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Timothy Sham
Research Analyst

Iris Pang, Ph.D.
Economist
irispang@ocbcwh.com

CHINA'S SMES DEVELOPMENT

INTRODUCTION

Small and medium enterprises (SMEs) play an important role in China economic growth and make substantial contribution to employment and outputs. However, many bottlenecks and obstacles appear on financing in SMEs. This limits further growth of SMEs as well as future economic development in China. To confront this challenge, the Chinese government has emphasized the development of SMEs, especially with respect to SMEs financing. It has stated in the 12th Five-year plan that credit guarantee system for SMEs will be established so that loan growth of SMEs can increase. In the following, we will take a closer look at the financing constraints faced by SMEs in China. We will also examine the impact of recent policies by the Chinese government on the development, and suggestions on medium and long term policies towards a healthy SME development.

BACKGROUND

According to a report in 2013 from the National Bureau of Statistics of China, SMEs provide around 80% of urban employment, contribute 50% of fiscal and tax revenue, account for 60% of GDP in China. Hence, a healthy development of SMEs is essential to ensure continual economic growth and social stability.

CONSTRAINT OF SMES FINANCING

SMEs are usually in an unfavorable position to get loans as SMEs are mostly in the initial stage of their business, and they are considered as higher risk to banks because of the lack of qualified collateral and the lack of credit repayment track record. Meanwhile, SMEs also face more acute asymmetric information problems because they lack mature accounting system, bill management, these lead to the lack of transparency of their financial position to banks. In addition, there is lack of credit rating assessments for SMEs in China, together with low incentive of SMEs to build credit reputation. In this context, financial institutions face higher costs in obtaining information and monitoring credit of small enterprises, and thus have less incentive to provide loan products to them. Even if banks were willing to lend to them, the interest rate would be much higher than large enterprise because there are more inherent risks in SMEs.

RECENT POLICIES FOR IMPROVING SMES FINANCING CONDITION

In view of these constraints of SME financing, the State Council released a guideline in August, which puts forward ten specific measures to solve the problem of high financing costs, including narrowing the financing chain and cutting unreasonable expenses of financing. The guideline also adds that the central bank should keep liquidity "steady and appropriate", ensure good implementation of targeted reserve requirement ratio (RRR) cuts, and facilitate lending to areas especially in agricultural sector and SME.

The government has addressed the financing needs of the agricultural sector. The PBoC has also increased its re-lending quota for agricultural sector by RMB20 billion to banks as part of the State Council's plans to increase financing support on development of "three rural issues" on August 27th. Meanwhile, The PBoC has also stated that the relending interest rate for qualified rural financial institution in poverty areas will be 1 percentage point lower than the current prime rate. The current 1-year relending prime rate for agricultural sector is 3.35%. This echoed the State Council's announcement on August 14th.

Since the agricultural sector and SMEs are two large pieces that the government has placed higher priority in policy support, we expect that the PBoC's next target for increasing re-lending quota or cutting relending interest rate would be on the SMEs sector.

Meanwhile, a credit insurance system will be created. The State Council released Guidelines on "Accelerating the Development of Modern Insurance Industry" in August. The guideline states that the development of guarantee insurance and credit insurance for SME loan will be accelerated to enhance SMEs to access financing. Meanwhile, it also proposes to encourage insurance companies to provide capital for hi-tech companies, small and micro-sized companies, and companies in strategic emerging industries through equities, bonds, funds and other forms under proper risk management and supervision.

IMPACT OF POLICY ON SMES FINANCING IN H1 2014

According to PBoC's statistics, loan growth of SMEs increased RMB1030 billion in H1 2014, which was RMB2.6 billion higher than the same period in 2013. Meanwhile, share of new SMEs related loans accounted for 32.5% to total new corporate loans by the end of H2 2014 which was 2 percentage points higher than Q1 2014. This shows that the impact of implementation of the "targeted RRR cut" policies in Q2 was limited on to increase financing for SMEs. We believe share of SMEs related loan to total loan should increase in H2 2014 as we expect further policies will be in place to increase confidence of financial institutions to provide loans to SMEs. In this regards, credit insurance system is crucial for the success of building an easier SME financing environment.

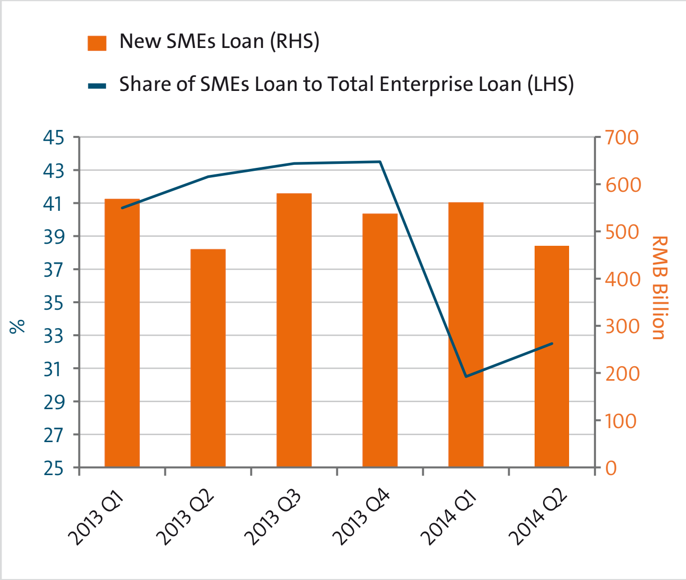
Meanwhile, China official manufacturing PMI recorded 51.1 in August and 50.7 in Q2 2014 from 50.3 in Q1 2014. This shows that conditions of overall manufacturing has gained momentum since Q1 2014. However, if we analyze the official manufacturing PMI by size of enterprises, we find that averaged manufacturing PMI of large enterprises recorded 51.4 in January-August 2014 in contrast to averaged manufacturing PMI of 50.1 and 48.8 for medium enterprises and small enterprises respectively for the same period. A PMI of above 50 represents expansion of the manufacturing sector and a reading below 50 represents a contraction. Figure 2 gives us a clearer picture that large enterprises always perform better than SMEs in China. This may suggest that policies have not effectively channeled to the SMEs to improve their business conditions.

LOOKING FORWARD - POLICIES TO IMPROVE SMES FINANCING IN CHINA

MEDIUM TERM

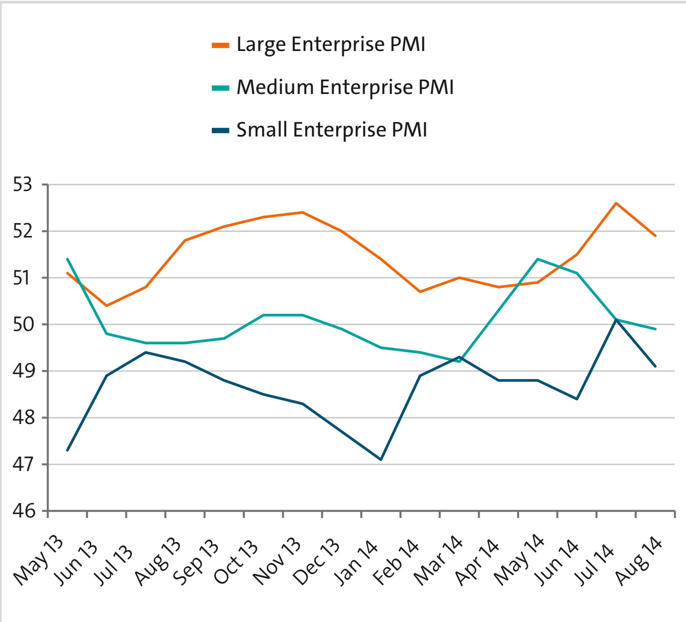
The Chinese government should continue to enhance the financing services of SMEs, such as help reduce borrowing

Figure 1. SMEs Still Face Difficulties to Have Access to Financing



Source: PBoC

Figure 2. Official Manufacturing PMI



Source: Bureau of Statistic of China

costs of SMEs through targeted RRR cut and targeted re-lending interest rate cut. Apart from these, we expect the Chinese government to actively develop credit guarantee institution or platform, and accelerate the development of credit insurance and loan guarantee insurance for SMEs in H2 2014 or 2015 to mitigate risks faced by financial institutions. Still, SMEs should need to pay premiums of related credit or loan guarantee insurance.

Credit guarantee institution mainly takes two forms: policy guarantee institution funded by government or commercial guarantee institution. The purposes, nature and management measures of the two kinds of guarantee institutions are different. Firstly, the guarantee targets vary. Policy credit guarantee has definite targets and focuses on financial support to small enterprises that do not have qualified collateral and therefore hardly obtain loans in banks. In contrast, commercial guarantee institutions would usually focus on large enterprises as their financial conditions are more stable than SMEs which provide sustainable income sources to guarantee institutions. Secondly, the nature varies. Policy guarantee is non-profitable, and the relevant charges are often subject to government control. Neverthelesss, commercial guarantee is profit-driven, usually under limited government regulations in respect of their guarantee targets and charges.

At present, China's guarantee institutions for SMEs exist in various forms, while some are in mixed operation of both policy and commercial guarantee. We believe, on the one hand, the Chinese government would continue to strengthen institutional administration over government-funded policy guarantee institutions in order to ensure those credit guarantee institutions to provide credit insurance or guarantee for qualified SMEs. On the other hand, the Chinese government would also concentrate on motivating the initiative of commercial guarantee institutions to support SMEs by giving commercial guarantee institutions incentives. Tax allowance can be pursued to encourage commercial institution to offer credit guarantee to SMEs.

LONG TERM

In the long run, the Chinese government should establish a comprehensive social credit system. At present, China's credit system is incomplete and enterprises are somewhat unaware of how their credit histories affect their ability to access financing. In addition, local protectionism and incomplete legal environment make it fairly difficult for creditors to recover their claims once the debtor enterprise breaches contract. Therefore, a sound credit bureau system and an enforceable legal system are very important factors to build an efficient financial system.

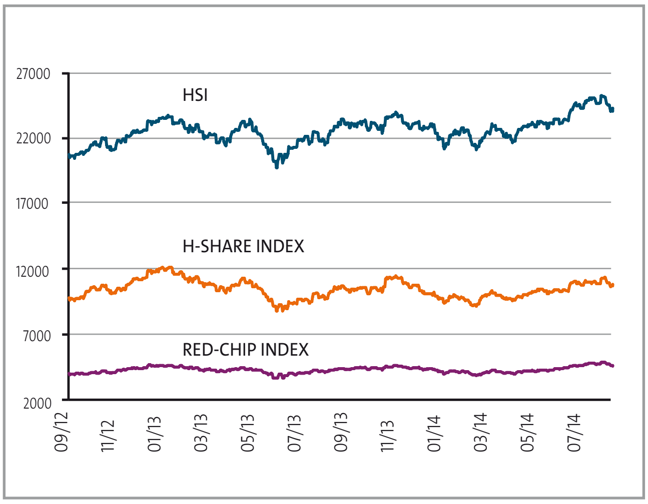
CONCLUSION

SMEs development is very important to China's economic growth. However, many constraints such as less credible, information asymmetric, high transaction cost and lack of credit system in China have dampened the financing condition in SMEs. In view of these constraints, the Chinese government has implemented polices in H1 such as targeted RRR cut to support the SMEs development. However, we found that the impact of the policies on SMEs is limited. We believe difficulties of SMEs financing would be eased moderately in H2 2014, but further policies such as increasing re-lending quota and relending interest rate cut for SMEs would be needed. Looking forward, in the medium term, the Chinese government will actively develop credit guarantee institutions, and accelerate the development of credit insurance and loan guarantee insurance for SMEs to mitigate risks faced by financial institutions. In the long term, Chinese government should establish a comprehensive social credit system and an enforceable legal system in order to build an efficient financial system.

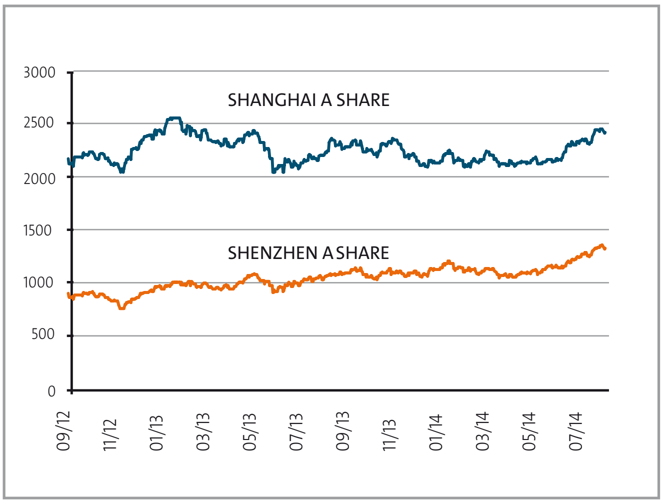
INTERNATIONAL ECONOMIC & FINANCIAL INDICATORS (AS OF 14:30, 19 SEPTEMBER, 2014 GMT+8)

STOCK MARKETS				
		52 WEEKS		
	PRIOR CLOSE MID	HIGH	LOW	1 YEARE AGO
HSI Index	24376.41	25362.98	21137.60	23117.45
INDU Index	17156.85	17221.10	14719.42	15676.94
UKX Index	6780.90	6904.86	6316.91	6558.82
DAX Index	9661.50	10050.98	8489.62	8636.06
NKY Index	16067.57	16320.22	13748.94	14505.36
KOSPI Index	2047.74	2093.08	1885.53	2005.58
STI Index	3296.48	3387.84	2953.01	3193.86
CCMP Index	4562.18	4610.14	3650.02	3783.64

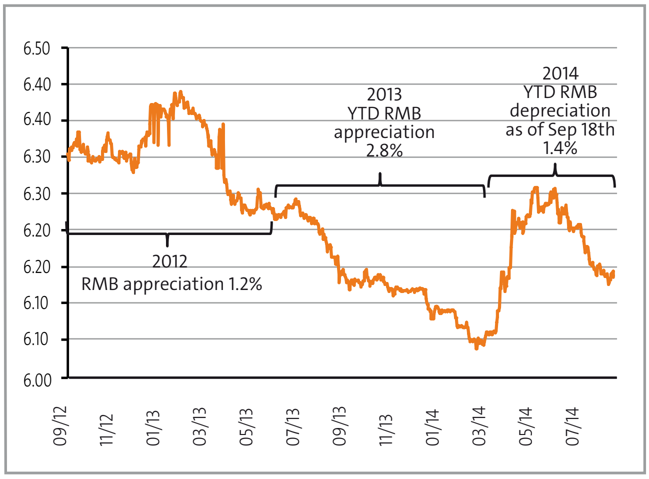
HSI, H-SHARE INDEX AND RED-CHIP INDEX



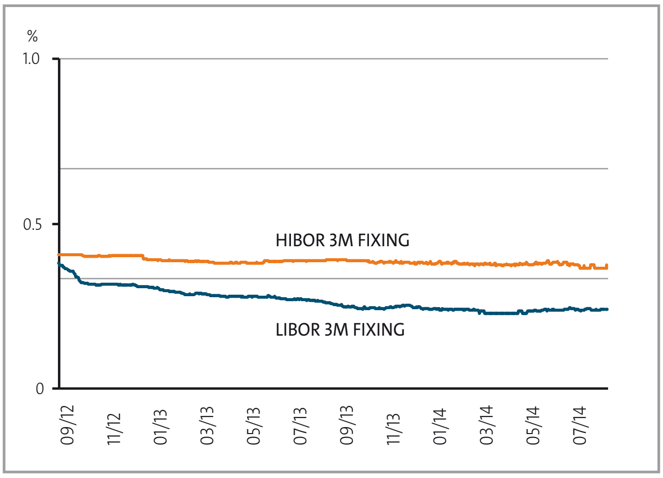
SHANGHAI & SHENZHEN A SHARE



CNY / USD



HIBOR AND LIBOR 3M FIXING



Source: Bloomberg

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