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AN OVERVIEW OF CHINESE SMES WITH THE BACKGROUND OF ECONOMIC GROWTH AND TRANSITION

1. Introduction

In the past 30 years China has gained remarkable economic achievement highlighted all over the world. As a young and vigorous section of China's economic body, SMEs have been playing an important role so far and determine the future of China's economy. When financial crisis broke out in 2008, China was shocked to an extent no less than USA or Europe and had to face up to economic problems of both growth and transition. With that background, it is of much significance to take an overview of Chinese SMEs, analyze their status and trends. And this will help to understand and expect the future of China's economy which occupies an increasingly part of world output and trade.

2. Definition and History

2.1 Definition and Data

The definition of SMEs in China is based on "Medium and Small Enterprises Promotion Law" (publicized in 2002) and "Small and Medium-Sized Enterprise Standard Provisional Regulations" (publicized in 2003). Table 1 gives the details as follows

Table 1. Standards for Classification of Enterprises

Sectors	Indicators	Units	Large	Medium	Small
Manufacture	employees	person	≥ 2000	$\leq 300-2000$	< 300
	Annual sale	Yuan 10,000	≥ 30000	$\leq 3000-30000$	< 3000
	Total assets	Yuan 10,000	≥ 40000	$\leq 4000-40000$	< 4000
Construction	employees	person	≥ 3000	$\leq 600-3000$	< 600
	Annual sale	Yuan 10,000	≥ 30000	$\leq 3000-30000$	< 3000
	Total assets	Yuan 10,000	≥ 40000	$\leq 4000-40000$	< 4000
Wholesale	employees	person	≥ 200	$\leq 100-200$	< 100
	Annual sale	Yuan 10,000	≥ 30000	$\leq 3000-30000$	< 3000
Retail	employees	person	≥ 500	$\leq 100-500$	< 100
	Annual sale	Yuan	≥ 15000	$\leq 1000-15000$	< 1000

		10,000			
Transportation	employees	person	≥ 3000	$\leq 500-3000$	< 500
	Annual sale	Yuan 10,000	≥ 30000	$\leq 3000-30000$	< 3000
Postal Service	employees	person	≥ 1000	$\leq 400-1000$	< 400
	Annual sale	Yuan 10,000	≥ 30000	$\leq 3000-30000$	< 3000
Hotels and Catering Services	employees	person	≥ 800	$\leq 400-800$	< 400
	Annual sale	Yuan 10,000	≥ 15000	$\leq 3000-15000$	< 3000

Data source: NBSC* (SETC** .SME.Doc 2003[241]).

According to the data of Sep. 2009, the number of SMEs in China was 10,231 thousand, more than 99% of the total number of registered enterprises, that is 10,300. SMEs afford 60% of China's GDP¹. Their share in the countries' total enterprise assets is 55%. They produce 70% of value of gross industrial output, pay 50% of the total taxes, and provide 60% of the total export².

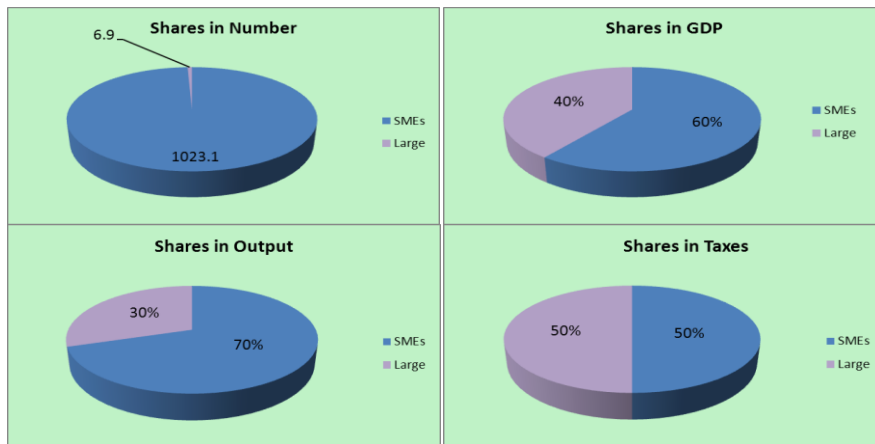


Figure 1. Survey of Chinese SMEs (“Large” stands for large-scale enterprises)

Most SMEs are located in China's three largest economic regions: Yangtze River Delta, Pearl River Delta and Circum-Bohai-Sea Region. Geographically, SMEs in East and Middle Zone occupy 42% each, and the rest 15% lie in West Zone. But the three zones' shares of industrial out value are 66%, 26% and 8%. So it is indicated that the average output capability of East is 1.5 times and 7 times larger than Middle and West³. About 75%

* National Bureau of Statistics of China

** State Economic and Trade Commission of China

¹ Wu Wei. *An Analysis on Measures Coping with Difficulties of Chinese SMEs*[J]. *CO-Operative Economy & Science*, 2008(2):98-99.

² Han Yongxin. *An Study on Development Strategies of SMEs*[J]. *China Collective Economy*, 2009(2):27-31.

³ Zhang Bo. *An Study on Strategies of Transition and Upgrade of SMEs*[J]. *Science and Technology Management Research*, 2010(12):147-149.

of employed population in cities and 75% of labour force shifted from countryside are working in SMEs⁴.

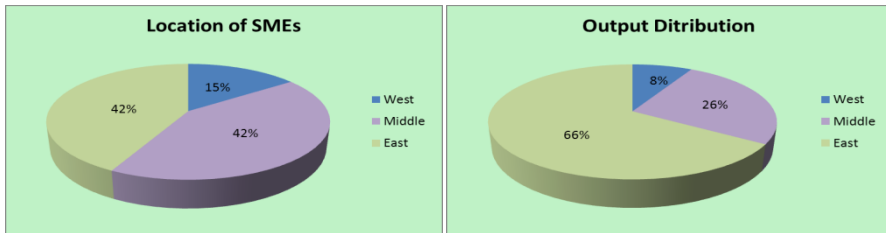


Figure 2. Geographical distribution of location and output of SMEs

Government has long been reorganizing and recombining state-owned enterprises, which keeps rising the ratio of private enterprises to SMEs. According to data from SAIC (State Administration of Industry and Commerce), till the end of 2008, private enterprises in the primary industry, second industry and tertiary industry summed to be 135.1, 2026.3 and 4412.8 thousand, the ratios being 2.05%, 30.82% and 67.13% respectively. Amongst all sectors, wholesale and retail sector had the most private enterprises, with 2330.1 thousand and the ratio 35.44%. Manufacture sector ranked second with 1627.7 thousand. The following were leasing and service sector with 603.5 thousand, research and technological service sector with 314.4 thousand, and construction sector with 312.2 thousand⁵.

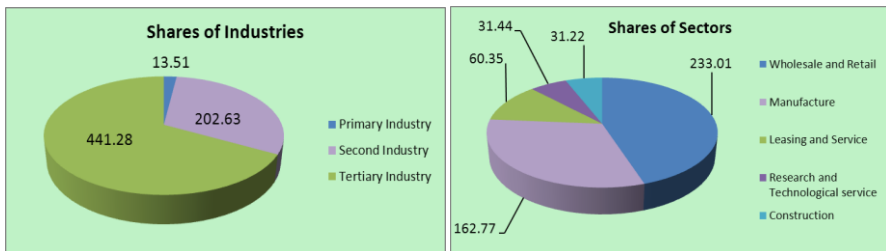


Figure 3. Distribution of Private Enterprises Among Industries and Sectors

At the meantime, of 30 thousand Chinese enterprises with transnational investment and operation, 80% are SMEs, indicating they acted one of main forces in the internationalization of China's economy⁶.

2.2 Brief History

⁴ Tang Renwu, Ding Rui. *On the Development Strategy of China's Minor Enterprises and the Governmental Countermeasures*[J]. *Journal of Xuzhou Institute of Technology*, 2008, 23(1):23-29.

⁵ SAIC (State Administration of Industry and Commerce). *Report on Development of Market Agents of China in 2008*. http://www.saic.gov.cn/zwgk/tjzl/200903/t20090320_50532.html

⁶ Chen Jiali, Chen Jianming. *An Overview of the Seminar on the Development Strategy of China's Minor Enterprises*[J]. *Journal of Xuzhou Institute of Technology*, 2008, 23(1):33-36.

During the past 30 years SMEs grew a very rapid speed, owing to the advantages provided by historical opportunity and need. From 1950s to 1970s China's economy ran in the authoritarian planning system, which attached the most importance and priority to the heavy industries. With most production factors and resources allocated to heavy industries, light industries and agriculture underproduced for decades because of lack of inputs. On the other hand, nearly all the SMEs were wiped out by the socialist transformation in the early 1950s, leaving only state-owned and collective enterprises of large scale as legal ones. These are two reasons why Chinese people's consumption level lagged so much.

As soon as economic reform started at the end of 1970s, the power of demands constrained for decades burst out like a volcano, which provides one of the largest markets until today based on the largest population in the world, making all other countries jealous.

The introduction of market system made China not only a large market, but also a large producer. This accomplishment was endowed to both the great domestic demands and the thorough industrial foundation established by many "five-year-plans" in the earlier 30 years. The factories, railways, roads and facilities built during planning times are now put into full use, providing varieties of raw materials and conditions for newly built light industrial and commercial enterprises. Meanwhile plenty of labours flew continuously to cities from countryside, where lived 80% of China's population. All these resulted the booming of SMEs in cities and counties in 1980s, and the long and rapid development in the 30 years thereafter.

Some of Chinese SMEs evolved from privatized stagnant state-owned enterprises, some stemmed from township enterprises, but most of them started as individual or family enterprises. Compared with SOEs, SMEs have better adaption to market, flexibility of decision, flexibility of factors and lower labour cost. With the exuberant market demand in the early years of reform, SMEs competed with SMEs by means of production and sale with much success. Nowadays Chinese enterprises produce much more than domestic need, meeting demands from overseas market through exporting or investing abroad. But with the economic development and intensifying competition, the limited financing, poor risk-resistance capability, backward management, inferior quality of labour and technology are becoming increasingly unendurable fetters.

3. Difficulties and Challenges

The environment and conditions have been changed a lot in 21st century, which reveal and highlight SMEs' shortcomings and imperfections which have brought more and more problems, although they were not so obvious in earlier years. The financial crisis in 2008 exacerbate SMEs' situation like a catalyst. Take Canton where Pearl River Delta locates as an example, Director of the Bureau of Medium and Small Businesses, Liu Huanquan declared in an interview in Dec. 2008 that the first three seasons saw the disappearance (shut-down) of 7,148 enterprises, but that number reached to 15,661 in October, more than doubled. The growth rates of 29 of 37 industries decreased, and the growth rate of export of private enterprises was 6.9%, which is 34.8% less than the same period last year⁷.

The difficulties should not be attributed only to the financial crisis. Actually they root in economic environment, policies and treatments, and enterprise management.

⁷ Wang He, Ren Xuan. *Fifteen Thousand Closed and Shut Down Bring Winter to SMEs[N]*. *Guangzhou Daily*, 2008-12-17(3).

3.1 Critical Economic Environment

The changes of economic environment include the following four ones:

First, energy resources and raw materials have come into short supply. The shortage of consumer goods exists no longer in most parts of China. But the demands for energy, raw materials, water, and electricity keep rising, which change China to an importer with good appetite in international trade. The gap between supply and demand is considered to be one of drives triggering inflation, which raises the cost of downstream enterprises, many of which are SMEs.

Second, the cost of wage is rising. In the earlier 20 years of economic reform, the great number of cheap labour coming out of countryside was one of the most profitable advantages for SMEs. In spite of high labour intensity, poor living conditions and low wages, workers were still working hard, because the life in their home villages could provide much less than these. With the exit of older workers, the young generations come upon the stage, who grew up in market society. Not contented about the wages and conditions stumbling for decades, they hope to be citizens in cities where they work. Most of them accept modern values and don't hesitate to express their demands and protect their rights. The rise of wages is an inevitable trend, and it is worsening the situation of those whose competitive advantage depends on low wages.

Third, corporate social responsibility (CSR) raises cost. The concept of CSR has been accepted and spread rapidly in China and many public incidents draw much attention to it. The responsibilities of environmental protection and public safety are the top foci. Decades' economic development was achieved at the huge cost of environmental disruption, pollution and safety accidents. As potential polluters and destructors, all enterprises are required to invest more on environmental protection and public safety. CSRs bring heavier burden to SMEs than SOEs because of their small size of capital.

Fourth, overseas trade brings new challenges. As a large manufacturer and exporter with a 60% Ratio of Dependence on Foreign Trade, Chinese SMEs depend heavily on overseas market. The shock from overseas market affects them much more than years before. Data indicate the financial crisis reduced the profit rates of SMEs in Yangtze River and Pearl River Delta, which are more export-oriented than other regions in China, to 11.04% and 10.22%, lower than 13.52% of Circum-Bohai-Sea Region and the nationwide average 12.47%⁸. Besides, China's large surplus in current account in international balance of payments (BOP) has lasted for many years, giving rise to the pressure of appreciation of RMB, which will weaken the competitiveness of commodities of elasticity that compose much of China's export. Threats from overseas will not be overcome until SMEs finish their production transition and technology update.

3.2 Policies and Treatments

The economic body was made of SOEs and large-scale collective enterprises before economic reform. The history made policy and treatment discrimination against SMEs, but in favor of SOEs and foreign-owned enterprises. Tougher criterion for registration, stricter

⁸ *China Centre for Promotion of SME Development. Report on Operation and Development of SMEs in China[J]. China Small & Medium Enterprises, 2010(1):36-38.*

approval, no tax preferential or training policy, and poor protection of property right all prevent SMEs from competing with other ones. The discrimination of finance tops all problems.

It is very hard and impossible for SMEs to finance via capital market, for their capital stock and financial data seldom meet the criterion listed by government's rules. According to PWC (Price Water House Coopers), there were unprecedented 204 IPOs in SMEs board of Shenzhen Stock Exchange (SZSE) in 2010, with 202.7 billion Yuan financed. But only three or four IPOs of SOEs such as CNPC (China National Petroleum Corporation or CCB (China Construction Bank) could exceed this number very easily.

In the case of loan, SMEs are discriminated against too. In order to cope with the recession caused by financial crisis, Chinese government brought forward a 4000 billion Yuan bailout. Of 7370 billion Yuan loan, large-scale enterprises got 47%, medium-scale enterprises got 44% and small-scale enterprises got only 8.5%⁹. Most of the loan went to the large projects of infrastructure supervised by government, leaving only a small part to SMEs¹⁰. What's more, the investments charged by governments especially local governments caused crowding out effect, which damaged market mechanism and strengthened the administrative power¹¹.

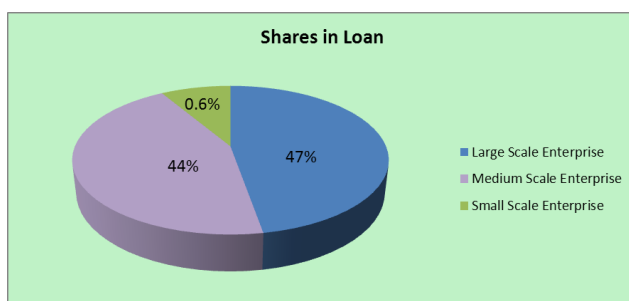


Figure 4. Shares of loan in 2009 bailout

Unfairness and discrimination worsened SMEs' situation while shocked by financial crisis, frustrating and disappointing enterprisers, and raised the risk of loss of capital and personnel.

3.3 Shortcomings of Family Enterprise

Due to the vacuum of market from 1950s to 1970s, Chinese SMEs were born to be without any accumulation of system, culture, experience and talent. When the market vacancy diminishes, the modernization of management is put on the agenda in order to overcome innate shortcomings.

First, most SMEs have little strategic planning. They were born in a tough environment where the most important is to struggle to survive the severe competition with SOEs and

⁹ Liu Li. *Focus on Loans and Micro-credits for SMEs*[N]. *Financial Times*, 2009-11-23(5).

¹⁰ Feng Nanxiang. *An Analysis on Difficulties of Finance for SMEs*[J]. *Modern Business*, 2009(33):41-42.

¹¹ Pan Yingli. *Development of Private Enterprises and Economic Transition*[J]. *Liberation Daily*, 2010-1-27(14).

foreign-owned enterprises. So they preferred tactics to strategies, short-run decisions to long-run planning. Sometimes they were forced to risk violating professional morals and laws, making them seem subjective, random, and speculative.

Second, SMEs lack coherent governance structure. There was no much conflict between sides in early stage, but when the enterprise grows into large size, it is absolutely necessary to establish a coherent governance structure. The structure is designed to give clear definition of management rights and propriety rights provide a mechanism for all stakeholders to negotiate. A successful enterprise belongs no longer to only a family or several founders, but to the whole society. It gets resources from society and serves it by providing products. It is unimaginable to manage a large enterprise in the way of running a small workshop. Modern governance structure is the route that must be taken.

Third, SMEs' management needs to be standardized and normalized. When the enterprise just begun, the leader took a tight control of it by disposing everything by himself, and there was no regular and clear division of members' responsibility. The leader's personal opinions play a decisive role and determine the future of the enterprise. This mode helped to gain steady growth of the nascent enterprise, but not suitable for sustainable development of a mature one. When the enterprise grows up, the complexity and load of managerial work grows far beyond personal capacity. Then it is time to establish standard rules and professional personnel of management, coordinating the functions of planning, organization, leadership and controlling.

Fourth, too much personal relationship and nepotism are harmful. Nearly all SMEs began with family or partnership enterprises. Organizational culture based on kinship and personal relationship affected SMEs' management during early years, playing an irreplaceable role in enhancing trust and cohesion, and reducing transaction cost. But it inevitably increases moral hazard and cost of human relationship when the enterprise is grown up.

4. Key Factors in Development and Transition

There is no expectation that domestic and overseas economic environment would soon turn favorable for SMEs. And in reality whatever environment will not ease the challenges unless SMEs finish the transition and update. According to investigation, while asked how to cope with the hovering difficulties, 36.9% of SMEs choose to improve labor performance, 31.9% to lower risks, 28.4% to turn export to domestic market, 28% to transfer from manufacture to service, 27.8% to perfect their management, 25.1% to integrate resources in industry chains, 24.4% to transfer from low to high end of industry chains, and 21.7% to transfer from OEM (original equipment manufacturer) to building private brands[8]. Above data indicate SMEs' awareness of the necessity and urgency of transition, and imply their measures and directions.

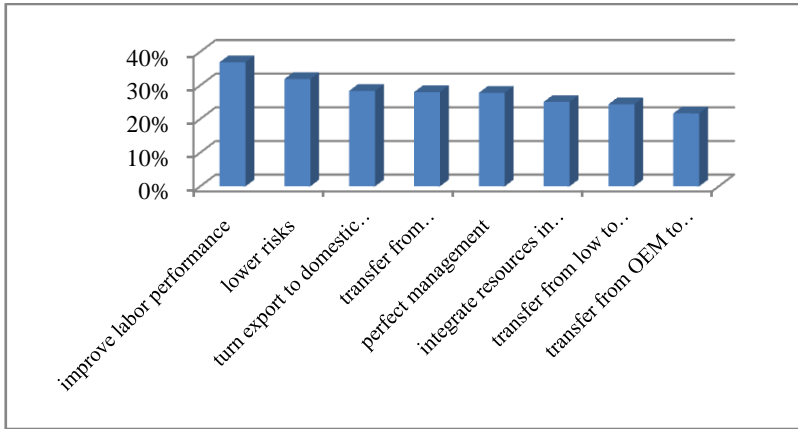


Figure 5. Measures and Directions for SMEs' Transition

4.1 Standardization of Management

As mentioned above, SMEs' organization structure is not coherent enough, confusing rights of ownership and operation. Its flattening hierarchies lead to the leader's too big role in unsystematic decision making, ensuring efficiency but failing to keep correctness and stability. On the other hand, many SMEs place too much emphasis on interpersonal relationship, ignoring systematic, standard and normal management, leaving performance varying with each individual. That will prevent staff from communicating smoothly with each other, especially between those inside and outside the leader's circle. Lack of trust weakens outsiders' sense of identity and cohesion.

4.2 Management of Financial Risk

Policies impose great financial risk on SMEs, which lack effective system to dispose it. They need to establish early warning system fit to their own enterprise. First of all, consciousness for risk should be rooted at all levels, avoiding any irrational decision under financial strain. Second, information management should be improved to enhance early warning ability, by inputting professional experts, software and facilities. Third, overall process management should be carried out to control risks in daily operation. The ultimate aim is to improve the efficiency of capital and ease financial constrain by controlling the risk of cash flow.

4.3 Innovation and Core Business

Due to imperfect policies and economic environment, many SMEs focused on short-run benefit instead of long-run competitiveness for sustainable development. They preferred to copy others rather than innovate. They went into diversification as blind as a bat, sometimes setting foot in unfamiliar business. As a result, few SMEs developed own core competitiveness¹².

¹² Jiang Tao, Nan Yongxin. *Core Competitiveness and Management of Development Strategies of SMEs in China*[J]. *China Business & Trade*, 2009(10):54-55.

Financial crisis led big rises and falls of price of energy and raw materials, and appreciation of RMB propelled inflation. All these eroded profit of labor intensive SMEs, eliminating those with low product quality and disorderly management.

Strategy above all specific business units focusing on future vision and overall control must be made to maintain sustainable development. Low-level expansion of business without potential should be cancelled and inputs focused on those with competitiveness, to guarantee SMEs' advantage over competitors.

4.4 Management of Value Chain

Connected with the lack of strategy is the backward management of value chain. SMEs fail to establish a unique value chain to satisfy customers. From a point of view of value and unique element, core competitiveness lies in advantages over competitors from any one or more of R&D, design, manufacture, marketing and service, etc., and abilities to satisfy customers in ways competitors can't imitate, which is formed by affecting value chain and creating value for customers. There are "common benefit" and "sharing benefit" between enterprise and its customers. Traditional marketing mode should be reconstructed based on customers' interests and demands, to obtain a win-win effect.

Facing with increasingly fierce competition, SMEs need a mechanism for simplified and fast response in business process management (BPM). Reorganizing of overall process, quality control and fast response mechanism and active customer-oriented mechanism will all be included to maintain competitiveness and adaption to market.

4.5 Brand and Enterprise Culture

Private brand is essential for SMEs to upgrade and win international market, and they are transferring their weight from sale to quality and brand. Encouragement from government helps them to develop more overseas markets.

Beside the lack of core competitiveness of goods, enterprise culture is another force hindering brand constructing. SMEs are on the road to transfer their family culture to modern enterprise culture, institutionalizing values shared by founders earlier to conduct all personnel. Objectively SMEs' management evolves from management via experience, to via science and then to via culture. So enterprise culture is an indispensable base on which SMEs establish and cultivate core competitiveness.

5. Conclusion

Whatever each period gives SMEs both opportunities and challenges. Although global economic condition and domestic policies won't change much in the short future, SMEs should make themselves more adapted to the whole situation. In fact Chinese SMEs have been leaning from overseas competitors and taking more and more emphasis on the improvement of their core competitiveness, including strategic planning, risk management, governance structure, value creating, brand and enterprise culture, etc. About ten years later, those SMEs which succeed in transition and innovation will be more powerful and influential at the economical stage worldwide.

6. Literature

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Summary

SMEs are the young and vigorous part in China's economy. They have been facing with challenges of both development and transition since financial crisis in 2008. The improvement of enterprise management is the most important determinant one. Based on SMEs' features and economic environment, this paper analyzes their difficulties and problems based on the data, and points out main directions for improvement.

Keywords: SMEs, transition, enterprise management.

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