in Chinese inflation, due to increases in food prices.

Keywords: inflation forecasting; business surveys; China.

JEL classification: C53; E31.

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Tiivistelmä

Tutkimuksessa käytetään Kiinan keskuspankin keräämää yritysbarometridataa inflaation ennustamiseen. Joidenkin barometrimuuttujien käyttö johtaa parempiin ennusteisiin suhteessa yhden muuttujan autoregressiiviseen malliin erityisesti hitaan inflaation aikana. Estimoidut mallit eivät kuitenkaan ennusta hyvin Kiinan inflaation viimeaikaista kiihtymistä.

Asiasanat: inflaation ennustaminen, yritysbarometrit, Kiina

1 Introduction

The stated objective of the Chinese central bank, the People's Bank of China (PBoC), is to "maintain the stability of the value of the currency and thereby promote economic growth".¹ While there is still no formal inflation target, China includes an annual target for CPI growth among the country's annual targets for social and economic development (see e.g. PBoC 2005). Moreover, for a transition economy where a major share of public wealth is held in cash or stored in bank accounts, price stability is an important determinant of social and economic stability.

The literature is notably sparse on forecasting inflation in China. Mehrotra and Sánchez-Fung (2008) consider 15 different models for forecasting Chinese inflation, and find that only those summarizing information from a large dataset by principal components beat the univariate benchmark. Both Gerlach and Kong (2005) and Burdekin and Siklos (2008) use the real money gap to provide out-of-sample forecasts for inflation. Qin et al. (2006) compare the forecast performance of an automatic leading indicator (based on dynamic factor analysis) with a macroeconometric structural method in terms of CPI and GDP growth in three economies, including China.

Inflation forecasting exercises for developed countries using surveys on inflation expectations have been found to forecast inflation well (see e.g. Ang et al. 2007, for the US). However, for China, long time series of inflation expectation surveys do not exist, as the People's Bank of China has compiled a quarterly index of future price expectations only during the current decade (see PBoC 2007). Therefore, we use published surveys on industrial firms' assessment of the economic situation collected by the People's Bank in order to obtain information about future price pressures. Nevertheless, empirical evidence suggests a close relationship between inflation expectations and business sentiment surveys.²

For China, Mehrotra and Rautava (2008) argue that "soft" business survey data exhibit the same trends as "hard" data on industrial production, and the former can be used to forecast the latter, which is of interest given the concerns about quality of Chinese hard data. Overall, however, the literature on using survey data for forecasting has focused on

¹ <http://www.pbc.gov.cn/english/huobizhengce/objective.asp> on September 17, 2008.

² For the time period 2001Q1-2008Q2 where data for China are available in the CEIC database, we find a contemporaneous correlation coefficient of 0.88 between the survey of general business condition and infla-

advanced economies, and to our knowledge only Mehrotra and Rautava (2008) have used Chinese business surveys for forecasting.

This study uses Chinese business survey data from the PBoC to study inflation forecasting performance. We find that our bivariate vector autoregressive models, comprised of one diffusion index and an inflation rate, in many cases produce an enhanced forecasting performance compared to a univariate process. However, the pickup in inflation in late 2006 and 2007 originating in food prices is not captured well by our models.

2 Data and methodology

We use quarterly business survey data provided by the PBoC on 5,000 principal industrial enterprises in China. Most of the firms surveyed are state-owned large and medium-size enterprises, and a total of 27 industries are covered. The business survey produces 15 diffusion indices, which are quantitative indicators based on qualitative answers given by firms. Their values range from -100 to 100 . Figure 1 displays the annualized change in CPI, together with the diffusion index for domestic order level and fixed assets investment. Other diffusion indices that may capture demand-side pressures are correlated with these two diffusion indices with a contemporaneous correlation coefficient exceeding 0.8 .³ The remaining diffusion indices that may capture supply-side factors instead are inventory level, raw materials supply, and energy supply. The two former series are depicted in Figure 2, together with our second inflation measure, the annualized change in corporate goods prices (CGPI, formerly known in China as the wholesale price index). Regarding the final remaining diffusion index, energy supply is contemporaneously correlated with raw material supply with a coefficient of 0.79 .

In order to examine the forecasting performance of the business survey indicators, we estimate bivariate vector autoregressions (VARs) comprised of one diffusion index and the inflation rate. These VARs take the form

tion expectations. This provides support for our approach of using business survey data for inflation forecasting.

³ These are cash inflow from sales, equipment investment, funds turnover, general business condition, lending attitude of bank, overseas order level, price level of sales, production capacity, products sales, and profitability.

$$x_t = A_1 x_{t-1} + \dots + A_p x_{t-p} + CD_t + u_t, \quad (1)$$

where p denotes the order of the model. $x_t = (x_{1t}, x_{2t})'$ is a (2×1) random vector, the A_i are fixed (2×2) coefficient matrices and D_t is a vector of deterministic terms. C is the coefficient matrix associated with the deterministic terms. $u_t = (u_{1t}, u_{2t})'$ is assumed to follow a 2-dimensional white noise process with $E(u_t) = 0$. The autoregressive models are estimated for a sample spanning 1996Q1-2006Q4. We then provide out-of-sample forecasts 1, 2 and 4 quarters ahead, covering 2007Q1-2007Q4. Formally, we write an h -step forecast as:

$$\hat{x}_{T+h|T} = \hat{A}_1 \hat{x}_{T+h-1|T} + \dots + \hat{A}_p \hat{x}_{T+h-p|T}, \quad (2)$$

where $\hat{x}_{T+j|T} = x_{T+j}$ for $j \leq 0$ and the \hat{A}_i 's ($i = 1, \dots, p$) are estimated parameters. As is standard, the forecasting performance of the VARs is evaluated by comparing the root mean squared forecast error (RMSE) to that from a simple univariate AR-process.

Given that inflation in China in 2007 originated in food prices that may be difficult to capture using business survey data, we also forecast for a period of moderate inflation, 2006Q1-2006Q4. Cheung et al. (2008) discuss the impact of rising food prices in Asian economies on general price inflation and monetary policy. Moreover, Stock and Watson (2008) document that the performance of inflation forecasts using an activity variable is episodic, thus varying from one period to another. Because business survey data may be more closely related to producer prices than the CPI, we forecast both consumer prices and corporate goods prices. China does not publish a series for core inflation, nor are the weights of the items in the consumer price index publicized.

As previous research has modelled the inflation process in China using variants of the Phillips-curve (see e.g. Gerlach and Peng 2006; Funke 2006), we also estimate a backward-looking Phillips curve including lags of output gap and inflation. Our measure of output gap is constructed by applying the Hodrick-Prescott filter to the monthly industrial production series in levels, with a standard smoothing parameter of 14,400. The use of industrial production as a measure of output can be justified, as Holz (2004) notes the regular statistical data reporting system in China to be most developed for the industrial sector. Additionally, we estimate the first principal component, obtained from an orthogonalization of the sample correlation matrix as a linear combination of the 15 diffusion indices, and include that in the bivariate VAR setup together with inflation (see Johnson and Wichern 2002, for a formal description of the principal component analysis). For the US

economy, Stock and Watson (2002) find that forecasts from a dynamic factor model based on principal components outperform univariate autoregressions, small vector autoregressions, and leading indicator models. Our first estimated principal component explains 53% of the total variance of the diffusion indices, of which it has the highest weights on general business condition, cash inflow from sales and fixed asset investment. The final model in our analysis is a trivariate backward-looking Phillips curve comprising the output gap, inflation, and the estimated first principal component.

A logarithmic transformation is applied to the price indices. All variables are included in the estimation in first-differences, to ensure stationarity. Lag length is based on the Akaike information criterion when no residual autocorrelation is detected. Otherwise another suitable lag order is used. In the case of CPI inflation, the estimated systems include a constant, and a trend is also included in the models with the CGPI index. The TRAMO-SEATS procedure was used to seasonally adjust the price data.

3 Results

The results are presented in Table 1 (forecasts for 2006Q1-2006Q4) and Table 2 (2007Q1-2007Q4). For the period of moderate inflation considered in Table 1, the RMSE ratio is less than one for 8 of the 15 estimated bivariate models including CPI inflation and one diffusion index. This suggests that many models that include a survey indicator outperform univariate inflation forecasts. Also the models including the output gap and the principal component forecast inflation well. Mehrotra and Rautava (2008) similarly find general business condition, overseas order level and lending attitude of bank to have forecasting power for real economic activity in China. For the CGPI, only inventory level and domestic order level turn out to be useful predictors.

For the recent period of higher inflation (Table 2), the forecasting ability of the diffusion indices deteriorates. We find RMSE ratios lower but very close to one at all forecasting horizons for four models with diffusion indices and CPI, and for the model with CPI inflation and the first principal component. The situation is worse for the CGPI, where no estimated model outperforms the univariate benchmark at all forecast horizons. This suggests that the recent pickup in inflation in China, mainly due to food price inflation, is not captured well by our models. Even for the naïve AR-process, the actual values for in-

flation fall outside the confidence intervals for the forecasts. Yet, comparing the results in Table 1 and 2, we do find three bivariate models that outperform or equal the univariate benchmark for the CPI for both forecasting periods (moderate and high inflation). These models include as predictors domestic order level, general business condition, and the first principal component, respectively.

The impact of food prices on the forecasting performance of the models can be further examined by including the IMF's world food price index as an exogenous variable in the models with diffusion indices. When this variable is included, the AR-process is outperformed at all forecast horizons in 9 models for CPI and 2 models for CGPI, when forecasting for 2007. This provides further evidence that the poorer forecasting performance of the models in the later period is indeed due to food price inflation.

4 Conclusion

We used business survey data from the People's Bank of China to forecast consumer and corporate goods price inflation. We find that some survey indicators are useful predictors of inflation pressures during a period of moderate inflation, especially for consumer prices. However, the forecasting performance of the survey data is weak for the more recent pickup in inflation. Nevertheless, the survey indicators domestic order level, general business condition, and the first estimated principal component from all survey variables maintain some of their forecasting power even during the recent forecasting period characterized by higher inflation.

Our results suggest that business survey data can be used to obtain information about price pressures in China, at least given the absence of major supply side disturbances such as food price increases. Our approach also has relevance for other emerging economies, where no formal surveys on inflation expectations may yet exist but business confidence indicators can be used to analyze future inflation developments.

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Tables and figures

Table 1 Inflation forecasts, 2006Q1-2006Q4

Predictor	CPI			CGPI		
	$h = 1$	$h = 2$	$h = 4$	$h = 1$	$h = 2$	$h = 4$
Capacity utilization	1.08	1.02	1.00	1.37	1.48	1.47
Cash inflow from sales	1.06	1.03	1.01	1.17	1.33	1.39
Domestic order level	0.83	0.88	0.95	0.94	0.92	0.94
Energy supply	3.23	2.56	1.67	1.60	1.81	1.92
Equipment investment	1.00	1.00	1.00	1.25	1.37	1.41
Fixed asset investment	0.52	0.79	0.92	1.34	1.46	1.50
Funds turnover	0.71	0.62	0.87	1.17	1.35	1.42
General business condition	0.90	0.94	0.98	1.03	1.05	1.06
Inventory level	0.69	0.86	0.97	0.93	0.95	0.98
Lending attitude of bank	0.68	0.73	0.91	1.12	1.26	1.31
Overseas order level	0.94	0.95	0.98	1.04	1.02	1.03
Price level of sales	1.44	1.45	1.30	1.28	1.42	1.47
Product sales	0.91	0.94	0.98	1.07	1.15	1.17
Profitability	0.86	1.24	1.00	1.30	1.39	1.45
Raw materials supply	1.98	1.64	1.26	1.06	1.16	1.18
Output gap	0.17	0.13	0.62	0.15	1.11	1.91
Principal comp.	0.96	0.97	0.98	1.03	1.06	1.07
Output gap & principal comp.	0.22	0.16	0.60	0.11	1.09	1.78

Note: RMSE relative to AR process. h denotes forecast horizon.

Table 2 Inflation forecasts, 2007Q1-2007Q4

Predictor	CPI			CGPI		
	$h = 1$	$h = 2$	$h = 4$	$h = 1$	$h = 2$	$h = 4$
Capacity utilization	0.98	0.99	1.00	1.69	0.99	1.07
Cash inflow from sales	1.01	1.01	1.00	0.90	1.00	1.07
Domestic order level	0.96	0.99	1.00	1.60	0.93	1.02
Energy supply	1.99	1.39	1.19	3.00	1.25	1.22
Equipment investment	1.09	0.97	0.93	3.73	1.16	1.16
Fixed asset investment	1.16	1.07	0.92	3.47	1.18	1.17
Funds turnover	1.09	0.98	0.95	0.36	1.04	1.10
General business condition	0.95	0.98	0.99	0.50	1.00	1.01
Inventory level	1.13	0.93	0.98	1.38	0.90	0.96
Lending attitude of bank	1.02	1.01	1.00	1.22	0.98	1.07
Overseas order level	1.05	1.04	1.02	1.54	0.68	0.91
Price level of sales	0.90	0.97	0.93	1.25	0.93	1.00
Product sales	1.10	1.05	0.93	3.13	0.90	1.00
Profitability	1.02	1.00	0.91	1.22	0.93	1.03
Raw materials supply	1.54	1.27	1.11	2.78	1.16	1.13
Output gap	1.68	1.34	1.01	5.65	1.35	1.15
Principal comp.	0.98	0.99	1.00	1.25	0.98	1.06
Output gap & principal comp.	1.06	0.97	0.86	3.28	1.27	1.12

Note: RMSE relative to AR process. h denotes forecast horizon.

Figure 1 CPI inflation and two diffusion indices.

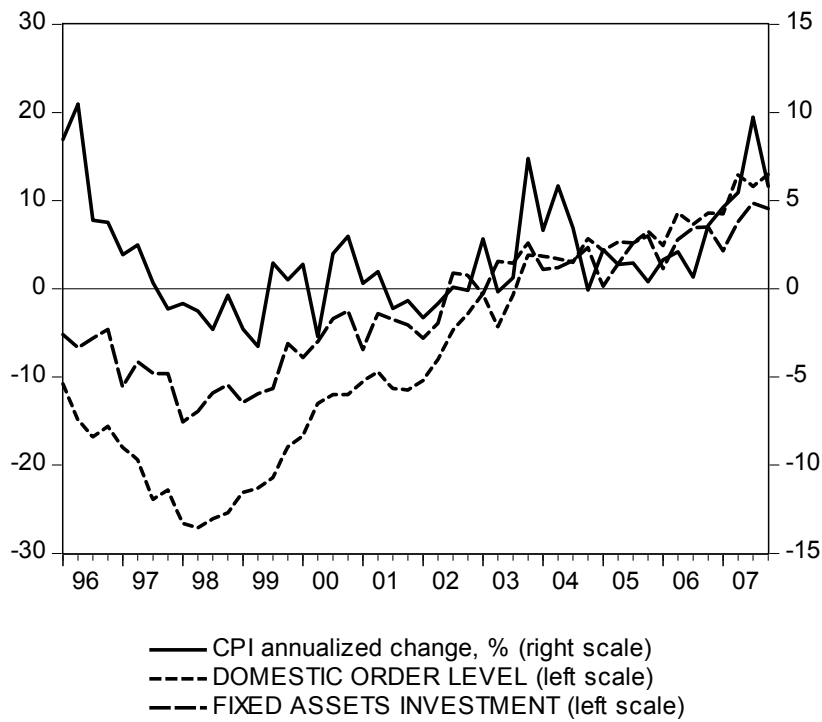
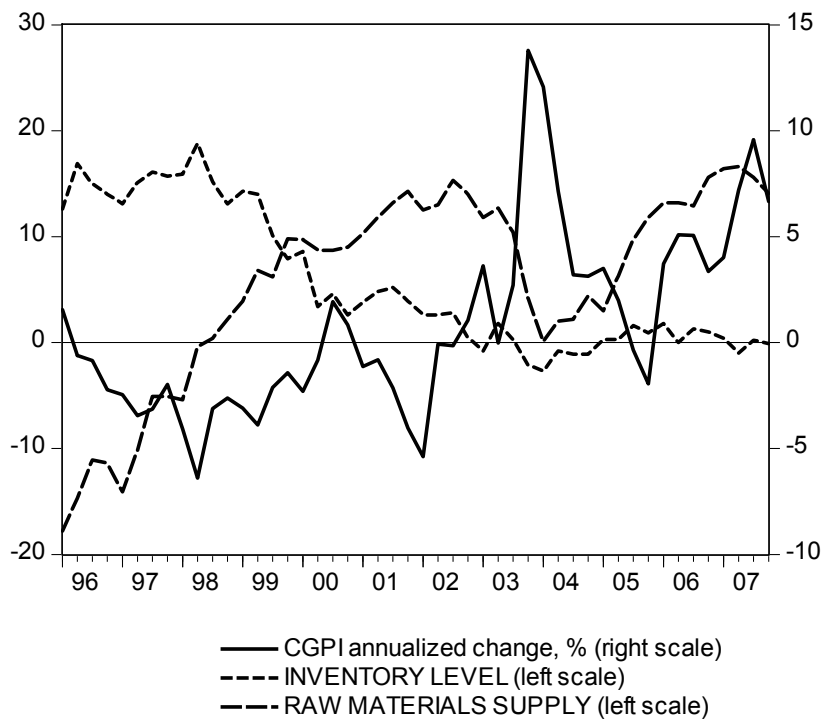


Figure 2 CGPI inflation and two diffusion indices.



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