As crisis looms, how can SMEs be saved?

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ment has introduced a transition period of three to five years during which farmers would not only be able to live in the city but also retain the land use rights acquired in their villages (including subsidies for crops) as well as social rights (to have more than one child in some rural areas, for instance).

As Hu Shuli has noted, while this ambitious policy as a whole seems concerned with securing farmers’ rights and appears humane, Chongqing’s rapid urbanisation plans are nevertheless being carried out through administrative diktat, which raises the question of possible drifts. Moreover, the model offered in Chongqing relies on a special political organisation, and it would be difficult to repeat it elsewhere: in fact, Chongqing is an autonomous municipality (zhixia shi, like Beijing, Shanghai, and Tianjin) and is thus not dependent on any province. Chongqing’s government has a direct line to the central authorities, which gives it considerable leeway in adopting innovative policies and greater freedom in raising and disbursing funds.

Chongqing therefore appears to be a testing ground for a new type of so-called “Third Hand” policy, at once interesting and novel. Given the city’s constraints and particularities, however, it would be risky to see it as a model for the rest of China.

Translated by N. Jayaram

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Analysis by Charlotte Wu based on:

– Wang Li, (3) Yu Hairong, (4) “SMEs’ long winter, multiple pressures could lead to aggravating the situation or towards large scale overhaul,” Xin Shiji, no. 463, 15 August 2011.
– Qiu Xiaomin, (5) “Gu Shengzu: It is imperative to alleviate SMEs’ existential troubles,” Xinhua Wang, 1 September 2011.

Since the start of the year, the difficulties of small and medium enterprises (SMEs) have made national news. The situation grew serious in April with the media speaking of an unprecedented “wave of bankruptcies” (daobi chao); but Chinese authorities flatly rejected such talk. Apart from the uncertain international economic context, three main factors lie behind SMEs’ difficulties: a sharp rise in salary costs, rocketing raw material prices, and restrictive domestic monetary policy.

The phenomenon is especially noticeable in the Yangtze and Pearl River deltas, where private small-scale export industries in particular have been seriously affected. In Wenzhou City (Zhejiang Province), renowned for its entrepreneurs, 40 percent of SMEs went bankrupt, and others suspended production or shut their factories. Some SME bosses fled or committed suicide as they were unable to repay loans, often procured in the informal economy. (9) The contagion even spread to northern China, confirming the national character of the crisis.

This wave of bankruptcies affecting SMEs in China is of a much different nature from those closely linked to the 2008 financial crisis, which hit several national economies (and hurt SMEs) around the world. In China, the difficulties are mainly linked to the firms’ intrinsic weaknesses and to the complex domestic context. The persisting global economic crisis is merely a secondary cause of the difficulties they face. Some entrepreneurs think the current economic environment is much worse for Chinese SMEs than in 2008. Many different industries were seriously affected, leading some entrepreneurs towards speculation and property deals, where short-term profits are greater.

SMEs have been unable to retain staff due to sharply rising wage levels. National People’s Congress Standing Committee member Gu Shengzu said during a discussion on SMEs at the Asia Pacific Economic Cooperation summit in Chengdu in August 2011 that the average wage increased by 20 to 30 percent this year. This has led some SMEs to suspend orders, fearing their inability to carry on operating, according to Caijing journalists Yang Zhongxu and Mo Li. China’s labour market is gradually changing, and the abundant labour model is now a thing of the past. The interprovincial labour supply imbalance is becoming sharper, raising demand for a “new generation” of skilled migrant workers.

The second cause of difficulties is the shortage and rise in prices of imported raw materials, especially oil, on which the Chinese economy is heavily dependent.

Apart from the three factors of production, other elements adding to the SME crisis are appreciation of the yuan, various taxes, and the rising cost of land. All these elements have led to a considerable rise in SMEs’ production costs.

The current tight monetary policy leading to a sharp rise in the cost of capital makes it difficult for SMEs to raise funds. The worst affected are the
under-qualified or those lacking collateral. These SMEs are compelled to turn to informal loan markets such as pawning, with interest rates of 50 percent or even higher in some cities. According to Wang Li and Yu Hairong of Xin Shi Ji, underground financial networks, such as loans among private parties, are growing at pace, with interest rates often far higher than the central bank’s indicative rate.

With the world economy still emerging from recession and talk of a second crisis, SMEs’ difficulties are growing. Economic uncertainties in Europe and the United States have led to a sharp fall in external demand for Chinese exports. As for the domestic market, following the 4 trillion yuan stimulus package unveiled in November 2008, Chinese authorities have had to tighten monetary policy since January 2010. Beijing has thus set stricter criteria for bank credit nationwide in order to fight inflation, which reached 6.2 percent on an annualised basis in August 2011, by raising bond yields 13 times in 21 months, and rates five times. Commercial banks’ tight liquidity has aggravated the financial situation of SMEs.

Besides these exogenous cases, SMEs have also faced problems with management and competitiveness. China’s industrial restructuring and optimisation have been too slow to help SMEs’ development. Further, the imperfect market system and lack of regulation governing property rights and intellectual property create an uncertain and inefficient economic environment. Another peculiarity of the Chinese market is the focus of bank credit on major cities, especially the concentration on financing major firms and that for state-owned companies is enormous, meaning that bank credit facilities are not equitably allocated. According to Gu Shengzu, companies. The difference between the interest rate charged to private credit on major cities, especially the concentration on financing major

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Meanwhile, the authorities in charge of industry appear not to recognise the wave of SME bankruptcies, something Gu Shengzu said was attributable to “zombies” that had failed to declare their bankruptcy to the administration. Gu proposed six solutions to resolve the SMEs’ financing difficulties, as reported by journalist Peng Chunlai:

– develop microcredit companies and small rural banks to service SMEs;
– innovate in the finance domain to facilitate access through, for instance, internet platforms for financing SMEs;
– adopt fiscal advantages or subsidies to stimulate bank credit;
– create systems of guarantors to facilitate lending to SMEs;
– relax financial control, continue liberalising interest rates and financial system reform;
– strengthen direct financing and widen the space for private capital investment.

According to Wan Donghua, in order to help SMEs emerge from this crisis, the problems have to be seen through two dimensions: those factors exogenous and endogenous to SMEs.

As for exogenous factors, a start has to be made with monetary and fiscal policies to alleviate the penury of SME financing as soon as possible. As inflationary pressure remains substantial, monetary policy will remain tight in the short term. In order to support SMEs and regularise private capital flows, microcredit companies and rural banks must be ceded a big

ger role. Financial sector innovation has to be sped up, the financial market


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deregulated, and a professional organisation built to direct private capital towards the real economy. Finally, fiscal incentives for SMEs would be the way to go about resolving the problems of financial overload in China. Financial support policies such as tax reductions and temporary alleviation of fiscal burdens as well as subsidies would need to be adopted. On the other hand, the structure and functioning of the labour market has to be strengthened, working conditions have to be improved, and the industrial structure imbalance between eastern and western China has to be set right. It is also important to speed up modernisation of the agricultural sector in order to free up labour and improve worker mobility towards SMEs.

As regards endogenous factors, SMEs have to learn to adapt to a relatively unfavourable environment. They must make use of the economic and financial pressures they face (bian yali wei dongli) in order to speed up transformation and modernisation of the industrial structure, speed up technological innovation, and boost labour productivity. SMEs could also create mutual aid systems or cooperate to benefit from remedial measures when needed. Meanwhile, there’s no free lunch in the market system, and it is inevitable that some firms will disappear, benefiting others that might grow bigger and stronger.

In order to eventually move towards a market system with fair competition among companies and to extricate SMEs from the current crisis, the following points need attention: continue improving the market economy system, abolish outdated property rights, and facilitate companies’ market access by lowering legal barriers. In order to resolve SMEs’ financing problems, financial system reform has to be pursued to remedy the current situation dominated by major banks. To do this, a multi-level financing system better suited to their needs has to be gradually established through the creation of special funds backed by fiscal policies, as well as more community banks, small and medium sized commercial banks, and microcredit guaranteeing companies in non-bank financial institutions.

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