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**Working Paper**

## Impacts of the global financial crisis on small and medium enterprises in the People's Republic of China

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## **ADB Working Paper Series**

### **Impacts of the Global Financial Crisis on Small and Medium Enterprises in the People's Republic of China**

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Xiangfeng Liu

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**Asian Development Bank Institute**

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**Abstract**

This paper conducts an in-depth analysis of the impacts of the global financial crisis on the People's Republic of China's (PRC's) small and medium enterprises (SMEs). It also provides relevant policy suggestions at the end. First, this paper reviews the impacts of the 1997 Asian financial crisis on the PRC's SMEs, evaluating the policy measures for coping with the crisis at that time and summarizing the relevant experiences. Second, it analyzes the impacts of the current global financial crisis on the PRC's SMEs, focusing the discussion on the causes of and resulting problems from SMEs' shrinking export markets via reduced export orders, rising operating costs, decreased efficiency, increased shutdowns, sharply rising unemployment, weakened investment confidence, broken lines of funding, and reduced resources. Third, the paper makes a preliminary analysis of the countermeasures taken by the government of the PRC, focusing on its support policies for SMEs and the problems exhibited in the implementation of those policies. Finally, the author makes policy suggestions for boosting the development of SMEs and puts forward relevant measures in the context of an SME credit guarantee, the expansion of financing institutions and channels, tax reductions, the improvement of service systems, and strengthening SMEs' self-construction mechanisms.

**JEL Classification:** F14, F41, O11, O20

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# 1. INTRODUCTION

The last 20 years have seen the rapid development of small- and medium-sized enterprises (SMEs) in the People's Republic of China (PRC). In 2003, the PRC issued *The Interim Regulations on Small and Medium Enterprises Categorizing Criteria*, which officially established the criteria for categorizing SMEs. For the industrial sector, SMEs are defined as those entities that employ less than 2,000 people, have annual revenue less than CNY300 million, or total assets less than CNY400 million.

Regarding the SME data used in this paper, the author compiled the data of all private enterprises referred to as SMEs. At present, there is no complete data series for SMEs, and so the data of private SMEs will serve to help explain the impacts of the global financial crisis on SMEs in the PRC. There are three points to explain as follows:

First, *The Interim Regulations on Small and Medium Enterprises Categorizing Criteria* (NDRC 2003) clearly defines what constitutes a SME. Table 1 provides a summary of the SME Categorization Criteria. However, the data for formal SMEs alone only reflects data for SMEs in the PRC from 2004 to 2007. Furthermore, these SMEs only include upscale enterprises with annual revenue in excess of CNY5 million. For example, in 2007 there were 330,000 formal SMEs, but the total number of SMEs including formal and informal SMEs was actually 33 million. Prior to the promulgation of the *The Interim Regulations on Small and Medium Enterprises Categorizing Criteria* (NDRC 2003), research was based mainly on indicators that private enterprises needed for analysis. SMEs are the main component of private enterprises as an economic group, and so the state of private enterprise development basically reflects the situation of SMEs.

**Table 1: Definition of an SME in the PRC**

Size Category	Number of Employees	Total Assets	Business Revenue
Small Enterprise (SE)	<300	<CNY40 million	< CNY30 million
Medium Enterprise (ME)	300–2,000	CNY40 million–400 million	CNY30 million–300 million

Note: By definition, a SME must meet one or more of the above conditions. An ME should meet all three conditions for employees, total assets, and business revenue. All others are considered SEs.

Source: People's Republic of China (2003).

Second, private enterprises include three types of enterprises, classified by the number employees hired. The first type is micro-small private enterprises that employ up to a maximum of 8 people. The second type is small and medium private enterprises with less than 2,000 employees, or with annual revenues under CNY300 million, or with total assets under CNY400 million. The third type is large private enterprises, which are businesses that employ more than 2,000 people, have annual revenue in excess of CNY300 million and total assets in excess of CNY 400 million. For example, in 2007, there were 27.59 million micro-small private enterprises, 5.51 million small and medium private enterprises, and only 2,950 large private enterprises.

Third, state-owned enterprises and foreign enterprises were not included in this paper, because all state-owned enterprises in the PRC are large and super-large enterprises.

There are another three points that need to be explained about the relationship between large private enterprises and SMEs. First, the ratio of 2,950 large private enterprises to total private enterprises in 2007 is irrelevant because the ratio is so tiny. The number of employees at the large private enterprises (6.71 million people) compared to all employees of private enterprises (127.49 million people) is 5.3%, and the ratio of the registered capital between the two types of enterprises is less than 10.0%. Furthermore, the ratio of total revenue of large private enterprises (CNY92.5 billion) to all private enterprises (CNY296.9

billion) is about 30.0%. Second, the fluctuation trend of the impacts of the global financial crisis on SMEs was totally reflected by that of all private enterprises. Obviously, the impacts of the financial crisis on the exports of SMEs would be more profound if the 2,950 large private enterprises were excluded from all private enterprises.

SMEs are playing an increasingly large role in the PRC economy. In 2008, SMEs accounted for 58.5% of the PRC's gross domestic product (GDP), 74.7% of industrial new value added, 58.9% of sales, 46.2% of tax revenue, and 62.3% of the total export values. In addition, 65% of patent technologies, 75% of technological innovation, and 82% of new products were developed by SMEs. Meanwhile, in 2008 the number of SMEs in the PRC reached over 42 million (around 38 million were macro-small private enterprises). SMEs accounted for 99% of all business enterprises in the PRC, employing 75% of urban dwellers and over 75% of the laborers transferred from rural areas.

However, SMEs' problems such as financing difficulty, poor technology levels, low creditability, and extensive management patterns have been bottlenecks in the course of their development. The current global financial crisis has exacerbated the problems of SMEs in the PRC despite a number of boosting policies developed by the government.

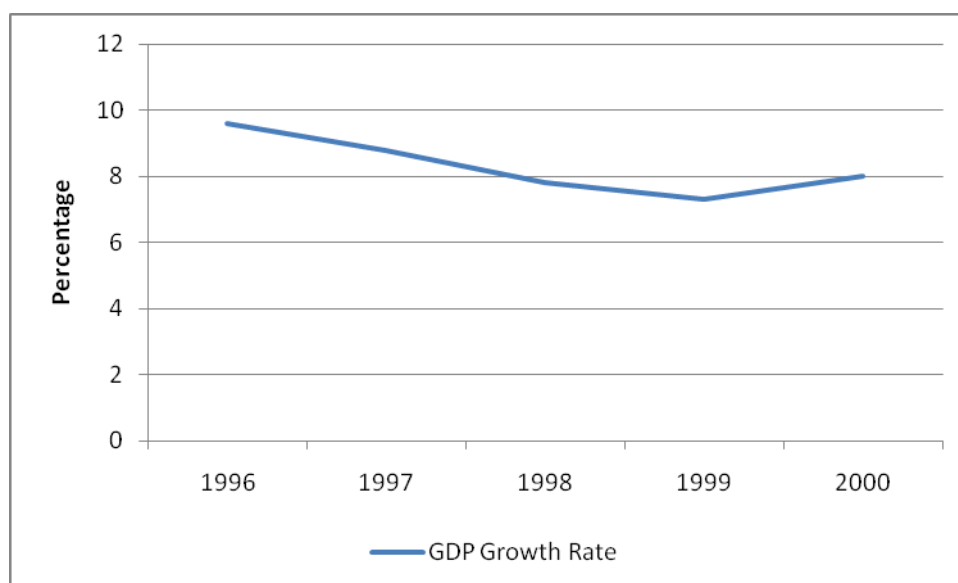
The purpose of this paper is to make a comparative analysis of the impacts of the 1997 Asian financial crisis and the current global financial crisis on SMEs and make suggestions for current PRC policies. There are four parts to this paper. Part I introduces and analyzes the impacts of the 1997 Asian financial crisis on SMEs and the government's policies. Part II makes a preliminary analysis of the impacts of the current financial crisis on the PRC's SMEs. Part III discusses the current SMEs support policies in the PRC, and Part IV puts forward relevant policy recommendations.

## **2. IMPACTS OF THE 1997 ASIAN FINANCIAL CRISIS ON SMES IN THE PEOPLE'S REPUBLIC OF CHINA**

### **2.1 Impacts of the 1997 Asian Financial Crisis on the PRC's Economy in General**

In 1997, the PRC's economy was not highly dependent on the outside world yet the Asian financial crisis still had strong impacts on it. During the crisis, the PRC experienced a slowdown in terms of its economic growth, export growth, and the growth rate of all societal fixed assets investment.

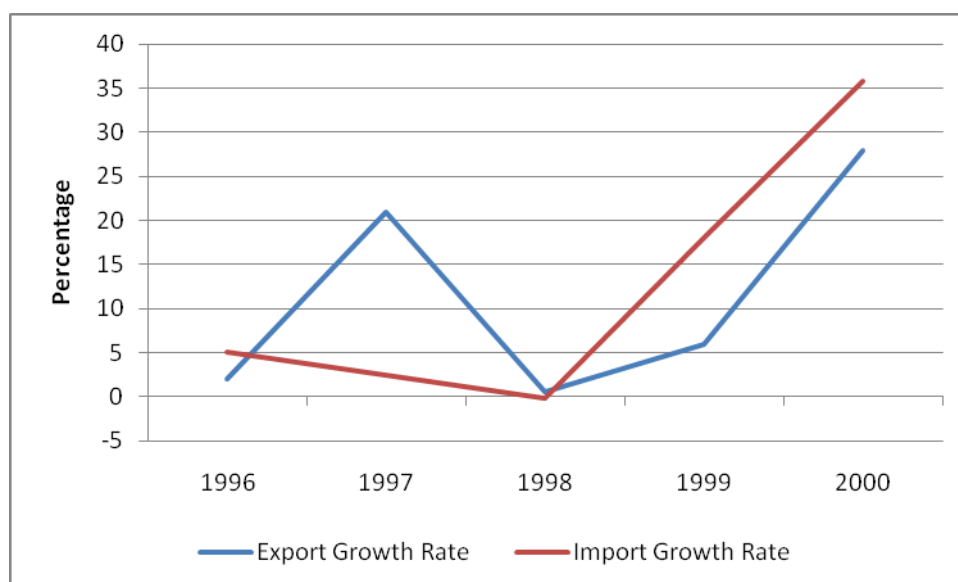
Due to the increasing globalization of the world economy in the late 1990s, the Asian financial crisis greatly reduced the rate of economic development of the global economy, thereby strongly affecting the growth of the PRC economy as well. As shown in Figure 1, the growth rate of the PRC's economy was 9.6% in 1996, 8.8% in 1997, 7.8% in 1998, and 7.3% in 1999. Domestic economic growth gradually regained momentum after the PRC government adopted a series of effective measures, such as boosting domestic demand, which resulted in a rebound in the growth rate to 8.0% in 2000.

**Figure 1: GDP Growth Rate 1996–2000**

GDP = gross domestic product, PRC = People's Republic of China.

Source: National Bureau of Statistics of China (1997–2001).

Export growth in the PRC slowed as a result of the Asian financial crisis. As shown in Figure 2, the export growth rate was large in 1997, however this was an artificial effect resulting from preexisting export orders. In 1998, though, the rate of export growth was only 0.5%, which was almost stagnant. The onset of the financial crisis directly resulted in the reduction of exports, which was further compounded by the insufficient internal and external demand that followed due to the multiplier effect of trade. This also adversely impacted SME business operations, and demand for products produced by export-related enterprises fell accordingly. In 1999, the export sector began to regain its strength.

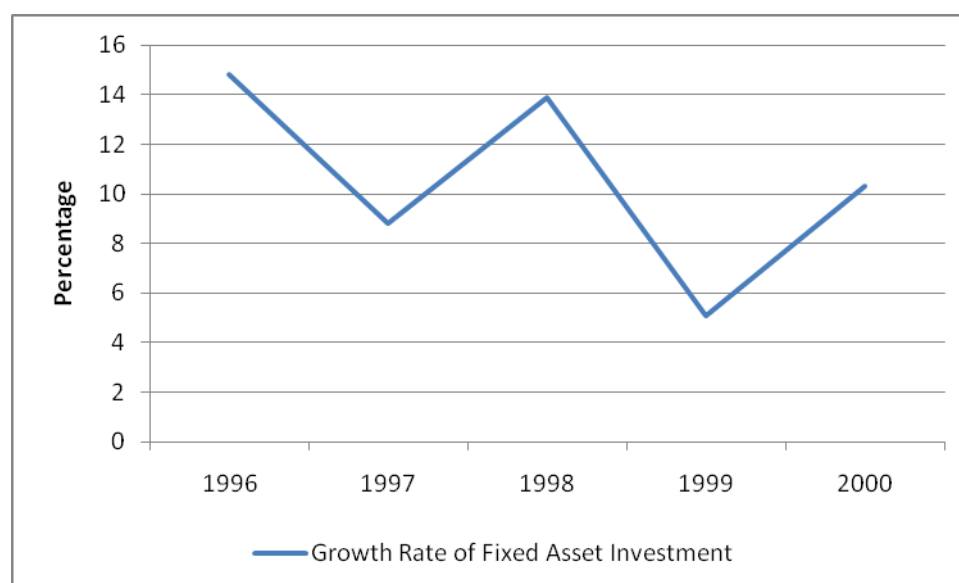
**Figure2: Growth Rate of Trade in the People's Republic of China 1996–2000**

Source: National Bureau of Statistics of China (1997–2001).

The Asian financial crisis also resulted in a slowdown of fixed asset investment in the PRC. As shown in Figure 3, in 1996 the growth rate of fixed asset investment was 14.8%, but it fell to 8.8% in 1997. Due to stimulative PRC policies, such as proactive fiscal policy, fixed asset investment rebounded to 13.9% in 1998, but then declined to 5.3% in 1999. In 2000, it recovered to 10.3%.



**Figure 3: Growth rate of People's Republic of China Fixed Asset Investment, 1996–2000**



Source: National Bureau of Statistics of China (1997–2001).

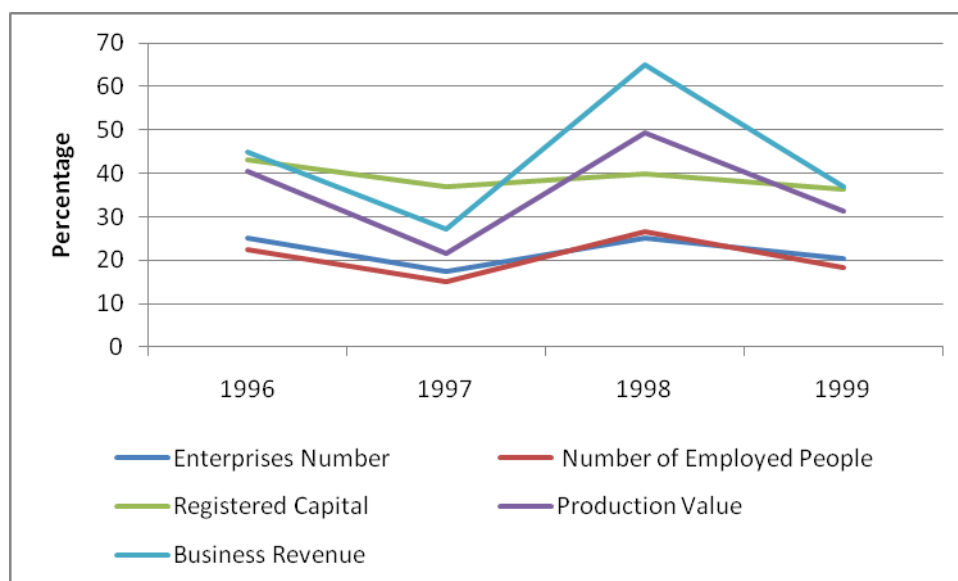
## 2.2 Impacts on SMEs in the PRC

In terms of the indicators for all private enterprises, such as employed staffs, registered capital, retail sums of consumption goods, and export growth rate, there was a significant decline in 1997 compared to 1996. Although there was a great rebound in 1998, a decline appeared again in 1999. As shown in Figure 4, the impacts of the Asian financial crisis on the PRC's SMEs lasted for three years.

### 2.2.1 Fluctuations in the Growth Rate of the Number of Enterprises

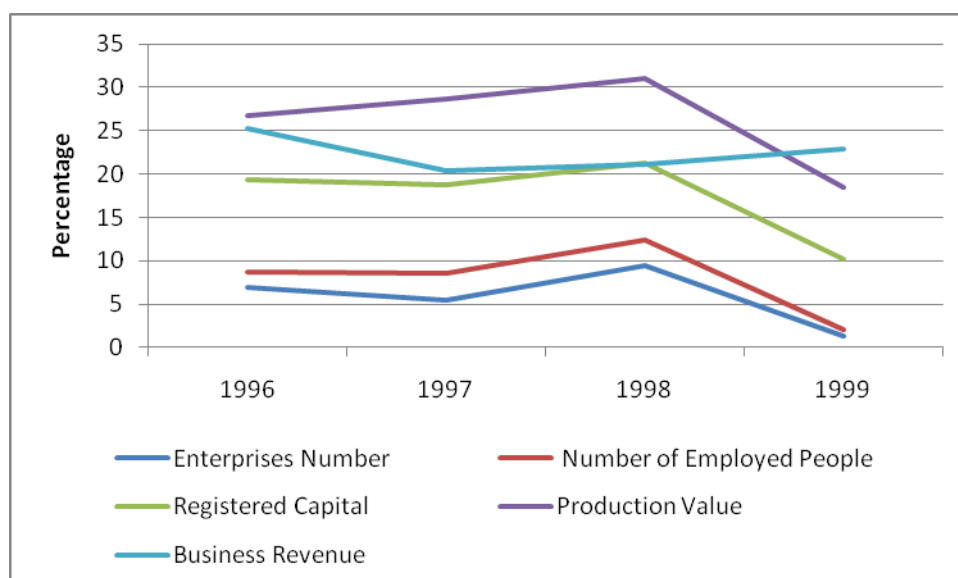
As shown in Figure 4, the number of small and medium private enterprises in the PRC in 1996 (820,000 SMEs) grew 25.2% over the previous year. In 1997 (960,000 SMEs) the growth rate dropped to 17.3%, and then in 1998 (1.2 million SMEs) the growth rate rebounded to 25.0%. Finally, in 1999 (1.5 million SMEs) the growth rate again dropped to 20.5%. Similar trends were also true of micro-small private enterprises. Figure 5 shows that for the growth rate of related economic indexes for micro-small private enterprises, in 1996 (27.04 million SMEs) the growth rate was 7.0%, whereas in 1997 (28.51 million SMEs) the growth rate declined to 5.4%. In 1998 (31.2 million SMEs), the growth rate reached 9.5% and in 1999 (31.6 million SMEs) the growth rate dropped to 1.3%, a very significant decline. Due to the smaller size of micro-small private enterprises (having less than 8 people in such organizations) this category experienced relatively large fluctuations.

**Figure 4: Growth Rate of Related Economic Index of Small and Medium Private Enterprises 1996–1999 by Percentage Point**



Source: PRC Industry and Commerce Association (2003).

**Figure 5: Growth Rate of Related Economic Index of Micro-Small Private Enterprises in the People's Republic of China (%) 1996–1999**



Source: PRC Industry and Commerce Association (2003).

## 2.2.2 Fluctuations in the Number of Employed People

Figure 4 shows that the growth rate of people employed by small and medium private enterprises was 22.5% in 1996 (11.71 million people), 15.2% in 1997 (13.49 million people), 26.7% in 1998 (17.09 million people), and 18.3% in 1999 (20.22 million people). In terms of the number of employed people in micro-small private enterprises, as shown in Figure 5, in 1996 (50.17 million people) the growth rate was 8.7% and, similarly, in 1997 (54.42 million people) it was 8.5%. In 1998 (61.14 million people) the growth rate increased to 12.36% and then in 1999 (62.41 million), the growth rate dropped to 2.06%. Thus it is evident during the period from 1996 to 1999 that the number of people employed by micro-small private enterprises was far greater than that of small and medium private enterprises. Due to their stronger market sensitivity, micro-small private enterprises were more vulnerable to policy adjustments.

### 2.2.3 Fluctuations in Investment Growth Rate

Figure 4 shows the registered capital of small and medium private enterprises from 1996 to 1999. In 1996, registered capital was CNY375.2 billion, an increase of 43.1% over the previous year. The growth rate then fell in 1997 (CNY514 billion) to 37.0%, but recovered in 1998 (CNY719.8 billion) to 40.0%. Finally, in 1999 (CNY1028.7 billion) the growth rate was 36.3%. Comparatively, Figure 5 shows that the growth rate of registered capital of micro-small private enterprises in 1996 (CNY353.9 billion) was 21.6%, 18.8% in 1997 (CNY257.3 billion), 21.2% in 1998 (CNY312 billion), and 10.2% in 1999 (CNY343.9 billion). During the startup phase, business owners, entrepreneurial teams, and their families provided over 90% of funds for these SMEs. The efforts to support SME growth and development from the financial sector were not great in the PRC. In 1997, loans garnered by all private enterprises accounted for only 2.3% of the total bank loans. Even in Jiangsu Province, where all private enterprises were developed relatively well, the ratio of the balance of their bank loans to the various types of loans was only 4.8% in 1999, and in 2000 the ratio only slightly increased to 5.2%.

### 2.2.4 Great Fluctuations in the Growth Rate of Production and Operations

In 1996, the production value of small and medium private enterprises was CNY322.7 billion, an increase of 40.6% over the previous year. Growth rates the subsequent years were 21.6% in 1997 (CNY392.3 billion), 49.2% in 1998 (CNY585.3 billion), and 31.3% in 1999 (CNY768.6 billion). In 1996, the production value of micro-small private enterprises was CNY353.9 billion, an increase of 26.8% over the previous year, CNY455.3 billion in 1997, CNY596 billion in 1998, and CNY706.3 billion in 1999.

The retail of consumption goods is also significant. In 1996, the retail of consumption goods by small and medium private enterprises was CNY145.9 billion, an increase of 45% over the previous year. Growth fluctuated in the years that followed, with an increase of 21.7% in 1997 (CNY185.5 billion), a sharp increase of 65.0% in 1998 (CNY305.9 billion), and maintained a steady 37% increase in 1999 (CNY419.1 billion), a great drop compared to 1998. In 1996, the retails of micro-small private enterprises totaled CNY670.6 billion, an increase of 25.2% over the previous year. In 1997 (CNY807.4 billion) the growth rate was 20.4%, followed by a 21.1% increase in 1998 (CNY978 billion), and an increase of 22.9% in 1999 (CNY1200 billion). Clearly, private enterprises were encouraged by the rapid growth of production values, especially micro-small enterprises since their production values were generally the same as those of SMEs and their sales several times more than those of SMEs. Consequently, micro-small enterprises were fast in responding to the market and able to make quick adjustments.

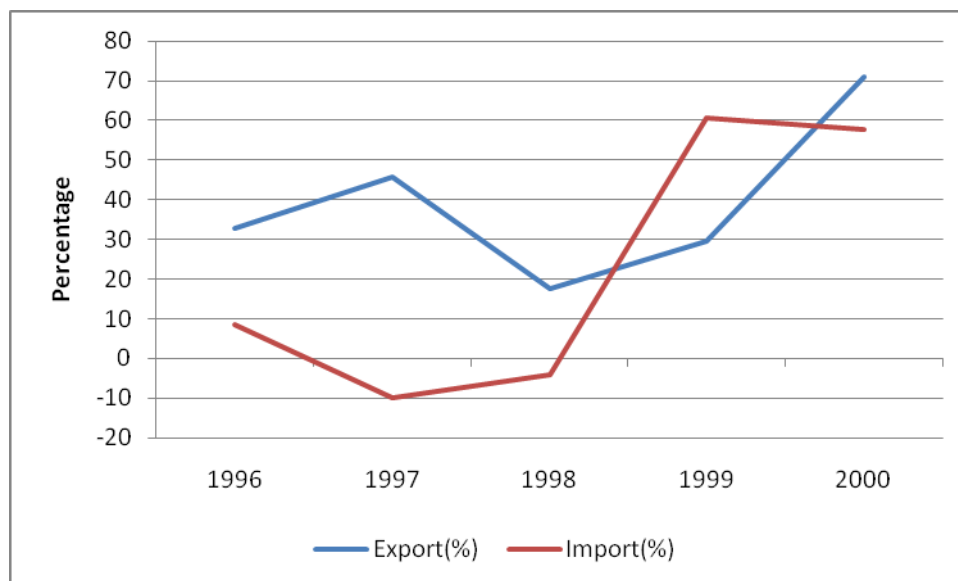
### 2.2.5 Significant Downturn in Export Growth in 1998

The exports of SMEs were also affected by the crisis. Figure 6 shows the growth rate of trade for all private enterprises in the PRC from 1996 to 1999. The trends in the figure show that impacts of the financial crisis on the exports of SMEs were consistent with the trend of affected PRC exports in general. Both had a dramatic downturn in exports in 1998, which began to rebound in 1999 and continued to rebound in 2000. International markets significantly affected export demand, which reached its lowest point in 1998. Thereafter, it rapidly rebounded and kept its growth momentum. An analysis of the relationship between the private economy and international markets in 1997 and 1998 shows 61.5% of the enterprises regarded other domestic private enterprises as competitors, according to the results of the 4<sup>th</sup> National Private Enterprises Sampling Survey (PRC Industry and Commerce Association 2007).<sup>1</sup> Compared with the direct impacts of international markets on

<sup>1</sup> As for how private enterprises judge the PRC's post-World Trade Organization situation, the survey showed that only 7.5% of the enterprises had considered that a large flow of foreign products would bring adverse impacts to their own enterprise. Only 6.6% of the private enterprises acknowledged that the appearance of more foreign-funded enterprises may mean more competitors, while 12.0% of the enterprises reported to

all private enterprises, domestic policy adjustments had stronger impacts on private enterprise. The impacts of the Asian financial crisis in 1997 on SMEs also reflected this situation.

**Figure 6: Growth Rate of Trade of All Private Enterprises 1996–2000**



Source: PRC Industry and Commerce Association (2008).

### 2.2.6 Low Level of Creditability

It was generally reflected in the survey of private enterprises that the most perplexing issue was that of SME credit detection. According to the survey, a significant number of entrepreneurs felt vexed at the low level of creditability of the whole society (Ding 2001). Therefore, it was necessary to make systematic adjustments in terms of laws, systems, and management mechanisms to improve societal access to credit.

## 2.3 Policy Response of the Government of the PRC to Cope with the Asian Financial Crisis

In order to cope with the Asian financial crisis in 1997 and prevent and defuse financial risks, the PRC government urgently needed to boost internal demand and increase the money supply. Under such circumstances, the PRC adopted a proactive fiscal policy and a prudent monetary policy. As a result, significant achievements were made in terms of handling the crisis and its impacts on the PRC economy.

### 2.3.1 Proactive Fiscal Policy

Strengthening fiscal investment became an important means of coping with the crisis and stimulating economic growth. First, the government issued additional state bonds for long-term construction. In 1998 CNY100 billion in special state bonds were issued, which effectively boosted the supplementary funds and bank loans for localities, sectors, and enterprises. In response to the situation at that time, funds were mainly channeled to the construction of infrastructure and played an important role in stabilizing the economy. Second, in 1998 the total sum of fixed asset investment in the PRC was CNY2.85 trillion, an increase of 14.1%, of which CNY1.57 trillion was invested in the state economy, an increase of 19.6%. Third, the PRC government also began investing in expressway construction to stimulate internal demand. Under the then economic conditions, highway construction was

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unclear on the issue. Finally, 10.0% of the enterprises had not even considered this issue. All around services for SMEs conducted by the PRC government and various intermediaries were just started, which lagged far behind those of developed countries.

characterized by a short construction period. In 1998, internal demand was significantly boosted by the large scale of investment in expressway construction, and resulted in a strong momentum of economic growth.

### **2.3.2 Prudent Monetary Policy**

Efforts to adjust PRC monetary policy were great, and many of the adjustments were put in place in a timely fashion. First, the government down-adjusted the required reserve ratio from 13% to 8% in March 1998, a down-adjustment of five percentage points. Second, interest rates were lowered. Various deposit and loan interest rates were reduced, with some annual deposit rates being lowered by 0.16 percentage points and several annual loan interest rates dropping by 0.60 percentage points. This met the demand for loans from the enterprises and greatly stimulated the economic growth. Third, the government lifted the restrictions on the scale of loans so as to give commercial banks full independent rights for issuing loans. Fourth, the central bank increased the money supply through the expansion of open market operations. In 1998, market operations were expanded six times with an investment of base money of CNY70.1 billion. In 1999, CNY192 billion in base money was issued, accounting for 52% of the additional base money of the year. Fifth, government policy established that the yuan would not appreciate and the exchange rate was to remain stable.

### **2.3.3 Continuous Support Policy for SMEs**

Management systems for SMEs in the PRC began to change with the increasingly improved external environment. Instead of a situation where there was strong desire but weak capability to handle SMEs, circumstances reversed with an influx of capable management.

In 1998, the SMEs Department was set up in the State Economic and Trade Commission, and the Bureau of Small and Medium Enterprises was also established in 21 provincial governments around the country.

In 1999, the legal position of the private economy was further defined with SME-related laws such as the Partnership Enterprise Law and Sole Proprietorship Enterprise Law.

In 2001, the government issued six documents that strengthened SME institutions and regulations. These documents streamlined SME establishment and approval, established measures for managing the SME financing guarantee industry, improved SME credit guarantee systems, outlined the implementation of business tax exemption for SME guarantees and re-guarantees, strengthened SME quality management, and improved SME credit management (Yao 2004).

In 2003, the *Interim Regulations on Standards for Small-and-Medium Enterprises* was promulgated, which promoted an accurate definition of an SME.

## **2.4 Evaluation of PRC Government Policy Responses for Coping with the Crisis**

In order to cope with the financial crisis, the PRC government proceeded with macro controls in a timely fashion by using both fiscal and monetary means to stimulate investment and boost internal demand, which mitigated the impacts of financial crisis. Although there was a downturn in SMEs in 1998, their various indicators maintained relatively high growth rates. After 2000, the PRC economy regained its momentum and resumed its rapid growth. The PRC managed to maintain a stable economy and stability in the yuan exchange rate, thus avoiding some of the more severe impacts that hit the Asian economic region and allowing the PRC economy to play an active role in stabilizing the world economy.

Although the fiscal and monetary policies issued by the PRC government were not directly related to SMEs, SME development was closely related to the PRC's domestic markets. Because the fiscal and monetary policies stimulated the growth of the PRC economy as a

whole, a positive economic environment was created for SME development and lasted over the next several years.

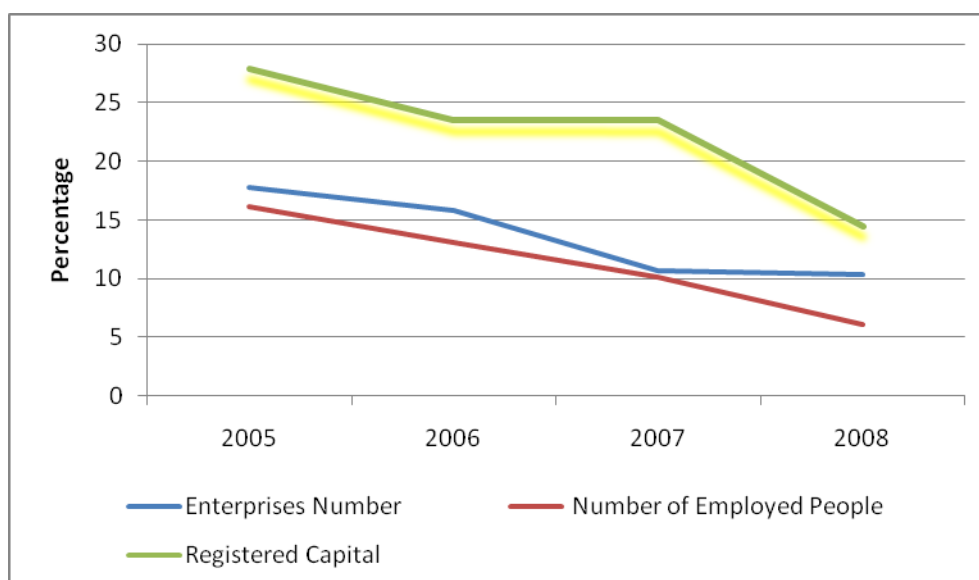
W-shape fluctuations appeared during the Asian financial crisis and are evident when analyzing the impacts of the crisis on SMEs. Because supportive SME policies were well in place in 1998, SME performance rapidly rebounded that year following the sharp decline in 1997. However, performance declined again in 1999, exhibiting the trends associated with the W-shape pattern. This showed that there was a lack of continuity in the crisis countermeasures, which is a relevant concern for future crises.

### 3. IMPACTS OF THE CURRENT FINANCIAL CRISIS ON SMES IN THE PEOPLE'S REPUBLIC OF CHINA

#### 3.1 State of Continuous Development of SMEs in the PRC from 2005 to 2008

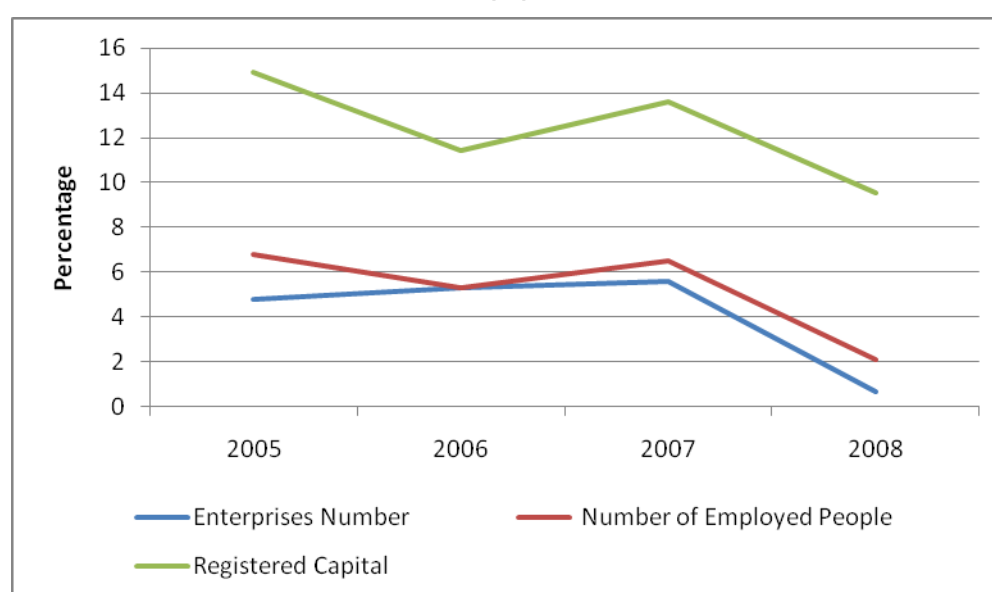
The PRC's private enterprises have maintained a relatively high growth rate. With the commencement of industrial upgrading and transformation after 2005, the number of enterprises, people employed, registered capital, and export growth began to show a mild downward trend. However, in 2007 an obvious inflexion appeared. This was because the central government promulgated a series of macroeconomic policies to reign in inflation. For instance, the People's Bank of China, the PRC's central bank, up-adjusted the deposit and loan interest rates on four occasions and up-adjusted the required reserve ratio six times. The rate of export rebates for enterprises with high-energy consumption, high pollution, or low addition values was also reduced or abolished. All of these factors greatly increased the operating costs of enterprises. Main indicators for the SME growth rate from January 2008 to May 2008 showed a relatively big downside (as shown in Figure 7). However, the ratio of SMEs' exports to the PRC's exports as whole remained in an upward trend.

**Figure 7: Growth Rate of Related Economic Index of Small and Medium Private Enterprises 2005–2008**



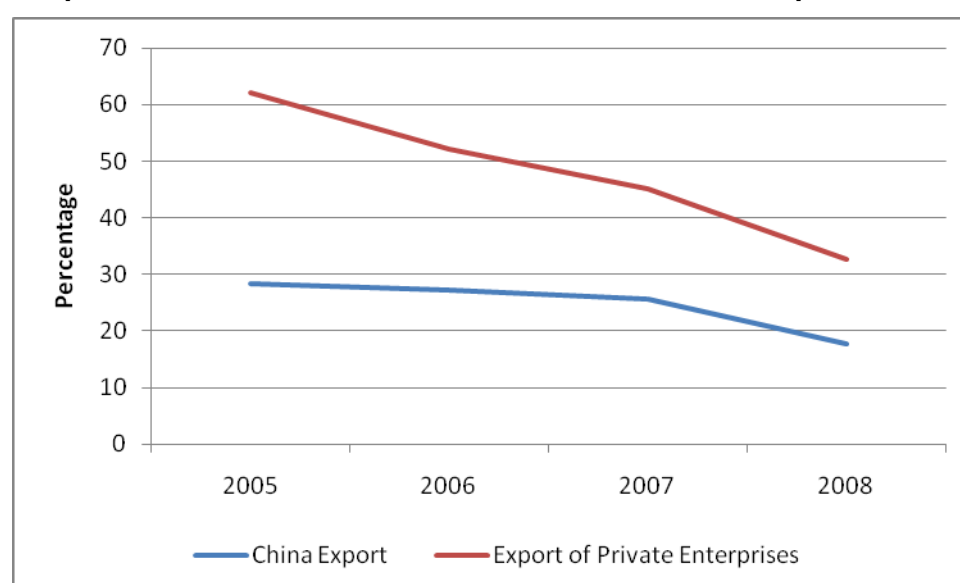
Source: PRC Industry and Commerce Association (2009).

**Figure 8: Growth Rate of Related Economic Index of Micro-Small Private Enterprises in the PRC (%) 2005–2008**



Source: PRC Industry and Commerce Association (2009).

**Figure 9: Export Growth Rate of Small and Medium Private Enterprises 2005–2008 (%)**



Source: PRC Industry and Commerce Association (2009).

### 3.2 The Current Financial Crisis Caused Severe Impacts on the PRC Economy

Catalyzed by the sub-prime mortgage crisis in the United States (US), the global financial crisis broke out in September 2008, having serious impacts on the PRC economy.

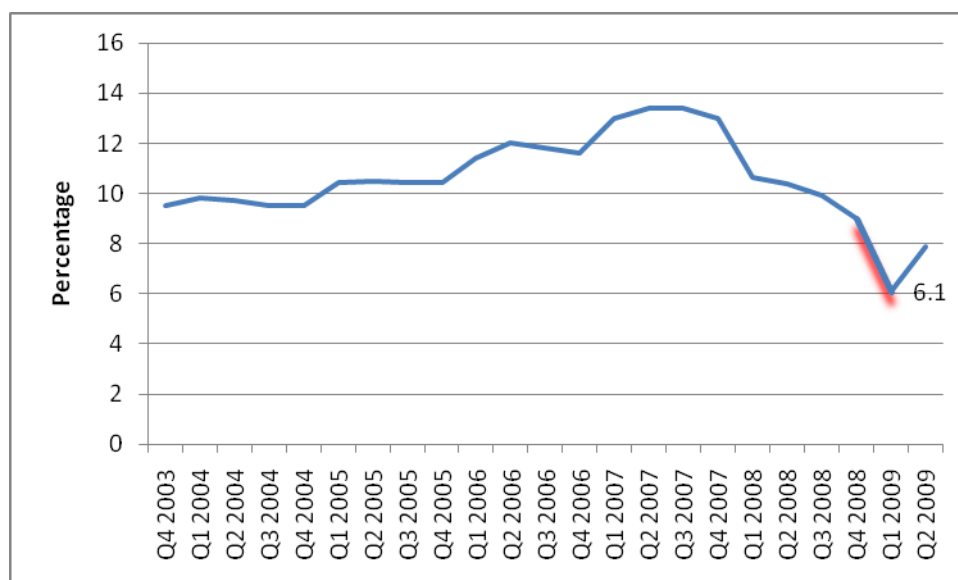
One impact was that GDP growth declined dramatically. According to statistical data from National Bureau of Statistics (NBS), the GDP growth rate in 2007 was 11.9% and quickly dropped to 9.0% in 2008. GDP grew at 6.1% in the first quarter of 2009, the worst performance in the PRC economy since 2002.

The financial crisis also caused export growth to drop sharply. *In 2007, the PRC's exports increased 23.5% over the previous year. In 2008, the PRC's imports and exports in foreign*

trade totaled US\$2.56 trillion , an increase of 17.8% year on year. However, the export growth rate in December 2008 was -2.8%, the first of its kind in 10 years.

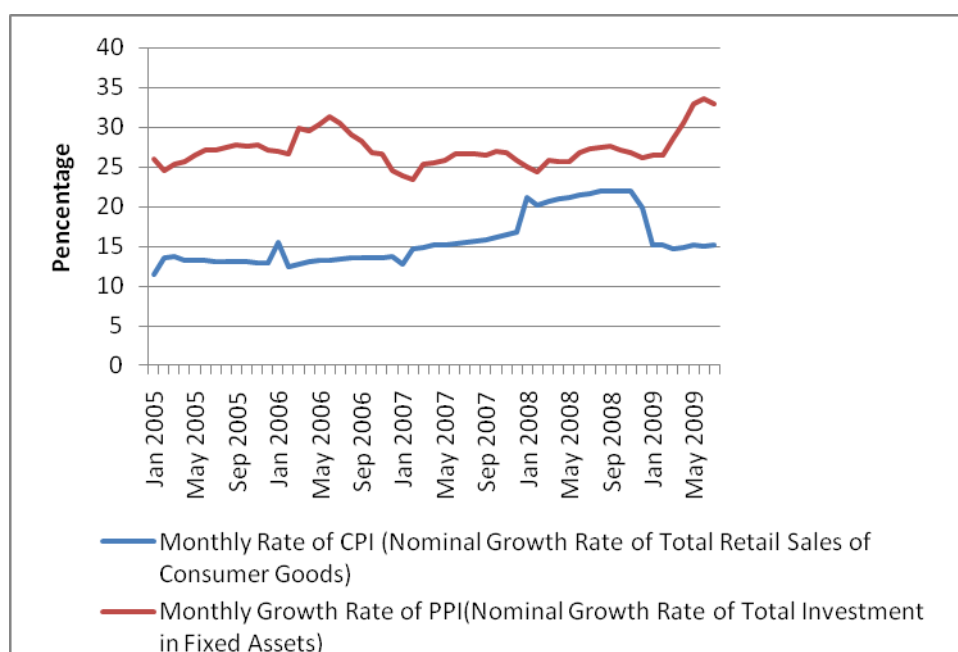
In the meantime, the rising unemployment rate tightened the liquidity of funds throughout the PRC, especially impacting export-oriented SMEs (Li 2008). To some extent, this damaged the PRC's foundation for its economic development.

**Figure 10: Real Growth Rate of GDP in the PRC (%)**



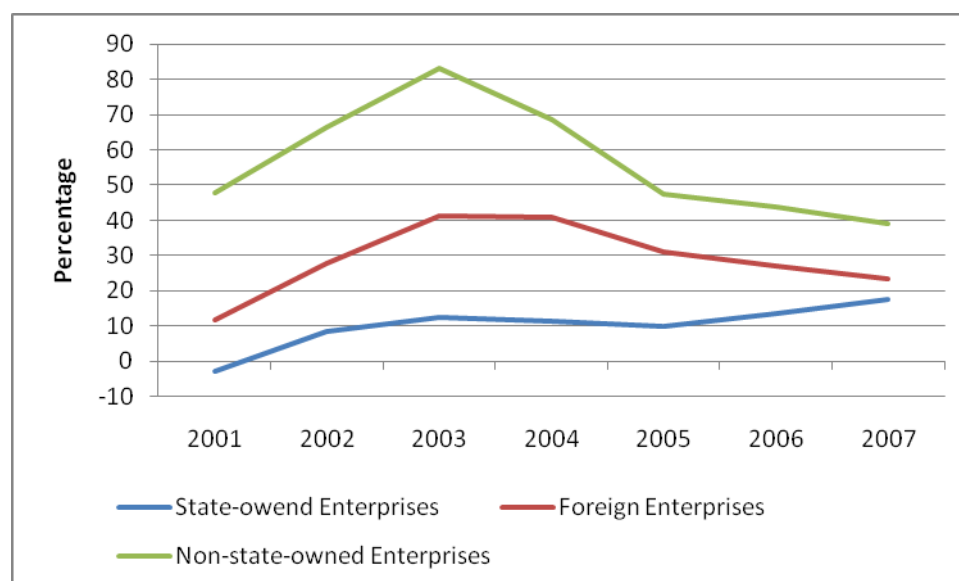
Source: National Bureau of Statistic of China (2003–2009).

**Figure 11: Growth Rate of the Consume Price Index (CPI) and the Producer Price Index (PPI)**

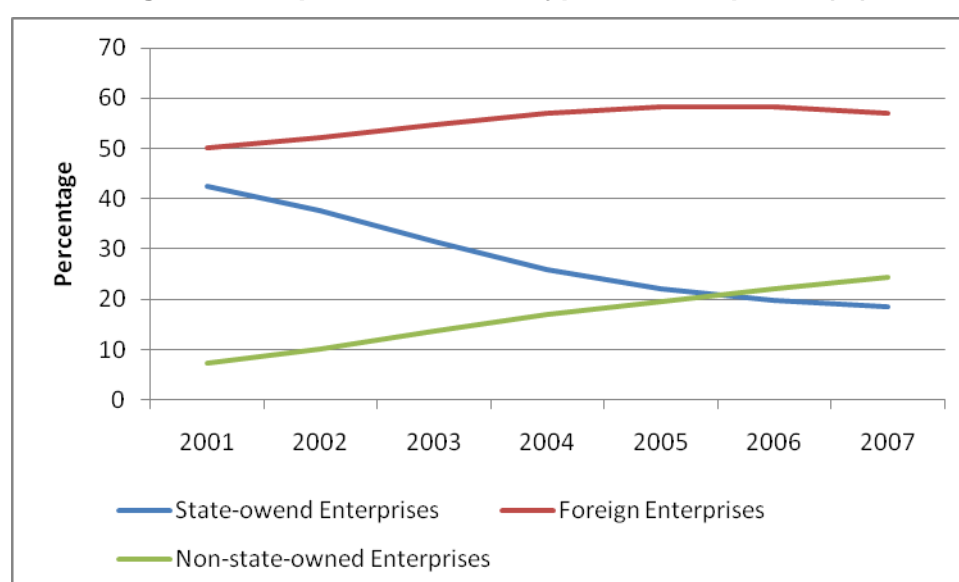


Source: National Bureau of Statistic of China (2003–2009).



**Figure 12: Export Growth Rate of All Types of Enterprises (%)**

Source: PRC Industry and Commerce Association (2009).

**Figure 13: Export Ratio of All Types of Enterprises (%)**

Source: PRC Industry and Commerce Association (2009).

### 3.3 Impacts of the Current Financial Crisis on the PRC's SMEs

The current financial crisis has had two big impacts on SMEs in the PRC. The crisis has resulted in a sharply decreasing external need for export-oriented SMEs and more severe financial difficulties for all SMEs overall.

#### 3.3.1 Sharp Decreasing External Need for Export-Oriented SMEs

As the crisis unfolded, deflation appeared in the world economy, directly causing a dramatic contraction of the international products markets. Beginning in November 2008, both imports and exports in the PRC declined year on year and showed negative growth. Enterprises producing daily necessities such as toys, clothing, textile products, shoes, furniture, sports gears, and stationeries were most affected, with the east coastal region being hit most severely. Most of the enterprises that were forced to shutdown were export-oriented SMEs.

The biggest problem currently facing export-oriented SMEs is insufficient market demand (Li 2005). In January 2009, the number of orders received by these SMEs dropped by 20–30% year on year, with some orders declining by as much as 50%. In addition to the reduction in new orders, there were also many suspensions and cancellations of contractual export orders. From January 2009 to February 2009 the cumulative realized values of goods exported and shipped by industrial SMEs with annual sales of over CNY5 million in Zhejiang Province was CNY82.8 billion, a decrease of 17.09% year on year. The ratio of export value to the sales production value of industrial SMEs with annual sales of over CNY5 million also declined to the low level of 22.8%. In January 2009, a questionnaire administered by the Bureau of Trade and Economy in Shenzhen surveying enterprises in the area revealed that 52.5% incurred a reduction orders. In January and February of the same year, the number of orders received by enterprises in Sichuan and Shanxi Provinces dropped greatly, sometimes even to nothing, and the possibility of reduced production, ceased production, and shutdown was imminent for many.

Because the import demand for PRC commodities from the European and US markets shrank dramatically, export-oriented SMEs felt the impacts of reduced orders and slow production. Many SMEs chose to limit or cease production and narrow their product lines. Export-related difficulties such as reduced international orders, increased trade risks, difficulty in recalling funds, and rapidly declining profits directly contributed to a severe contraction of market demand in relevant upstream domestic industrial chains, exacerbating the deterioration of the domestic economy. Consequently, some of the export-oriented SMEs began to turn to domestic market development. However, domestic market development takes a long time, requiring the building of brands and opening up of domestic market channels (Ding 2001). Thus, due to sluggish internal demand, it proved difficult for these enterprises to divert from international to domestic markets.

The global financial crisis had strong impacts on export-oriented enterprises along the eastern coast of the PRC, resulting in ceased production, business suspension, and even shutdown of a large number of enterprises. According to the sampling survey, by the end of 2008 SMEs along the coast that suspended business, ceased production, or were shutdown accounted for around 7.5% of troubled enterprises in the country (Li 2008). According to a research report on SMEs by the Chinese Academy of Social Sciences (Chen 2009), by the second half of 2008 67,000 SMEs had ceased production around the country. By the end of 2008, over 100,000 enterprises had ceased production. Except for those that had changed products or locations, the rest of the enterprises had to shutdown and accounted for over 60% (about 60,000) of all enterprises on the eastern coast. For these enterprises, their current task is to figure out how to survive.

There are 130 million migrant workers being employed in urban areas. Due to the ceased production, business suspension, and shutdown of many SMEs in 2008, approximately 20 million migrant workers (accounting for 15.3% of the entire migrant work force) lost their jobs and returned to rural areas. Statistics showed that the number of employed people in the first quarter of 2009 dropped by 5% (Chen 2009).

### **3.3.2 More Severe Financial Difficulties**

The economic trend for 2009 is still unclear. Many entrepreneurs are not optimistic about the expected market demand. They worry about the future of their corporate development and are not confident about the growth of the industrial economy (Jiang 2006). Some entrepreneurs are frustrated by investment markets and are cautious about entering the market; in some cases, entrepreneurs have even withdrawn their investments from the market. Since the inception of the financial crisis, pressure for SME sales has constantly increased, with large sums of working capital backed up in production, increasing account receivables, and stagnant inventories. For production to return to its original scale, enterprises need more turnover funds, exacerbating SMEs' funding shortage. Delayed payment between enterprises has resulted in tight cash flows, which is compounded by the fact that most SMEs are unable to obtain new loans from banks.

In order to boost internal demand, the government has designed an investment plan of CNY4 trillion to stimulate economy in 2009 and 2010. The funds are mainly being channeled to key projects such as railways, highways, and infrastructure. However, SMEs will receive little benefit from this investment, though some of them may indirectly benefit through project subcontracting, which takes a long time and is not usually felt over the short run.<sup>2</sup> In 2009, despite a larger increase of loan issuance by banks there has not been much capital flowing to SMEs. In January 2009, national credit amounted to CNY162 million and was mainly used in energy, transportation, and infrastructure projects. Loans for small enterprises accounted for only 5%.

Most development funding for the PRC's SMEs comes from the capital of business owners and their internal retained profits, which are maintained at levels over 50–60%. Direct financing, such as corporate bonds and equity financing, accounts for less than 1% and bank loans account for around 20%. Because indirect financing is the main form of financing for the PRC's SMEs, it is difficult to determine the financing risk of SMEs. A lack of standards, poor laws and regulations, and serious creditability problems for SMEs has made access to the domestic financing market for SMEs more difficult than for public companies. Over 70% of short-term funds for all private enterprises will have to rely upon credit and loans from non-governmental sources. However, as the performance of even the best SMEs suffers due to operational difficulties, more SMEs worry about making loan payments and lack the confidence to borrow funds from non-governmental sources. As a result, formerly vigorous non-governmental financing has shrunk conspicuously and SMEs' access chains to funds are on the verge of being broken. The current financial crisis has exacerbated the difficulty of securing financing for the PRC's SMEs.

The cost of enterprises began to rise during the second half of 2007. Since the onset of global financial crisis, the situation has become more severe. The crisis has dramatically increased the financing costs from SMEs. Since September 2008, although the government lowered the benchmark interest rates for banks, quite a few banks have still up-floated 20–60% over the benchmark interest rates for SMEs loans in situations where a guarantee has been implemented. Some banks also charge corporate caution money or financial advisory fees. In 2008, the financial fees for industrial SMEs sales in Zhejiang Province with over CNY5 million in annual increased 26.9%, while interest increased 32.0% year on year. Some banks would even ask enterprises experiencing cash flow difficulties to pay off their loans ahead of time for fear of overdue payment. The monthly interest rate of non-governmental loans is generally over 1%, plus an asset appraisals fee, financial fee, and guarantee fee. The annual interest rate of non-governmental loans will generally fall between 20–30%. In general, financing costs have increased by 40–50%.

The rise of raw material prices as a result of the crisis has contributed to the increasing costs for enterprises. Since 2007, the prices of large volumes of goods such as energy have fluctuated greatly, increasing pressure on input costs. The price of raw materials went up by 11–15%, while the factory price of the enterprise only increased by around 5%.

After the Labor Contract Law was implemented, the labor cost for enterprises went up dramatically. For instance, the labor cost of labor-intensive enterprises in Jiangsu Province increased by 20–30% on average.

The dramatic rise of comprehensive corporate costs seriously narrowed the room for profit for enterprises, and many enterprises incurred just slender profits or even operating losses. The labor-intensive industry was impacted to a conspicuous extent.

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<sup>2</sup> In the loan structure of the first quarter of 2009, short-term loans catering to SMEs accounted only for 25%. Those loans decreased by CNY300 billion from January to February, and so SMEs are still facing difficulty in terms of financing.

### 3.3.3 SMEs' Own Abilities Become More Fragile

SMEs are short on capital and marketable products and so it is difficult for them to withstand the impacts of market changes. Due to a lack of skill, extensive corporate management, and a poor level of technology, most SMEs have to manufacture products that are close to the market or produce supplementary products for large enterprises through the labor-intensive production. In short, they have to adapt themselves in a passive way.

## 4. PRC GOVERNMENT POLICY TO COPE WITH THE CURRENT FINANCIAL CRISIS AND RESULTANT EFFECTS

In order to cope with the global financial crisis, the PRC government has shifted the mode of economic development, issued important measures for boosting internal demand, increased investment, stimulated consumption, and has practiced proactive fiscal policy and loose monetary policy so as to ensure the healthy and steady development of the economy. In 2009, the government put forward a target GDP growth of 8%. Currently, it appears the government's stimulative measures have been achieving this goal. It is projected that the PRC's economy will reach its nadir and rebound during the second half of 2009. To continue coping with the financial crisis and to assist the recovery of SMEs, the PRC government has taken a series of measures, which are explained in the following section.

### 4.1 Macroeconomic Policies

#### 4.1.1 Expanding Government Investment

Toward the end of 2008, the PRC government began to practice proactive fiscal policy by introducing an economic stimulus package of CNY4 trillion in order to cope with the financial crisis. The CNY4 trillion is broken down into CNY1.18 trillion invested by the central government and CNY2.82 trillion invested by local governments. From historical data, we can notice that from 1998 to 2004, the Central government practiced the proactive fiscal policy for seven years, during which CNY910 billion in long-term construction bonds was issued. This stimulus plan boosted economic growth by 1.5–2 percentage points on a yearly basis during this period. In light of this, the investment of CNY4 trillion should boost economic growth by at least 2 percentage points. Investment structure focused on infrastructure. The central government has chosen 10 major measures for boosting internal demand, deciding that 60% of the total investment will be used to improve people's well being in areas such as medical care, education, and social security. This will not only stimulate the economic development, but also solve actual problems that currently afflict the PRC.

In 2009, the central government arranged for CNY908 billion for public investment, an increase of CNY487.5 billion over the budget in 2008. Also in 2009, the PRC's fiscal deficit will expand to CNY950 billion, the highest sum since the founding of the PRC. The ratio of the fiscal deficit to GDP will be controlled within 3%, and the deficit will be made up through increasing the issuance of state bonds. In 2009, the balance of state bonds of fiscal finance will be CNY6.27 trillion, which is CNY1 trillion more than the balance of state bonds of CNY5.33 trillion in the PRC in 2008.<sup>3</sup>

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<sup>3</sup> Two indicators are needed for judging the room issuing bonds in a country. These are the deficit rate (deficit/GDP) and the debt load rate (debt/GDP). However, the practiced international standard is that the central finance deficit rate is 3% and the state bonds debt load rate is 60% of the GDP. In 2007, the government issued an additional sum of CNY1.5 trillion in special state bonds, making the state bonds debt load rate increase rapidly to 21.64% in 2007; it still has a long way to go before reaching the international warning line of 60%.

#### **4.1.2 The Monetary Policy Increasing Credit Supply**

According to the February 2009 Government Work Report (Wen 2009), in 2009 the target for loan increases was over CNY5 trillion, an increase of approximately 50% over the target of CNY3.6 trillion in 2008. It is also higher than the 2008 credit increase of CNY4.9 trillion for the banking industry. The central bank's statistics show that the newly increased credit in the first quarter of 2009 reached CNY4.58 trillion, an increase of CNY3.25 trillion year on year, or over three times that of the same period in 2008. The issuance of credit in March 2009 alone was as high as CNY1.89 trillion, a record high for the sum of increased credit in a single month.

#### **4.1.3 Developing Industry Rejuvenation Plan**

To boost internal demand, the PRC government developed a plan for rejuvenating 10 industries: iron and steel, automobiles, vessels, petrochemicals, textiles, light industry, non-ferrous metal, equipment manufacturing, electronic information, and logistics. These industries are national economic pillar industries, strategic industries, or important industries concerning people's well being. All play important roles in the national economy. The industrial value-added of the nine of these industries account for around 80% of the total industrial value-added and one third of GDP. In addition, taxes submitted by enterprises with annual sales of over CNY5 million account for 40% of the total tax revenue in the PRC, and the number of employed people account for about 30% of the total number of employed people by organizations in the urban areas of the country.

#### **4.1.4 Stimulating Domestic Consumption**

The PRC government has taken several actions to stimulate domestic consumption. First, it is expanding employment by increasing investment in the tertiary industry to enhance the average income of residents. This is intended to stimulate domestic consumption demand by improving personal ability for consumption (Li 2008). Second, the government is reducing the tax burden by increasing the tax threshold for personal income tax. Third, the government is taking action to control price hikes. Fourth, many actions have been taken to stabilize housing prices. In order to maintain stability in the real estate market and avoid the rapid decline of housing prices, housing prices were stabilized mainly through the market mechanism and adjusted by increasing the housing supply. A fifth action has been the reduction of automobile prices. Currently, the price of raw materials such as steel has declined, lowering the cost of vehicle production. Consequently, the cost of vehicles has dropped and the new highway construction should encourage traveling by automobile. Finally, the government has taken steps to stimulate rural markets. This stimulus has come in the form CNY40 billion in subsidies and is meant to facilitate the "Bringing Home Appliances to Farmers" program, under which enterprises benefit from increased sales while farmers receive improvement in their daily lives.

#### **4.1.5 Developing the Social Security Plan**

With regard to employment issues, the government has planned to invest CNY42 billion to implement a more proactive employment policy. This includes promoting the employment of university graduates, creating more employment opportunities for rural migrant workers, helping people with difficulty finding employment get jobs in urban areas, and supporting people seeking to find employment through entrepreneurship (Li 2008).

The government also has targeted medical care as an area for investment. The plan is for CNY850 billion to be invested by various levels of government (from central to local) to ensure the smooth implementation of medical and pharmaceutical institutional reforms. The reforms should work earnestly to resolve the problems in medical care such as improving facilities that are too expensive and too difficult to access for the average PRC citizen, thereby providing safe, effective, convenient, and inexpensive medical and health services for the people in the country.

The insurance sector is set to receive CNY293 billion in social security funding from the government to improve the basic old-age pension insurance system, greatly develop social welfare undertakings, and expand the coverage of social security.

In 2009, the government plans to invest CNY49.3 billion to create more economically affordable housing. The funds will support for the construction of low-rent housing and the revamping of shantytowns. Over the next three years, the state will invest CNY900 billion to strengthen the construction of welfare housing.

## 4.2 Support Policy for SMEs

In the first quarter of 2009, a tax break policy was promulgated in Guangdong, Jiangsu, and other provinces to support the development of SMEs. Specifically, this policy is aimed at providing tax preferential treatment to SMEs engaging in technological transfers, development, and services. For instance, the policy increased the ratio of deduction for research and development expenses, and technological and environmental protection enterprises will receive preferential treatment with regard to their income taxes.

The China Banking Regulatory Commission (CBRC) took a strategic view for strengthening the credit support of small enterprises and required that the five big state commercial banks complete the establishment of special service outlets of credit for small enterprises within the next five years, emphasizing that the growth of small enterprises credit should not be lower than the average credit growth (Jiang 2009).

To strengthen the credit guarantee system for SMEs, the government has issued policies for strengthening the credit support for SMEs (Zhao 2008). In 2009, an additional sum of CNY1 billion was allocated to the SME guarantee fund to further increase the guaranteeing capability of the institution and improve the development of guarantee and re-guarantee companies around the country.

The rapid development of small-sized financial institutions for rural SMEs in the countryside will also help SME development. According to statistics from CBRC, by the end of 2008 there were 89 village and township banks approved for operations around the country; by the end of September 2008 there were 144 small loans companies around the country.

In 2008, the main government policies for maintaining the stable development of SMEs included the following:

- Notice of National Development and Reform Commission Concerning the Printing and Distribution of Opinions on Promoting SMEs Informatization through Reinforced Services,
- Notice on Supporting and Guiding Credit Guarantee Institutions for Small-and-Medium Enterprises to Strengthening Their Services and Mitigating SMEs' Difficulty in Production and Operations,
- Notice of the Ministry of Finance and the State Administration of Taxation Concerning Adjustments of Export Rebate Rates for Part of the Textile Products and Garments,
- Notice of the Ministry of Finance Concerning the Increase of Export Rebate Rates for Part of Export Commodities,
- Notice of the Ministry of Finance Concerning the Printing and Distribution of *Measures for Management of Special Funds for SMEs Development*,
- Notice of the Ministry of Finance and the State Administration of Taxation Concerning the Increase of Export Rebate Rates of VAT for Export Commodities, Such As, Labor-Intensive Products,

- Notice of the Ministry of Finance and National Development and Reform Commission Concerning the Implementation of Preferential Treatment in Fees and Charges for Relevant Staffs Engaging in Privately Owned Business,
- Notice of the Ministry of Finance, National Development and Reform Commission and the State Administration for Industry and Commerce Concerning Relevant Issues on Terminating the Collection of Administrative Charges from Privately Owned Business and Wet Market Management Fees,
- Notice of China Banking Regulatory Commission on Earnestly Implementing the Policy of “Encouragements and Discouragements” to Further Improve the Financial Services Provided to Small Enterprise,
- Notice of China Banking Regulatory Commission Concerning the Guiding Principles for Banks to Establish Special Business Outlets of Financial Services for Small Enterprises,
- Notice of the People’s Bank of China, the Ministry of Finance and the Ministry of Human Resources and Social Security on Further Improving the Management of Small Guarantee Loans and Actively Boosting Employment Through Entrepreneurship,
- Notice of the State Administration for Industry and Commerce Concerning Issues on Pre-payment of Income Tax by Small Enterprise with Minor Profits,
- Notice of the Ministry of Finance and the Ministry of Industry and Information Technology Concerning the Proper Application for Approval of Subsidies for SMEs Credit Guarantee Business in 2008,
- Opinions of the State Council General Office on Currently Boosting Economic Development Through Finance.

### **4.3 Efficiency Evaluation of Implementing the SMEs Support Policy**

#### **4.3.1 Difficult to Shift external Demand to Internal Demand**

The financial crisis provides an opportunity for the PRC’s SMEs to upgrade and improve their productivity. SMEs in the PRC need to switch their long-run strategy from relying on external demand to internal demand. The export rebate policy does offer some benefits for export-oriented enterprises, but it is not strong enough as intermediaries, such as foreign trade companies, usually grab these benefits and use them to lower their prices. Some export-oriented SMEs are ready to divert themselves to domestic sales. However, it is rather difficult for enterprises to engage in domestic sales. For instance, most large government procurement orders are given to internationally renowned brands, and it is impossible for SMEs with independent property rights and similar product quality to garner such orders.

#### **3.3.2 The Problem of Financing Difficult Remains Unsolved**

Finance support policies for SMEs should reduce the risks and transaction costs associated with SME lending, increase the competition in financial markets, and strengthen the capacity for institutions to serve SMEs, thereby promoting sustainable lending to SMEs (Yuan 2008). The current loose monetary policy has failed to improve the financing situation for SMEs. Because SMEs have a weak resistance to risk, banks are more cautious about issuing loans to them. Although both the central bank and CBRC expressed their intent to strengthen the credit support for SMEs, banks remain reluctant to issue loans to SMEs if the government does not provide the final guarantee and bear the losses of banks (Li 2001). In addition, it is difficult to launch small loan companies, which both takes a long time and requires business development.

## **5. POLICY SUGGESTIONS FOR BOOSTING THE DEVELOPMENT OF SMES IN THE PEOPLE'S REOPUBLIC OF CHINA**

### **5.1 Promote the Shift of External Demand to Internal Demand for Export-Oriented SMEs**

Sustainable growth in the PRC will require a very substantial shift from external to domestic demand, moving away from investment in export-driven growth to consumption-driven growth. Strengthening domestic demand will also strengthen the PRC's ability to weather fluctuations in global supply. Support policies for SMEs should also address demand concerns. These support policies would strengthen the local markets by improving domestic consumption ability. Furthermore, these policies should reinforce and encourage innovation in SMEs and lower the cost of innovation activities (Liang 2007).

### **5.2 Resolve Financial Difficulties of SMEs**

The government should formulate policies to mandate that banks to lend to the SMEs, or provide good incentives for the banks to lend to SMEs willingly, and increase the ratio of bank loans to SMEs to at least 10%. In this light, financial institutions issuing loans to SMEs can be exempted from business tax. Relevant organizations and individuals transferring or leasing patents to SMEs can also be exempted from, or have a deduction of, business taxes (Gao 2008).

It is advisable and important for local governments at various levels to establish guarantee institutions and provide guarantees for SMEs using government funds to help them garner loans from financial institutions or issue bonds at the bond market (Gu 2008). First, the access to guarantee companies needs to be opened further with simplified approval procedures. Second, the scope of tax break policies for guarantee companies should be increased, reducing and exempting them from income tax. Third, the rate of risk provisions should be increased above the current rate of 30%. Finally, the risk decentralization and compensation system of guarantee companies and national re-guarantee institutions should be firmly established. However, the government should be careful to avoid a tendency to over-guarantee without considering the probability for repayment. The guarantee provision should be modest and increase the chances of hitting the optimal level of guarantee.

Commercial banks can make use of financial product innovation based on mortgage guarantees to help SMEs obtain bank loans (Li 2001). Proceeding from the scope of the entire industrial chain, banks can issue credit based on the comprehensive business chain and effectively inject funds into relevant enterprises according to the business's transactional relationships. This will allow banks to provide flexible financial products and services. In terms of modalities for financing the supply chain, the strength of creditability of core large enterprises can be utilized to help SMEs obtain financing from banks. This will lower bank exposure to loan risks to some extent.

Commercial banks should improve services for SMEs. First, the banks should, in light of SMEs' unique characteristics, have a department dedicated to the management of financing services for SMEs and set up a center for operation for SMEs credit business, with dedicated account managers for SMEs services. Second, in terms of enhancing the efficiency of loan approval, banks should simplify the approval procedure and combine the establishment of SMEs loan relationships, ratings, credit approval, and mortgage pricing into one basket service.

The government must also initiate capacity building support services for both banks and the SME sector. Banks must be capacitated such that they'll be able to lend not merely on the



basis of collateral, but rather, on the basis of SME risk using several indicators. Concurrently, SMEs must receive assistance to make them more credit-ready. A multi-faceted approach must be employed, training SMEs to cover marketing, product development, efficiency, etc. This will positively impact their growth and development.

Financing channels for SMEs through the capital market must also be developed. It is necessary to expand the scale of the SMEs board at the Shenzhen Securities Exchange, accelerate and boost the Growth Enterprise Market (GEM), improve the fostering mechanism for the listing of SMEs, and encourage various business startup institutions to strengthen investment for SMEs, especially innovative SMEs. It is important to encourage local governments to issue collective bonds to SMEs so as to effectively expand their direct financing channels. The SMEs Development Fund and the SMEs Innovation and Investment Fund must also be established.

### **5.3 Complete the SME Sector Policy Framework for Benign Business Environment**

A benign business environment is usually a key determinant for the development of SMEs. Evaluation of this environment includes barriers to entry and exit, property rights protection, contract enforcement, and the functioning of the public service system.

Several steps can be taken to reduce SMEs' tax burden. These are:

- Encouraging the establishment of SMEs. It has been suggested that investors establishing SMEs should be exempted from tax based on 40% of the prescribed sum of investment.
- Reducing SMEs' fees and expense burden. Currently, SMEs' burden in taxes and surcharges is excessively heavy, and therefore it is necessary to abolish all unreasonable fees and charges to create an easy and relaxed environment for SME development.
- Accelerating the promulgation of tax breaks for SMEs in a special period. It is necessary to further raise the tax threshold for small-scale taxpayers, from the current CNY3,000 to CNY5,000 so as to help them pull through.

SMEs' ability for self-construction can be strengthened as well. This can be done by:

- Strengthening technological innovation capability.
- Strengthening financial management, improving financial systems, and enhancing credit grading.
- Building brand awareness to enhance competitiveness. The global financial crisis is a good opportunity for corporate upgrading, and SMEs must be responsive to updating products, developing new products, and building their own brands on an active and constant basis.
- Boosting the construction of SMEs credit systems for further market development.

The government should also improve the public service system for SMEs. To do so, the government must:

- Accelerate the construction of bases for small enterprises business startups, lower business startup costs, enhance advisory service capabilities for business startups, and support SMEs in various industrial parks and zones.
- Organize and boost technical service resources to provide support and services for SMEs' industrial upgrading.
- Improve commercialized services for SMEs. It is necessary to boost allies and mergers of SMEs, develop supplementary industrial and product chains based on

large industries and key projects, and enhance the subcontract capability of large enterprises. It is important to implement the planning for SMEs service systems well, and to strengthen credit guarantees and services. Technological innovation services, business startup training services, market development services, and management advisory services must also be implemented so as to accelerate the establishment and improvement of a commercialized service system for SMEs.

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