INSIGHT

Small and fragile

Andrew Collier and **Sara Hsu** say a study of loans to China's SMEs shows their considerable reliance on the shadow banking system, raising their risk exposure to any liquidity crunch

What will happen to small business as China's economy slows? The country's small and medium-sized enterprises are an important part of the economy and even more integral to employment; they account for 60 per cent of gross domestic product but a full 82 per cent of employment. With China's GDP growth dropping from over 10 per cent three years ago to 7.5 per cent or below, SMEs are going to struggle, which could have a disastrous effect on China's future.

The biggest problem facing them is a shortage of capital. The five state-owned banks, which control half of all bank assets, are much happier lending to state firms because they are generally "too big to fail". Even the smaller city and commercial banks prefer local-government-backed companies to private enterprise.

That forces small businesses to rely on the shadow banking sector. The shadow banks in China include a wide gamut of enterprises, ranging from family and friends and private lending groups to giant trusts. Figures vary but, according to the People's Bank of China, these lenders accounted for 30 per cent of credit issued last year.

We recently conducted a study of SME bank loans in China for the Shadow Banking Working Group at Guangxi University, sponsored by Beijing's Central University of Finance and Economics.

We examined data for more than 4,000 SMEs in 2007 and 2011 in two surveys conducted by China's State Administration for Industry and Commerce and collected by the Chinese University of Hong Kong.

The results were dismaying. Loans from the official state and local banks, for the most part, go to the traditional sectors of the economy, including real estate, mining, manufacturing and older registered companies. The only non-traditional lending from the banks goes to firms whose net income "increases as a result of innovation".

In contrast, unofficial "shadow" loans tend to go to rural borrowers or those sectors typically dominated by SMEs, including agriculture, forestry, consumer services (like barbershops and local repairmen).

What does this mean for the future of SMEs? First, their capital is more expensive. On average, they pay 8.9 per cent for non-bank financial loans and a whopping 12.6 per cent for personal loans, compared with only 8.1 per cent for the official bank loans.

Second – and more worrisome for the nation's macroeconomy – shadow loans are likely to be the first to disappear if liquidity tightens in China. Why would this happen? Here's where we take a step back to look at Japan's financial crisis and China's own history.

Japan's crisis in the 1990s started with a shortage of liquidity that caused a deflation in asset prices. Land prices escalated, and companies increasingly issued shares collateralised by rapidly escalating land prices.

This happy little game worked fine – until the funds ran out. New capital adequacy rules from the Bank for International Settlements and growing dismay at the loosely regulated credit co-operatives meant that the fire hose of money dried up.

> **More worrisome for China, shadow loans are likely to be the first to disappear if liquidity tightens**

Who were the first to fail? The smaller, peripheral financial institutions – shadow banks. In 1994, the Tokyo government closed the Tokyo Kyowa Credit Co-operative and Anzen Credit Co-operative. In 1995, the Cosmo Credit Co-operative in Tokyo and the Kizu Credit Co-operative in Osaka also folded. Eventually, Japanese regulators let larger institutions go.

What about China? Since the majority of the banking sector is owned by the central government in Beijing, including the state banks, they are well insulated from such liquidity shocks.

But not the shadow banks. Unless they are large or well-connected enough to have direct ties to Beijing, they are not going to avail themselves of central government protection.

There is a historical precedent for the failure of shadow banks in China. In 1989, regulators shuttered dozens of Wenzhou (温州) money houses or converted them to urban credit co-operative banks.

Ten years later, suffering from growing bad loans, 18,000 rural co-operative foundations were either closed or taken over by a new group called Rural Credit Co-operatives, with much of the debt ending up back in the hands of the local governments. Such actions were prudent in light of weak lending controls and inadequate capital. But it also meant small business lost an important source of credit.

The regulators, including the People's Bank of China and the China Banking Regulatory Commission, are aware of the risks. They are doing their best to push the official banks to lend to SMEs.

In 2010, following orders from Beijing, SME loans jumped 34 per cent compared with a 20 per cent rise in total lending, according to Moody's.

And last July, the authorities approved additional measures requiring state banks to lend to small businesses and provided new support for village and township banks.

But all this may be in vain if China faces a new credit crunch. Like starving wheat during a drought, a crisis could lead thousands of small business to shrivel and die. It happened in Japan in the 1990s, again in the US during the mortgage crisis, and it could happen in China.

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Pain of the past

Hitoshi Noda says Abe's visit to the Yasukuni shrine to remember the war dead did not include honouring war criminals. Instead, it affirms Japan's remorse and wish for peace

I have carefully read the contribution by Song Zhe, the commissioner of the Ministry of Foreign Affairs of the People's Republic of China in Hong Kong, concerning Japanese Prime Minister Shinzo Abe's visit to the Yasukuni shrine. As a diplomat stationed in Hong Kong, I have no intention to start a war of words here. However, I have to offer the Hong Kong people some clarification on the visit and further details because Mr Song's arguments are unfounded and misleading. As a courtesy to the hosting country, and for the sake of the space available, I will confine myself to Prime Minister Abe's intention and the relevant facts.

The prime minister has expressed profound remorse for history and made "a pledge never to wage a war again". That is what he wanted to express more than anything else in his visit to the Yasukuni shrine. While paying sincere condolences and respect to the souls of all those who have perished in wars, to the international community he reconfirmed in the sincerest manner the conviction for everlasting peace, based on his deepest remorse for the past – as expressed in the statement he issued after the visit. There is nothing else to his visit. In other words, he squarely faces the historical fact that Japan caused tremendous damage and sufferings to many countries and sincerely expresses the country's deep remorse and heartfelt apology for this past. No other positions and views are taken. This position, which has been shared by previous Japanese governments, is firmly upheld by Prime Minister Abe as well.

An important part of this feeling derives from the damage and sufferings caused to Hong Kong and its people during the war. Also, Prime Minister Abe has stated at Diet hearings that he accepts the judgments of the International Military Tribunal for the Far East. Paying honour to or justifying the Class-A war criminals was not part of his visit. If you look at Japan's course of progress throughout the 68 years of the post-war period, its sincerest remorse for its past, the country's conviction of never waging a war and its contribution to peace could never be doubted.

Japan has been one of the strongest and most consistent defenders of freedom, democracy, human rights and the rule of law, and has been making its utmost contribution to peace and prosperity not only in the Asian region but also in the whole world. There is no room for "militarism" to exist. I am confident that this is something commonly acknowledged by the international society. This course of progress of Japan as a peace-loving nation will not change hereafter. Ideas and values such as peace, democracy and human rights have already been ingrained in the bodies and souls of the Japanese, transcending generations. I assume that many people of Hong Kong personally share this understanding of the Japanese, as so many Hong Kong people visit Japan and have seen for themselves what kind of a country it really is.

The relationship with China is one of the most important for Japan. As neighbouring countries, it is inevitable to have difficulties between each other from time to time. In no way would I try to deny that there exist issues and challenges between Japan and China today. That is exactly why dialogue between the two countries and their leaders is necessary. As the prime minister himself emphasises repeatedly, the door for dialogue is always open on the Japanese side. And I sincerely hope China will come forward.

I would like to take this opportunity to express my heartfelt thanks to the government and the citizens of Hong Kong for their deep friendship and hospitality towards the Japanese community here.

Hitoshi Noda is consul general of Japan in Hong Kong

Self-styled voices of middle class should not begrudge a lift for the city's needy

Mike Rowse says Leung's policy plan of pragmatic measures will put tax dollars to good use

The immaturity of some of our politicians shows no sign of abating, as is evident from their responses to the policy address delivered last week by Chief Executive Leung Chun-ying.

In his first address a year ago, Leung concentrated on the housing situation, which, on any sensible analysis, is the most serious problem facing Hong Kong. We have some of the highest prices on the planet, alongside some appalling living conditions that would shame a third world country.

This time, he gave an update on the various plans to address the issue and the prognosis is reasonable: it will take time because, after a decade of neglect, it was bound to. But after a massive behind-the-scenes planning effort, the pieces are in place, the bulk of the land has been found and we are on our way to a solution.

The main thrust of the policy address could therefore focus on our next most serious problem: the shocking findings on poverty revealed a few months ago by the Commission on Poverty, a body resurrected by Leung in one of the earliest decisions of his term, after being disbanded by the previous regime.

We have the first official poverty line in Hong Kong's history, and a whole raft of poverty alleviation measures to bring help to those most in need. These will provide practical assistance and support, in particular to the working poor. This is not a welfare state; it is a helping hand reaching down to pull up those trying to help themselves.

Other sections of the address outline good pragmatic measures in elderly care, education, the environment and economic development.

> **The policy address is full of good things for the middle class. First of all: no new taxes**

What has been the response of our politicians to this workmanlike manifesto? "There's nothing for the middle class," says chairman of the self-styled Voice of the Middle Class Alvin Lee Chi-wing. There was immediate support for this view from the Business and Professionals Alliance, who also shed a tear for small and medium-sized enterprises. Other politicos have since joined the chorus.

Look again, everyone; the policy address is full of good things for the middle class. First of all: no new taxes. All the things being proposed can be comfortably financed without upsetting our basic low-tax environment. If you think that is not a big plus, talk to your middle-class friends in Europe or other advanced economies and see how they're doing.

Secondly, developing our economy and maintaining our pro-business operating environment bring most benefit to those best able to take advantage of them, namely, the very businesses and professionals now complaining.

Thirdly, for those fortunate enough to be in the middle-income group, the priority outside the economy relates to quality-of-life issues: the environment, the arts and culture, sports, and so on. Progress is being made in all these areas.

But there is a more fundamental reason why the middle class and those claiming to speak on their behalf should applaud the policy address. The reason we pay taxes is so the government can do good things with our money.

What was proposed last week is a list of very good things, in some cases urgently needed. Given that the tax threshold is set so high – fewer than half of working people have to pay any salaries tax at all – taxpayers are by definition among the better off in our community.

I can think of two main reasons why a sensible and reasonable policy address is being attacked. Some people just don't like Leung as a person. Others object to his policies in other areas, in particular political reform. On this, I, too, have serious doubts about what is going to emerge when the consultation period ends.

But neither of these is sufficient reason to attack the proposals to help the poor because they don't also help the better off. It's an immature response. Thinking of the government doing good work with my tax dollars gives me a warm, fuzzy feeling. Or maybe that's just the zero tax on wine.

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Leung skips the sweeteners for more nourishing fare

Alice Wu welcomes the belated attention paid to the city's poor and disadvantaged in the policy address, with no attempt to overreach

The fact that the chief executive isn't the life and soul of any party isn't news. He's not the type to dazzle, so when the time came for his second policy address, there wasn't a lot of pre-address fanfare, which was really kind of nice.

Opinion polls leading up to the address showed that public expectations were low.

That may be the most striking thing Leung Chun-ying did right with the address. Low popularity ratings can never be a blessing in disguise but Leung made expectation management work in his favour.

A non-crowd-pleaser has no need of grandstanding statements. So out went the bells and whistles of previous policy addresses, and in came the non-flashy "Support the Needy, Let Youth Flourish, Unleash Hong Kong's Potential" and its content that did not try to overreach.

However, to say that this year's policy address was inconsequential would be grossly unfair.

Despite its presentation, it carried far greater meaning than those that came before. The focus on supporting the needy, which took up the bulk of the policy address, is a first for this city.

For years, we have been outraged by how little the government has done for the poor. The so-called "N-nothing" class, the working poor and wealth disparities have been given considerable media attention for a long time. The response, in real policy terms, has been disproportionate, year after year.

Was it a lack of political will or political incentives? Lines needed to be drawn for policies to be formulated. Hong Kong's poverty line, defined for the first time last September, is needed to see clearly the size of the holes in our social safety net.

While the poverty alleviation measures in Leung's policy address are by no means complete or enough, they are significant.

After all, they represent the first attempt by the government to go beyond paying just lip service to helping the city's disadvantaged, and replace all the smoke and screen with actual dollar signs.

Tackling poverty will take more than subsidies, or consideration of how much these policies will dent the public purse. Education is key. And it will take a well-planned and -executed overhaul of our education system to provide solutions to intergenerational poverty.

Introducing a Chinese-as-a-second-language curriculum for ethnic minority students is a good start. It must serve as a constant reminder for administrations that poverty here has been institutionalised. Our education system leaves behind ethnic minorities, children with learning difficulties, and families that cannot afford to put their children into expensive programmes, because it predetermines success at too early an age and, often, on the premise of parents' economic prowess.

It's an elitist system that is becoming more archaic and inappropriate by the day.

It's too early to tell whether this policy address can, in fact, set in motion the momentum for change this city needs.

But, at the very least, it is a move away from the ritual of handing out crowd-pleasing sweeteners that are truly unsustainable – both on the public purse, and for the city's political development.

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