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PRESS RELEASE

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SMEs in China: Monetary easing won't be sufficient to reduce credit pressure

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 Small and Medium Enterprises (SMEs) should not be neglected. SMEs are scrambling to access financial resources to meet their working capital and long-term expansion needs, amidst a looming trade war with the United States and rapidly deteriorating financing conditions. Given their importance in the Chinese economy, it is likely that policymakers will take steps to prevent SMEs from becoming the weak link. Several measures could be helpful: prudent fiscal stimulus, 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 experienced tighter financial conditions in H1 2018

SMEs are the backbone of the Chinese economy: they account for 97% of total businesses, 60% of GDP, and 80% of total urban employment. Moreover, they are more prominent in the manufacturing and wholesale and retail trade sectors. These sectors have recently come under scrutiny for fear that they may be adversely impacted by increasing headwinds. Manufacturing includes activities that have become subject to new tariffs implemented as part of the US-China trade war. SMEs in these sectors might 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. Additionally, these firms will also have to grapple with a more restrictive financial environment, following on from tighter global central bank liquidity.

High debt levels and capital misallocation have become risks to Chinese growth, something that policymakers are well aware of. Starting in the first half of 2018, China decided to nudge corporates towards deleverage by reducing risky alternative financing ("shadow banking"). While shadow banking may sometimes lie at the edges of the existing regulatory framework, it nonetheless constitutes an important source of financing for SMES. Cracking down on it had very detrimental effects on the financing needs of already stressed SMEs: SME loan growth decelerated, with just 20% of bank loans going to SMEs in H1 2018, down from 30% in H1 2017. 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.

P R E S S R E L E A S E

A less negative view of shadow banking would help to reduce pressures on SMEs

Policymakers in Beijing have backtracked on monetary policy tightening, while regulators have come out to voice their support for SMEs. However, this won't suffice to reduce uncertainty around SMEs entirely as banks are likely to continue to be reluctant to loan to segments of the private sector with weaker credit credentials. In addition, stricter underwriting guidelines are expected to limit credit to SMEs that are currently engaged in trade with the United States, as uncertainties still linger on this front.

A less negative view of shadow banking would help to alleviate pressures on SMEs, as it complements the formal banking sector by providing services that are not well suited to state banks. A move towards more flexible interest rates would also be conducive to removing some of the barriers that are currently interfering with SME lending.

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