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Could SMEs become the weak link in China's economy?

When considering risk in the Chinese economy, a lot of the discussion has focused on large State-Owned Enterprises (SOEs), or large private conglomerates. However, headwinds impacting an understated group of smaller firms have the potential to be much more disruptive: Small and Medium Enterprises (SMEs) account for the majority of enterprises and a sizeable proportion of employment. However, the need to address financial stability risks associated with China's vast corporate indebtedness – most of which has historically been associated with SOEs – has left SMEs scrambling to access financial resources to meet their working capital and long-term expansion needs.

Policymakers have since retracted on their tightening stance, afraid that a looming trade war with the United States, rapidly deteriorating financing conditions, and bond defaults could threaten the Chinese economy.

A return to a more accommodative monetary policy stance will not sufficiently alleviate pressures for SMEs. Given their understated importance, it is likely that policymakers will take steps to prevent SMEs from becoming the weak link in China's economy. In order for this intervention to be successful, the measures to implement will likely include prudent fiscal stimuli, a rational approach to regulating shadow banking, and a shift to more market-based interest rates, so as to reward underwriting procedures that allocate adequate risk returns.

SMEs are an important part of the Chinese Economy

In most OECD economies, micro, small and medium-sized enterprises (SMEs) are defined by the number of employees (typically between 100- and 500)[1]. In the European Union (EU), SMEs are companies with fewer than 250 employees and an annual turnover of EUR 50 million[2]. SMEs are a large proportion of the economy in the EU, representing 99% of all businesses.

However, in the context of an economy as vast as China's, the definition of an SME is more complex. It includes a proportion of companies that would be considered "large" in other markets, and this differs by sector. The SME Promotion Law of China[3], which sets guidelines for classifying SMEs, defines these as employing fewer than 100-3000 people depending on the sector (the highest thresholds are for construction and transportation). Notwithstanding these caveats, and similar to the situation in the EU, SMEs are an important backbone

1 - *OECD, 2005.* Small and Medium-Sized Enteprises (SMEs). *[Online] Available at: https://stats.oecd.org/glossary/detail.asp?ID=3123 [Accessed 11 November 2018].*
2 - *EUR-Lex, 2003.* Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (Text with EEA relevance) (notified under document number C(2003) 1422). *[Online] Available at: https://eur-lex.europa.eu/eli/reco/2003/361/oj [Accessed 6 November 2018].*
3 - *http://www.npc.gov.cn/englishnpc/Law/2007-12/06/content_1382128.htm*

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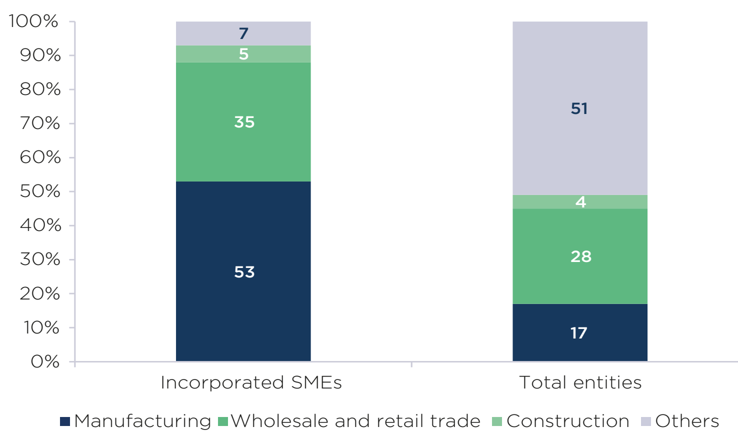
of the Chinese economy: they account for 97% of total enterprises, 60% of GDP, and 80% of total urban employment[4] (99% and 65% respectively in the EU). Following the opening and reform process in the 1980s, the number of SMEs in China grew rapidly, reaching more than 60 million (compared to 20 million in the EU), with over 20 million incorporated SMEs in 2016 according to China's National Bureau of Statistics (NBS).

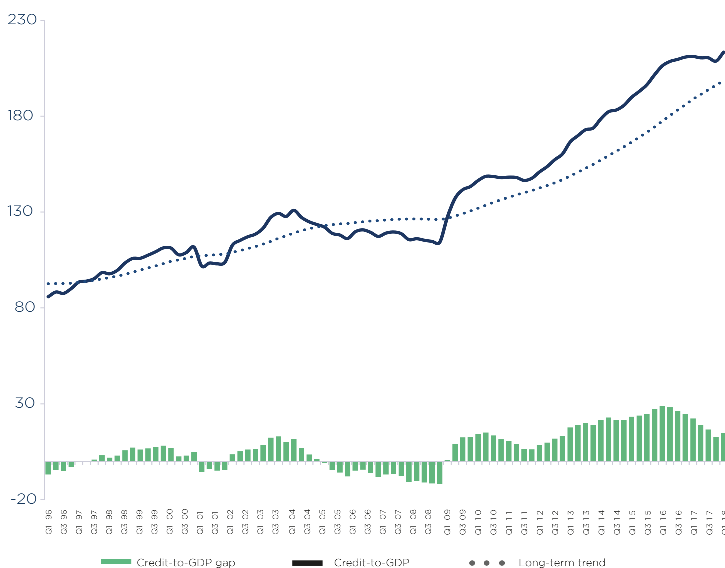
SMEs are significantly more prevalent in the manufacturing sector, as well as the wholesale and retail trade sector (**Chart 1**)[5]. Both sectors have recently come under scrutiny, for fears that they may be adversely impacted by mounting headwinds. Manufacturing includes activities ranging from the production of general purpose machinery, electrical and transportation equipment to textiles, chemicals and plastics. A lot of these products have become subject to new tariffs implemented as part of the US-China, trade war. SMEs in these spaces maight struggle to absorb the increase in cost, leading to higher credit risks. The wholesale and retail sectors are not exempt from similar pressures, as many of these firms will see the cost of their inputs increased, leading to slimmer margins. Moreover, these firms will also have to grapple with a more restrictive financial environment overall, as a result of tighter global central bank liquidity. Given the central role that SMEs play in terms of output and employment, this poses an important question: could SMEs become the weak link in China's economy in 2019?

CHART 1
Proportion of Incorporated SMEs by sector vs. total number of legal entities in China



Sources: Liu, X. (2008), NBS, Coface

CHART 2
Credit-to-GDP ratio remains above its long-term trend (% of GDP)



Sources: BIS, Coface

The need to redirect credit to productive sectors – including SMEs

Chinese economic growth in 2017 was robust (6.9%) and it, remained strong at 6.5% year-on-year in the third quarter of 2018. However, growth was supported by a steep increase in credit. This is a concern given that China's total debt levels are high by international standards, and currently stand at approximately 250% of GDP, led by corporate debt levels equivalent to 160% of GDP. Furthermore, owing to China's economic structure, a lot of this capital has been allocated to less productive sectors of the economy.

The expansionary policies pursued in 2017 spurred a widening of China's already positive credit-to-GDP gap[6] (**Chart 2**). A high positive gap means that the corporate sector borrows at levels that are not justified by the current output-producing abilities of the economy. Each marginal unit of additional credit generates a diminishing marginal increase in output. In other words, China's "addiction" to debt[7] is leading to an accumulation of non-performing assets. Under normal circumstances, banks may thus experience an abnormally high level of loan defaults. Why has this not happened in China?

Chinese SOEs have enjoyed a much higher leverage ratio than that of their peers in the private sector (**Chart 3**) despite SOEs accounting for a smaller proportion of total output and employment than their SME counterparts, they received over 75% of bank loans in 2014. Tsai identifies the main reasons why this build-up in debt has historically been attributed to SOEs, which can be summarised in three broad areas[8] :

1) **Political concerns:** The banks are state-owned. They extend soft loans to SOEs in order to promote employment in less dynamic regions, even when this implies an increase in non-performing loans (NPLs). They also serve as vehicles for public policy, lending to sectors that are considered preferential.
2) **Financial repression:** Interest rates in China are not fully liberalised. By suppressing interest rates, depositors are taxed so that borrowers (historically SOEs) can access cheap credit[9]. This also means that banks are not able to price loans to reflect the trade-off between profit and risk associated with lending to SMEs.

4 - OECD (2016), "China (People's Republic of)", in Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard, *OECD Publishing, Paris. Available at:, https://doi.org/10.1787/fin_sme_ent-2016-12-en.*
5 - Liu, X. (2008), "SME Development in China: A Policy Perspective on SME Industrial. Clustering", in Lim, H. (ed.), SME in Asia and Globalization, *ERIA Research Project Report 2007-5, pp.37-68. Available at: http://www.eria.org/SME%20Development%20in%20China_A%20Policy%20Perspective%20on%20SME%20Industrial%20Clustering.pdf*
6 - The Bank of International Settlements (BIS) defines the credit-to-GDP gap as the difference between the credit-to-GDP ratio and its long-run trend, and captures the build-up of excessive credit in a reduced form fashion.
7 - Wolf, M., 2015. How addiction to debt came even to China*. Financial Times, 24 February.*

3) **Ideological reasons:** Credit offers are less likely to be held accountable for NPLs in their portfolios if these are related to SOEs. In case of payment delay or default, the problem is dealt with internally, meaning fewer repercussions are incurred.

SMEs experienced tighter financial conditions in H1 2018

Policymakers in Beijing are aware of the risks associated with high debt levels and capital misallocation. For this reason, starting in the first half of 2018 (H1 2018), they decided to nudge corporates to deleverage by reducing the amount of Total Social Financing (TSF) that was available in the system. In particular, efforts centred on risky lending, such as, shadow banking (**Chart 4**). In tandem, the regulators also urged the banks to move the financial needs of the corporate sector onto their balance sheets for macro prudential reasons, and to lend more to the private sector. It worked: leveraging of SOEs decreased, while that of the private sector increased.

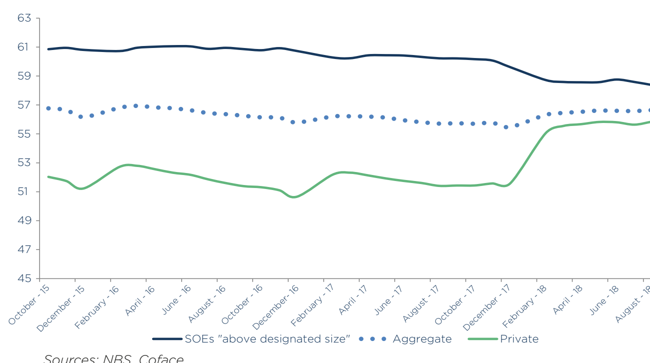
Nevertheless, while there was an uptick in lending to the private sector in general, the tightening of liquidity had very detrimental effects on the financing needs of SMEs. According to the OECD, SMEs face structural funding gaps in most major developed and emerging economies. However, this gap widened significantly in China in H1 2018: SME loan growth decelerated, with just 20% of bank loans going to SMEs in H1 2018, down from 30% in 2017 (**Chart 5**). Access to working capital loans can be even more restrictive than normal loans, given higher credit risks and low appetite on behalf of the banks.

Being able to secure long-term financing and working capital is an essential part of growing a business and managing cash flows. Given the constraints on SME financing, it is not surprising that companies have gravitated towards a wide variety of alternative non-banking sources of financing, including shadow banking -credit intermediation involving entities and activities fully or partly outside of the regular banking system" [10]). In China, the State Council differentiates between three categories of shadow banking from a regulatory perspective (**Table 1**):

For structural reasons, growth in shadow banking has outpaced that of the regular banking sector in most emerging market economies[11]. However, this increase has been more pronounced in China. Shadow banking assets in China peaked at around 87% of GDP in 2016 (112% including Wealth Management Products, WMPs)[12]. To put this into context, the IMF estimates that shadow banking assets account for 30% of GDP in emerging markets, although this figure can be much more elevated in the case of developed markets (300% in the US). The fast accumulation of shadow banking assets since 2009 justifies measures to reduce this source of systemic risk. More specifically, the need to crack down on this type of financial risk may be attributed to the unexpectedly rapid growth of Local Government Financing Vehicles (LGFVs) and WMPs, inspiring anxiety on the part of regulators. However, the implementation of policies to restrict shadow banking growth was too blunt and left many SMEs unable to access financial resources.

Neither LGVFs or WMPs constitute a major form of lending for SMEs. According to the China SME Finance Report 2017[13], other than the bond and stock markets, micro-credit, venture capital and financial leasing are the main sources of SME financing. Cracking down on shadow banking deprived SMEs from accessing valuable working capital as well as longer-term financial resources. Despite banks having been exhorted to increase their lending to SMEs, this has not been backed by policy directives, leading to a deterioration in financial conditions for the already stressed SMEs.

CHART 3
Steep uptick in the leverage ratio of private enterprises, as SOEs continue to deleverage



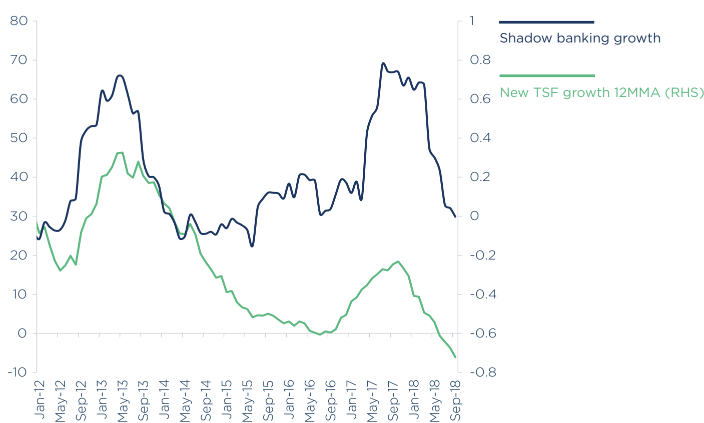
Sources: NBS, Coface

TABLE 1
Types of shadow banking in China

Degree of regulation	Type of entity/product
Unlicensed and unregulated financial activities	Underground banks, internet finance, P2P lending platforms, crowd funding, interest-free uncollateralized lending
Unlicensed but regulated financial activities	Trust loan, entrusted loan, investment companies, micro-finance companies, credit guarantee companies, pawn shops
Inadequately supervised activities of licensed, regulated financial institutions	Money market funds, wealth management products, asset securitization, bankers acceptances

Source : China State Council

CHART 4
Tighter monetary policy in H1 2018 exerts pressure on financing needs of SMEs



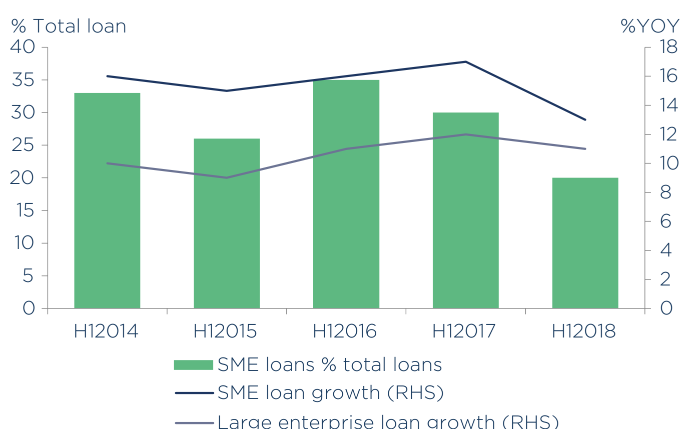
Sources: Bloomberg, Coface
NB: Core shadow banking includes trust loans, entrusted loans and bankers acceptances

8 - *Tsai, K. (2015).* "Financing Small and Medium Enterprises in China: Recent Trends and Prospects beyond Shadow Banking". *HKUST Institute for Emerging Market Studies Studies. Available at: http://iems.ust.hk/assets/publications/working-papers-2015/iemswp2015-24.pdf*
9 - *Lardy, N. R., 2008.* Financial Repression in China, *Washington DC: Peterson Institute for International Economics*
10 - *Financial Stability Board (2018).* "Global Shadow Banking Monitoring Report 2017".
11 - *IMF Global Financial Stability Report: October 2014.*
12 - *WMPs are not included in China's core measure of shadow banking.*
13 - *Shi Jian Ping (2017).* "China MSME Finance Report 2017". *China Central University of Finance and Economics, Beijing.*

Policy easing alone is unlikely to reduce pressures on SMEs

Although China does not release insolvency figures, pressures have already started to visibly manifest. The number of corporate bond defaults has increased, reaching almost USD 9 billion in 2018 year-to-date, compared to under USD 5 billion in 2017. Most of these defaults were private companies. As a result, corporate bond yield spreads have widened for domestic issuers with weak credit credentials, while the number of loss-making private industrial enterprises is higher than it was in 2017. Banks have therefore become more reluctant to loan to segments of the private sector with weaker credit credentials, where we typically find a lot of SMEs. To make matters worse, stricter underwriting guidelines are expected to limit credit to SMEs that are currently engaged in trade with the United States.

CHART 5
SME loans decelerated in H1 2018, adding to the pressures of an underbanked segment



Sources: PBoC, Coface

In response to these pressures, the People's Bank of China eased monetary policy settings in H2 2018. A series of targeted Reserve Requirement Ratio (RRR) cuts were implemented. Meanwhile, interbank rates were driven to their pre-H1 2018 lows. Moreover, the central government also reiterated its support for the private sector: on the 18th October, Vice-Premier Liu released public letter to business leaders, in which he stressed the need for policies that help the development of SMEs, stating that China is committed to the "two unwavering" principle, as the public and private sectors are interdependent. However, bank credit conditions for SMEs are unlikely to change drastically as a result of amplified political rhetoric.

Current underwriting procedures do not favour SMEs. Historically, banks tend to lend more to SOEs when conditions are loose, while finding ways to limit their exposure to riskier SMEs when conditions are tight. This is unlikely to change unless the China Banking Regulatory Commission (CBRC), supported by the State Council, fully commits to embarking on a journey of interest rate liberalisation (the interest rate ceiling is currently capped at four times the benchmark rate). This would enable credit officers to write loans to SMEs aptly, striking the right balance between risk and reward. While some progress has been made on this front over the years, the issue remains thorny. At the very least, policymakers will likely ensure that the onus of policy easing falls on the fiscal front (tax cuts and productive infrastructure investments), while interest rates continue to support a gradual deleveraging of the state sector.

In the meantime, a shift away from pejorative attitudes towards shadow banking in China would help to alleviate pressures on SMEs. Shadow banks compliment the formal banking sector by providing services that are not well suited to state banks. In addition, they add to the resilience of the financial system to economic shocks. The nature of risk posed by the proliferation of LGFVs and WMPs should be distinguished from that associated with the types of shadow banking products that provide necessary credit to private SMEs. Rather than focusing exclusively on the current state of regulation, assessing the exposure of banks to unsuitable forms of credit intermediation, while simultaneously nurturing beneficial shadow banking activities, provides a better metric for analysing and managing financial stability risks.

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