The future's looking bright for small- and medium-sized business

Sean Maguire

AS the ramifications of the global financial crisis unfold, questions are being asked as to whether China's foreign reserves and financial system may be at risk.

Such questions underestimate not only the intrinsic strength of the Chinese banking system, but also its flexibility as it takes a more generous perspective on domestic small and medium enterprises (SMEs), opening up avenues of funding to them that were once the preserve of only the larger domestic companies.

Anxieties regarding the vulnerability of the Chinese banking system are typically based upon the assumption that China's foreign reserves would be significantly affected by sub-prime debts.

This assumption ignores the closed character of the Chinese banking system and overestimates the magnitude of Chinese banks' holdings of US mortgage-backed securities.

In fact only a very few of the large state-owned banks, the Bank of China being the principal player, have been significantly affected and the losses are still manageable.

The small- and medium-sized banks have escaped more or less unscathed.

The resilient stock price performance of the Chinese state banks, which are listed in overseas exchanges, after disclosure of their sub-prime holdings, confirms market confidence in the banks' control over their exposure.

The real cause for concern is not the sturdiness of the banking system, but the effect of the credit crunch on consumption demand in the West and the consequences for the Chinese export market.

Small- and medium-sized enterprises are particularly vulnerable to any slowdown in demand. Additionally, when confidence is low, the real estate sector naturally assumes an air of vulnerability.

Raw materials and labor costs rose during the first half of 2008 and continue to remain high, and a slowdown in global demand will only be exacerbated by the ramifications of the credit crunch.

Indeed, preliminary estimates by the National Development and Reform Commission indicate that approximately 67,000 SMEs went into liquidation during the first half of 2008.

Chinese banks, particularly the large state-owned banks, have traditionally been rather unsympathetic to SMEs. Operationally conservative, the big players have shied away from the risk-inherent SMEs, preferring instead to make the most of the imbalance of supply and demand in the market and gearing their lending towards the larger, more stable clients.

Exports slow down

So despite contributing almost 60 percent of GDP, SMEs receive only 20 percent of the loans by large financial institutions.

As net exports are a mainstay contributor to economic growth, it is likely that reduced exports will dampen overall economic growth. However, the effects of the global economic downturn on SMEs will be mitigated somewhat by the steady growth in domestic consumption averaging over 10 percent in recent years.

This trend will speed up due to the policy of boosting private spending as a GDP driver, rising income growth, accelerating urbanization, particularly in central and western areas enjoying an investment boom under the national policy of equitable distribution.

As domestic demand continues to increase, SMEs will gradually emerge as the leading banks' favored funding clients.

As banks strengthen the use of risk-pricing technology and risk-control mechanisms, they will increase their profit-generating ability.

With the policy decision to reduce the profit-reserve ratio, the central bank wishes to increase the availability of bank loans to SMEs by increasing liquidity of small- and medium-sized banks.

This dovetails with the policy of increasing special project SME loans.

So, as domestic growth continues, the future is looking increasingly bright for China's SMEs.

(The author is counsel of AllBright Law Offices in Shanghai. The views expressed are his own.)

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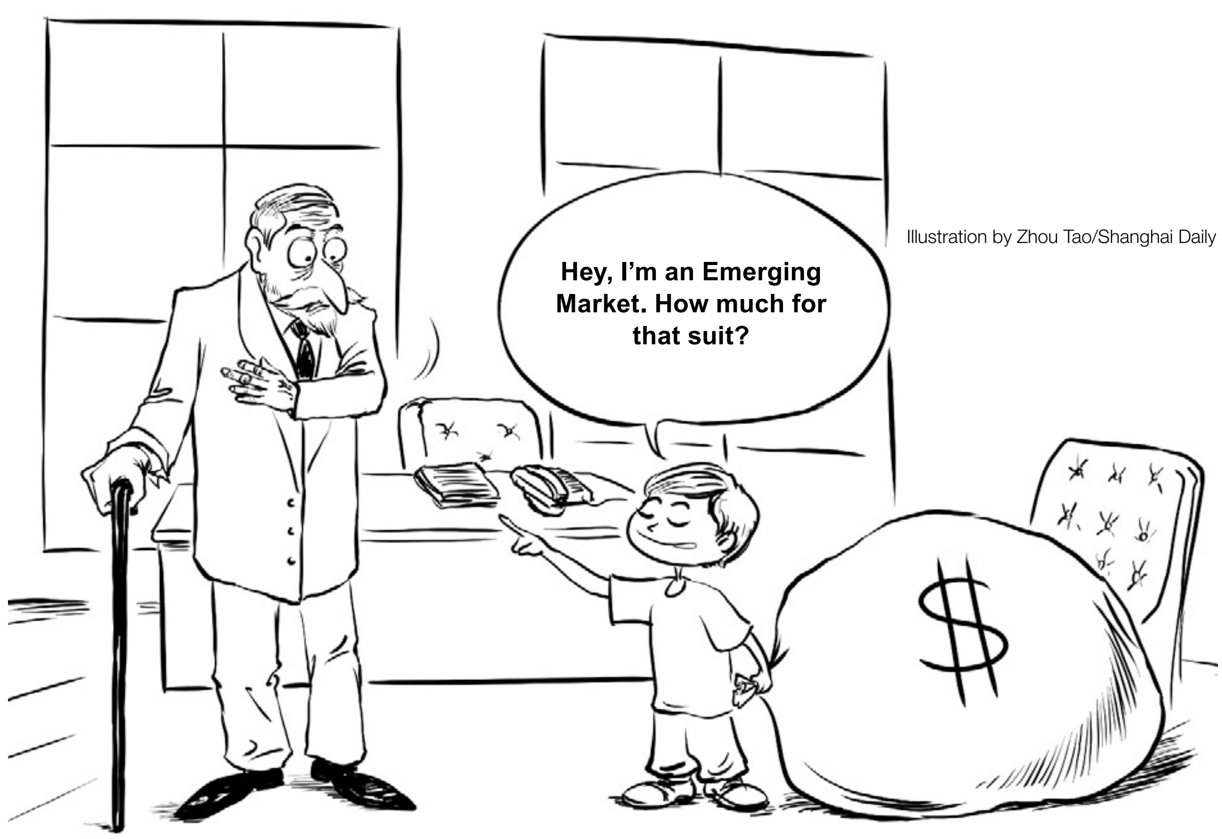

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Emerging markets' FDI strikes sensitive nerve

Karl P. Sauvant

WHEN CNOOC, a state-owned Chinese oil company, tried to buy the American oil company Unocal three summers ago, it generated a firestorm of protest by US politicians.

The Chinese firm eventually withdrew its bid. But the bid — and the resulting outcry — was a harbinger of two trends that have accelerated since then: the rise of emerging market multinationals and the defensive reaction to it in some developed countries.

As investors from emerging markets increasingly take over targets in developed countries, the developed world grows increasingly uneasy about such deals.

The trepidation is understandable, since foreign direct investment (FDI) from emerging markets has grown large enough to pose a competitive challenge — and some view some of it as a national security risk.

But developed countries need to question any protectionist impulses, and recognize that the growth of emerging market investment brings potential benefits to them as well.

At the same time, emerging markets need to realize that some of their takeovers touch a sensitive nerve as reflected, for instance, in the strengthening of the Committee on Foreign Investment in the United States in 2007 and in the discussions in Europe to establish similar defense mechanisms.

So far, the impact of FDI from emerging markets on developed countries remains small.

But it is growing quickly.

Among the most dynamic are multinationals based in the Chinese mainland, with their outflows this year reaching perhaps US$50-60 billion — more than double the 2007 total.

It is therefore fitting that the ranking of large Chinese multinationals undertaken by the School of Management of Fudan University and the Vale Columbia Center on Sustainable International Investment (a joint center of Columbia Law School and The Earth Institute at Columbia University) was released yesterday at in a press conference in Shanghai (available at www.vcc.columbia.edu).

> "Rather than seeing multinationals from emerging markets as a threat, outward FDI from these economies should be welcomed."

The combined outward FDI of all emerging markets accounted for less than one-fifth of world FDI flows: It was US$300 billion in 2007 (six times higher than world FDI flows some 25 years ago), with accumulated stocks of some US$2.5 trillion.

As a result, emerging market multinationals have become important players in the world FDI market.

That raises the stakes and poses a challenge for well-established firms from developed countries, particularly when it comes to natural resources — witness the close attention being paid to recent acquisitions in Africa by Chinese and Indian firms.

At the same time, the new multinationals invest more in developed countries, bringing new competition to established firms on their home turf.

This challenge is pursued increasingly through mergers and acquisitions (M&As), such as Tata's (India) acquisition of Corus (Netherlands/UK) for US$13.5 billion and CVRD's (Brazil) takeover of Inco (Canada) for US$16.7 billion.

M&As especially draw fire when the buyer is the state-owned entity of an emerging market and the acquired firm is considered key to the target country's national security, or when the target entity is in a strategic sector or a national champion.

The CNOOC bid exemplifies this, as does the takeover of P&O Steam Navigation Company (UK) by Dubai Ports World, which went forward only after the assets in the US were divested.

National security

This reaction is particularly strong in the US; hence the Deloitte US Chinese Services Group and the Vale Columbia Center are completing a project examining the question of whether the US is ready for FDI (and especially M&As) from China.

In the absence of internationally agreed definitions, these concepts are open to wide interpretation.

For the US, "national security" involves mostly military and political considerations, while for many European countries and especially emerging markets, the economic dimension is paramount.

This creates regulatory and market uncertainties and makes it difficult to distinguish genuine security concerns from efforts to protect domestic firms from the new competitors.

To reap the benefits of FDI, developed countries need to be careful about their approach to the rise of emerging market multinationals.

Rather than seeing multinationals from emerging markets as a threat, outward FDI from these economies should be welcomed.

(The author is executive director of Vale Columbia Center on Sustainable International Investment, research scholar and lecturer in law at Columbia Law School. The views are his own.)