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# When the dragon awakes: Internationalisation of SMEs in China and implications for Europe

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Napoleon is sometimes quoted as saying "When China awakes, the world will tremble" or, as a variant, "When the sleeping dragon awakes, it will shake the world". China is well and truly awake, to the sound of the pattering feet of many little dragons: SMEs. Many of these SMEs are internationalised. This paper explores three converging and interrelated phenomena.

First, WTO statistics suggest that by 2006 China had already overtaken the United States as the second largest exporter in the world in terms of export volume, and will overtake Germany in the next year or so to be the leading exporting country in the world (WTO 2007). China has achieved remarkable growth of exports and GDP in the last two decades. The internationalisation of its economy is important to its growth and to the stability of the region and the world.

Second, most of these exports come from SMEs. SMEs contribute 68 percent of China's exports. This is a much higher proportion than in any other economy in the OECD or APEC. China's export growth is about double its GDP growth. Chinese SME exporters are a major contributor to Chinese economic growth.

Third, most of these SMEs were "born" in the last decade. China has created more SMEs in the last 20 years than the total number of SMEs in Europe and the United States combined. It was only with the opening of the private economy in China in the reforms of 1980s by Deng Xiaoping that private SMEs were recognised at all. Ten years later, in the 1990s, officially at least, China had only about one million private sector SMEs, but it now officially recognises about 40 million. It still falls short in that it should have about 60 million if it is to have a normal density of entrepreneurs.

Together these three factors suggest that the world may well shake to the march of an army of Chinese SMEs, but in jubilation or in fear? This paper explores:

- the rising importance of SMEs in China's internationalisation;
- why Chinese SMEs have become such an international force;
- whether the trends are likely to continue; and briefly,
- the implications for Europe.

## The rising importance of SMEs in China's internationalisation

The number of SMEs in China has grown rapidly since the economic reforms of the early 1980s, which led to a more market-based economy. However, finding out how many SMEs there are in China is not an easy task. There are two issues. The first is how to define an SME and the second is whether it is privately owned or not.

First, the definition of an SME in China is quite complex and can include relatively large firms. In OECD and APEC economies, the definition of an SME also varies, but most commonly is based on the number of employees. Usually an SME employs fewer than 100 employees, with a maximum of about 500. In reality, the vast bulk of SMEs, around 70 percent or so, employ fewer than five people or are self-employed people. The definition used for regulatory purposes (and thus for the collection of statistics on SME exports) in China depends on the industry category and is defined in terms of employees, sales and assets. For example, an industrial SME is defined as having up to 2,000 employees, while a small business has less than 300, and a medium-size

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business has between 301 and 2,000 employees. Consequently, what is regarded an SME in China may be quite large relative to an SME in Europe or the US. However, the labour intensity of production and the huge size of China still make these firms relatively small. Further, the definition of an SME in China has also been changed at least four times since the 1950s, which renders comparisons over time difficult.

Second is the issue of private ownership. In western economies, SMEs are usually privately owned and run by the proprietor. In China, from the 1948 change of government until the Deng Xiaoping reforms, which commenced in the early 1980s, private sector firms did not officially exist. Most SMEs were usually Town and Village Enterprises (TVEs), which could be quite large. These were not state owned nor were they really private in a western sense; for example, they might be collectively owned, with the state still having some role.

On the best information available, China had about 8.6 million non-agricultural SMEs in 1990, and this has actually declined as a result of reforms (Chen et al. 2000). In 1995 there were about 7 million SMEs of this type employing about 119 million of a total of 143 million employed by all industrial enterprises (China 1995). Most of these so-called SMEs were actually state owned enterprises; some of them were quite largeand by their nature more bureaucratic than entrepreneurial.

The private sector grew very rapidly over two decades from 1980, and much of this growth was in SMEs which were privately owned. Under China's statistical collection methods it is not usually possible to get the breakdown by size and by ownership (for example, private sector versus state owned, by size of firm). According to the National Development and Reform Commission (NDRC) data, the number of private sector firms grew from zero in 1980 to about 100,000 in 1990, to 3.65 million in 2004, or an average growth of about 30 percent per annum. However, the Chinese Bureau's of Statistics (CBS) first Economic Census, completed in 2006 (China 2006), arrived at a figure of 39 million private sector SMEs in 2004 or more than ten times the NDRC estimate. The difference is explained by a different definition and collection methodology; for example, the CBS included firms with less than eight employees in its collection as well as non-employing firms, which the NRDC did not. The CBS figure is probably more representative of the real number of SMEs in China.

Contrast this with a figure of about 19 million SMEs in Europe (European Commission 2003) which includes micro-firms and self-employed, and about 6 million in the US, or about 16 million if self-employed people are included. This means that the US and Europe combined account for about 35 million SMEs relative to about 40 million in China alone. However, almost all of the Chinese SMEs have been born in the last ten years. This explosion of entrepreneurial businesses is unprecedented in human history.

What international contribution do these SMEs make to the Chinese economy? The official Chinese estimates of the contribution of SMEs to exports are set out in Table 1. These show that from 2002, the first year that SME exports were separately identified, SMEs contributed 62 percent of exports, growing to 68 percent in 2005. To put this in context, Chinese SME exports were USD 518 billion in 2005, or equivalent to about double the total GDP of Greece, and about one quarter of the total GDP of France.

These exporting Chinese SMEs include some firms which are quite large relative to the normal definition of an SME in Europe or the US and include firms which are not just privately owned firms. However the same is true in Europe or the US, and neither of those countries has accurate figures on the level of SME exports at an international level either. What figures there are (and ignoring interstate trade) probably suggest that SME exports are less than 30 percent of all exports in the US and Europe. European figures are hard to compare, because they often contain a lot of intra-European trade, so comparable only to beer being shipped from Shandong to Yunnan, or bourbon from Kentucky to California. However, a rough gauge can be obtained from the European Commission (2002) which estimated that European SMEs derive only 13 percent of their turnover from exports. The US Department of Commerce estimated that about 30 percent of US exports come from SMEs (Hall 2003). In rough terms, Chinese SMEs are more than twice as internationalised as those US counterparts, and more than five times as internationalised as European SMEs.

To further put this in context, Figure 1 shows that the level of Chinese exports, of which most come from

**Table 1**

**Chinese exports and SME exports in billions USD**

| | Total exports | SME exports | SME exports as % of total |
|---|---|---|---|
| 2002 | 438.23 | 272.48 | 62.3 |
| 2003 | 593.32 | 390.44 | 65.8 |
| 2004 | 761.99 | 518.16 | 68.0 |

Sources: Data in SME exports and ratio of SME exports to total exports in 2003, 2004, 2005 are adapted from Ministry of Commerce, cited in SME Briefing, Vol 91, published by SME Division of National Development and Reform Commission on 28/10/2006.

SMEs, was greater than that of the US in late 2006. Assuming the continued growth of Chinese exports at 28 percent per annum relative to the 10 percent per annum growth of exports in the US and Europe, Chinese exports will exceed those of Europe, when intra-European trade is excluded, some time in 2009. China has also moved to having significant surpluses in its balance of trade in the last year, both with the US and Europe.

**Why have Chinese SMEs become such an international force?**

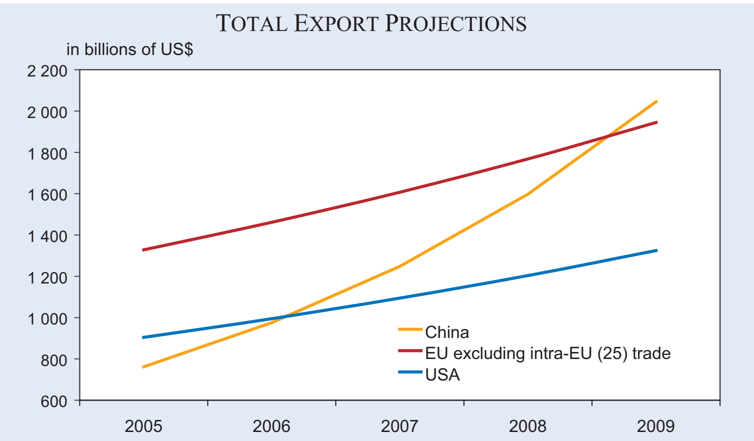
In summary, Chinese SMEs have risen from almost nothing to become a significant international economic force in the last ten or fifteen years. Why has this occurred? There has been little serious research on this topic. The trend can be hypothesised to be a result of a complex constellation of factors.

First, there is always a possibility that some of the phenomenal growth in Chinese SMEs and their exports is a mix of statistical manipulation or misunderstandings. In the past, Chinese statistics have tended to be part reality and part imaginary. Statistics tended to be reworked to meet the targets set by the Central Committee. Consequently, if a given level of growth was a government target, the statistics were massaged to show that the growth target had been achieved. In the case of the SME figures this is unlikely to be the case. China has always cited that SMEs make up about 60 percent of its total exports. A similar figure used to be quoted for Taiwan until the late 1990s, when it was more correctly assessed at 28 percent of exports coming from SMEs. The discrepancy arose because of the way the statistics were calculated (OECD 2004; Hall 2002). This may also be the case in the mainland Chinese statistics, but even if the estimates of the importance of SMEs in exports are halved, they still make a very big contribution. Further, that contribution by SMEs seems to be increasing, in both relative and absolute terms.

Second, the reforms and the restructuring of state-owned enterprises (SOEs) has meant that there are many entrepreneurial opportunities available to SMEs. As SOEs have closed down, the vacuum has allowed entrepreneurial SMEs to flourish. For example, Haier, one of the more successful Chinese white-goods manufacturers, took over and turned a failing SOE around, and it has since become a leading global exporter.

Third, up until the beginning of the 2000s, formal finance was not readily available to SMEs. Even official estimates of non-performing loans (NPL) in the banking sector were around 30 percent of assets. This situation arose because of loans being directed on non-commercial criteria (usually giving preferential treatment to inefficient SOEs), and then supported by a policy of continuing automatic roll-over of unpaid principal and interest, forgiving of non-performing loans, and the selective use of below-market interest rates. Lending rates to SMEs were set by the central bank (the

**Figure 1**




Figures after 2005 are projections.
Source: WTO.

People's Bank of China – PBOC) and were set to be artificially low for political rather than economic reasons. This meant that the rates were not attractive enough to encourage banks to lend to SMEs, especially when the banks had high NPLs. In the last five years, changes to the financial regulation in China have meant that more finance is available for SMEs. This has mostly come through banks which lend against collateral provided by credit guarantees, which nominally relieves the bank of credit risk. Accession to WTO status has helped by encouraging international finance suppliers to set up in China and by encouraging entry of foreign investors.

Fourth, the Chinese diaspora is large, often entrepreneurial and well educated. This entrepreneurialism is not always by choice in many countries (Indonesia is an example). Chinese have been prohibited from government jobs or restricted and discriminated against in their activities. In the last few decades many Chinese have sought education abroad. Attracted by the burgeoning opportunities, many of these (foreign resident and also) foreign educated Chinese have returned to China, and have set up international businesses. For example, Vimicro, which produces chips for cameras, was set up in 2004 by a small group of Chinese returning from the US and has rapidly become a successful international company.

Fifth, the vast supply of low-cost labour, especially in the western provinces, and the regulation of the exchange rate has kept many Chinese SMEs extremely cost competitive. For example, the ILO database gives the monthly rate for manufacturing wages in China in 2004 as about 1,169 yuan per month. Compare this with a German wage in manufacturing of about EUR 15 per hour. Allowing for about 200 hours of work per month for a Chinese worker, the Chinese wage is about 4 percent of the German one.

Sixth, Chinese SMEs need to pursue foreign markets. Chinese domestic consumption is relatively low, because domestic saving is high. China had a huge savings pool, approximately 7.8 trillion yuan (= USD 942 billion) as of February 2002, but at that time most of this was apparently lying idle in banks.

Seventh, new technology has allowed many Chinese to enter international business directly, so they are less dependent on being part of large firm supply chains. Typically, many Chinese businesses do not have computers, but all have mobile phones, usually 3G phones, and those mobile phones can link through high quality wireless broadband. In effect, China's SMEs have jumped over the copper infrastructure to allow a more flexible and adaptable approach to international opportunities.

**Are these trends likely to continue?**

In summary of the preceding, there are many factors which have contributed to the unprecedented growth and internationalisation of Chinese SMEs. Will these trends continue apace? In short, it seems likely they will, but with possible interruptions.

First, although officially China has 40 million SMEs, it should have about 60 million, so the number of SMEs is likely to further increase by about 50 percent. This is based on an approximate estimate of entrepreneurial density, observed in most developed economies, of about 5 percent of the total population being an owner-manager of an SME (Hall 2002). The ratio in China has risen from about 0.08 percent in 1990, to about 3.3 percent in 2004. It is likely to move to something around 5 percent in the next few years. Casual observation in China shows that the start-up rate of businesses is not decreasing. There is virtually no way that the Chinese government can now stop the dragons that have been unleashed.

Second, there is, however, relatively little professional management experience or legal infrastructure available for these new SMEs. This absence will cause hiccups and may slow the expansion. The flying-geese model of Akamatsu (1961) suggests that the Chinese can develop faster than their predecessors' economies, because, like geese or bicycle racers, the Chinese can ride on the bow wave of the leaders. It took Europe about 800 years to go from a feudal agricultural economy to a post-industrial economy. It took North America a bit over 300 years to do the same; America had the benefit of the knowledge and mistakes learnt by Europe. It took Japan about 50 years to do the same, so each follower can take a shorter time. China is attempting to take the same journey in around 25 years, about the length of the career of an average manager. Many of the managers in China have never had any training in management. Few have ever experienced a serious downturn in the economy. The legal and social infrastructure has not developed as quickly as the entrepreneurs have. The growth has been a wave that has carried everyone along. If and when a major downturn does take place, many managers may simply not be able to deal with it. Nor is the financial system likely to be able to cope. Most of the credit guarantees are provided by private sector operations, and there is a real risk that in cases of major default, the guarantors will not be able to meet their liabilities. These guarantor organisations were established largely to get around central government and PBOC restrictions on interest rates, and can provide little real financial collateral.

Third, China faces some major structural and demographic changes in the coming years and decades. For example, by 2025 about 35 percent of China's population will be over the age of 50, up from about 17 percent in 1995. The Chinese work environment, the amount of smoking and the pollution levels mean that many older Chinese have major health problems. More old people will be depending on a smaller working population to support them in their "golden years", especially as a result of the one child policy. The working population, those in the age bracket from 20 to 49 years, will fall as a percentage of total population from about 48 percent in 1995 to about 40 percent in 2025. The absolute number of those of working age will peak at about 665 million in 2010, and then decline to 597 million in 2025. In 2000, just around 70 percent of China's population were still living outside urban centres and only 30 percent were in towns and cities. In most developed economies, urbanisation means a reversal of this ratio. In China this may mean bringing half a billion people into cities. These challenges will require infrastructure and funding. Many SMEs (and SOEs) in China treat paying taxes as optional. Many of the larger SMEs (and some SOEs) are incorporated in the Canary Islands, specifically for tax minimisation purposes.

Fourth, China faces significant international diplomatic and economic pressures in respect of its balance of payments surpluses. At present, China emphasises exchange rates over interest rates as its primary monetary management tool. China has engaged in a form of banded float since 2006, and has allowed the slow appreciation of the yuan. The PBOC does not fully sterilise the exchange intervention used to slow the appreciation of the currency. Consequently there are artificial competitive cost advantages accruing to Chinese SMEs and additional financial funds in the economy to support growth. The appreciation of the yuan and the slow move to full currency convertibility on capital account has been recognised as inevitable in China for some time. The real dispute is about the rate of change. If the currency were to be corrected in a major way (such as a sudden appreciation of 30 percent or so in yuan to USD) in a short period, then it would cause some disruption to Chinese SMEs and their internationalisation. However, it is really a matter of the rate of change, and how fast the SMEs can structurally adjust. It is unlikely to slow the rate of SME expansion much, but it may alter the pattern. This is already happening. For example, SMEs in the south of China (Shen Zhen, Guangdong, Fujian, etc.) are already adjusting their international activity to be more competitive. They are doing this by shifting to cheaper locations in and out of China, including Africa and Eastern Europe, and in improving productivity and quality in the face of rising costs. This is just what Hong Kong did twenty years ago. SMEs are remarkably adaptable animals, a sort of chameleon dragon.

## The implications for Europe

Napoleon's concern was that China was a sleeping dragon with a vast population, many of whom lived in poverty. China thus had huge potential military implications for the world. However, as it awakes much of China's energy is economic and entrepreneurial, not military. The internationalisation of Chinese SMEs is both an opportunity and a threat for Europe. The challenge is to create an economic and political environment which is not a zero-sum game, but which gives everyone opportunities to gain.

The threats to Europe posed by the internationalisation of Chinese SMEs are fairly obvious. The most common manifestation of the threat is in the disputes over textile exports from China to Europe, within the broader threat of the trade surplus that China holds against the US and Europe. Political concerns are understandable, especially, for example, for an employee or owner in a German SME with statutory protections and excellent working conditions. However, the threat will not go away, and it will not be solved by accusations of dumping or exchange rate complaints. These are just salves. The real issue is one of structural adjustment and the rate of structural change. Voters do not worry much about a business closure if they know another firm will be opening up, or expanding, just down the road.

The more difficult issue is if one business is closing down in their area, but opening up in another area which is hard for them to move to, or if nothing else is opening up at all. This adjustment process is not a new phenomenon in Europe, as evidenced by empty villages in Greece, for example, as a result of the post-1940s migration to better jobs, or by the migration from Africa to Europe in search of jobs. It can be a painful experience, and there is understandable resistance to it. The clear implication is that Europe will have to continue to go through structural adjustments, many of which will be driven by Chinese SMEs.

The opportunities are less apparent, because the structural changes are international and so are the opportunities. SMEs make up about half of any local or national economy (in employment and value added terms), but historically their contribution to the international economy has been much smaller. SMEs only make up about 30 percent of trade across borders, and about 10 percent of international investment (Hall 2002). SMEs contribute disproportionately to net job creation: SMEs contribute about 70 percent of net new jobs, while larger firms tend to be job destroyers. Politicians and bureaucrats have been slow to realise the real significance of this in a globalised economy. Many well ensconced businesses in the West prefer to look to politicians for protection, rather than seek opportunities abroad. Policies to assist SMEs to internationalise are often just disguised subsidies to exporters. Chinese SMEs have sketched out a new paradigm, where SMEs have the same important role internationally as they have domestically. This allows them to simultaneously provide an engine of job creation in China and abroad. It is through this process that SMEs in Europe could also add significantly to the total amount of value added or GDP.

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