

FOCUS

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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 million². 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 China³, 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 Enterprises (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/oi> [Accessed 6 November 2018].
3 - http://www.npc.gov.cn/englishnpc/Law/2007-12/06/content_1382128.htm