Constraints of External Sources of Financing for Domestic Private Enterprises in China

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***Abstract*—Private enterprises have been playing an increasingly important role in the development of Chinese economy, but they are having difficulties in accessing external sources of financing which mainly include bank loans, stock market and informal finance. This paper has analyzed the reasons why they face such constrains and also given suggestions to Chinese private enterprises so as to improve their access to external sources of financing. It is believed that it can be helpful to domestic private enterprises in China.**

Keywords-financing; private enterprise; bank loan; stock market

I. INTRODUCTION

The development of China's economy depended on state owned enterprises to a large extent before 1978 when China carried out the opening-up policy. After that, China conducted the economic reforms. This resulted in a decline in state owned enterprises and a significant expansion of private enterprises, especially small to medium-sized enterprises. The number of Chinese domestic private enterprises has increased from 2.4 million in 2001 to over 10 million in 2013, which equals 99% of all registered companies in China (Li 2006, p.10; China Daily 2013). Also, private enterprises have played an important role in the development of Chinese economy since the economic reforms. It is reported by Fung et al. (2007, p.27) that the domestic private sector provided over 60% of production, 90% of employment and 70% of tax revenue in 2002 and 2003 in China. This implies that the Chinese private sector has become an essential part of the nation's economy. However, Chinese private enterprises, who contribute to more than 60% of the nation's production, frequently complain that they have difficulties in accessing external sources of financing.

This paper aims to analyze the reasons why Chinese private enterprises face constrains in getting access to external sources of financing in China and provide suggestions to Chinese private enterprises so as to improve their access to external sources of financing. Firstly, it will introduce different external sources of financing for domestic private enterprises in China. Then, the factors which lead to difficulties for Chinese private enterprises to obtain those external financing will be examined. Finally, the implications for Chinese private enterprises on how to improve their access to external sources of financing will be stated.

II. EXTERNAL SOURCES OF FINANCING FOR CHINESE PRIVATE ENTERPRISES

External sources of financing for Chinese private enterprises mainly include bank loans, stock market and informal finance. Banks, especially state-owned banks, are the biggest financial institutions in China, so bank loan should be the most important external source of financing for Chinese private enterprises. However, Chinese private enterprises accounted for only 0.09% of state-owned banks' lending and 0.23% of all banks' lending in 1990 in China; although the percentages increased to 0.59% and 0.77%, respectively, in 2001, they were still extremely low (Bai et al. 2006, p.613). This indicates that access to bank loans is a universal problem for domestic private enterprises in China. With regard to stock market, entering stock market can help private enterprises to raise capital through the listing of shares. Thus, it is also a desirable external source of financing for Chinese private enterprises. There are two major stock exchanges in mainland China, which are Shanghai Stock Exchange and Shenzhen Stock Exchange. According to Gregory and Tenev (2001, p.17), Chinese private enterprises only account for 1% of the listings on these two stock exchanges. That is, domestic private enterprises are also prevalently confronted with difficulties in entering stock market in China. Leggett (1998) confirms that listing on stock exchanges is an unreachable goal for most Chinese private enterprises, and there were only two private companies which had been approved to offer shares on stock exchanges by 1998 in China. As far as informal finance is concerned, it refers to loans from private credit agencies or individuals. Because of constraints in accessing formal finance, including bank loans and stock market, Chinese private enterprises consider informal finance as an important external source of financing. Gonzelez (2006, p.49) reports 75% of Chinese private enterprises' finance comes from informal finance.

III. WHY CHINESE PRIVATE ENTERPRISES FACE CONSTRAINTS FOR EXTERNAL FINANCING?

Chinese private enterprises are confronted with unfavourable government policies in terms of borrowing money from banks and entering stock market. Although Chinese government is paying increasing attention to the development of domestic private enterprises and interventions in financial markets have been included in government policies in order to support the private sector's access to external finance, government policies to a certain extent are still biased for Chinese private enterprises. First of all, the state will share the risk of bad loans with banks for state-owned enterprises' loans but it will not do so for the private sector's loans (Zhou, 2006). If a state-owned enterprise fails to repay its borrowings from a bank, the state will get involved and share the loss with the bank; nevertheless, if a private enterprise is unable to amortize its bank loans, the state will not step in and banks are 100% responsible for risk of lending to Chinese private enterprises. This makes banks more careful about lending to Chinese private enterprises. In other words, it makes Chinese private enterprises more difficult to obtain bank loans compared with state-owned enterprises. Then, according to government policies banks are free to vary their lending rates up to the rates which are 30% higher than the prescribed rates for loans to Chinese private enterprises, and rural credit cooperatives are even allowed to charge Chinese private enterprises at interest rates which are 50% higher than the prescribed rates (Gregory & Tenev 2001, p.15). There is little doubt that the high interest rate is a factor which discourages Chinese private enterprises to borrow money from banks. Also, the stringent regulations and quota restrictions for listing on stock exchanges represent a constraint for Chinese private enterprises to enter the stock market in China (Fung et al., 2007).

Banks in China have lending bias and they discriminate against domestic private enterprises in lending decisions. Before the economic reforms, state-owned enterprises played a crucial role in the development of China's economy, and they were generally big and stable. On the other hand, Chinese private enterprises started to emerge after China carried out its opening-up policy in 1978. In 1980s, the maximum number of employees a Chinese private enterprise could have was only 8; it is until Deng Xiaoping's Southern Tour of 1992 Chinese private enterprises began to expand and develop dramatically (Li et al. 2007, p.3). Because of shorter history, compared with state-owned enterprises, most domestic private enterprises in China are smaller and younger. Therefore, banks, especially state-owned banks, have lending bias in favour of large state-owned enterprises. Domestic private enterprises are generally considered as borrowers with higher risk by banks in China. Furthermore, as has been mentioned previously the state will get involved and share banks' loss when state-owned enterprises fail to repay bank loans but the state will not intervene and banks must absorb all the loss when domestic private enterprises fail to settle loans from banks. This definitely leads to banks' preference of lending money to state-owned enterprises, since banks face higher financial risks when lending to Chinese private enterprises.

The complicated, costly and time consuming procedures make it difficult for Chinese private enterprises, especially small firms, to get access to bank loans and enter the stock market in China. All the domestic private enterprises interviewed by Gregory and Tenev (2001) describe the procedure of applying for a bank loan as a complicated process, and 70% of them state that the paperwork required represents a restriction for them to apply for a bank loan. Apart from paperwork, banks require for collateral, such as land, buildings, houses, apartments, saving instruments and equipment, or guarantees. Not every Chinese private enterprise, small to medium-sized enterprises in particular, has adequate assets which can be used as collateral for loan applications. Zhou (2006) claims that the majority of Chinese private enterprises which have less than 50 employees can not provide adequate collateral for bank loans. Moreover, it is not easy for Chinese private enterprises to find appropriate guarantees. Fung et al. (2007) state that credit guarantee companies, which are the most common guarantees for bank loans, tend to support large companies rather than small ones. Zhou (2006) concludes that smaller companies face considerably higher barriers in getting access to bank loans than larger companies since they have less capacity to meet banks' requirement of collateral or third-party guarantee. Even if Chinese private enterprises have adequate assets to be used as collateral or they can find satisfactory third-party guarantees, the cost of having the assets registered and the application charges can be very high (Tam, 2004). Also, the loans needed by Chinese private enterprises, especially small firms, are generally small in size but the demand is often seasonal and frequent; this makes the cost of loan applications extremely high (Tam, 2004). Tam (2004) further points out that registration of a mortgage can not be completed without the approvals from multiple government departments, and it takes from a few weeks to several months to get the relevant formal documentation. It is clear that the high expense and long process time required can not cope with Chinese private enterprises' need of seasonable and short term loans. Similarly, the procedure of entering stock market is also complex and costly, and long process time is required as well (Tam, 2004). All these put Chinese private enterprises at a disadvantage in terms of getting accessing to bank loans and listing on stock exchanges.

The presence of asymmetric information is another reason why Chinese private enterprises have difficulties in accessing to external sources of financing. Chow (n.d.) makes clear that asymmetric information can result in significant cost disadvantages of external financing for Chinese private enterprises. For instance, the management of a firm has information about the return of its project but this information is not available to its potential suppliers of external funds, such as outside investors; given the fact that investors can not accurately estimate the return of a project they usually attach an average return to every project; in this regard, a Chinese private enterprise with a good project which likely generates a high return is forced to issue under-priced securities; this leads to higher costs of external financing for this particular firm (Chow, n.d.). Furthermore, asymmetric information between firms and banks can prevent Chinese private enterprises from accessing to bank loans. For instance, in order to evaluate the performance, especially financial performance, and repayment ability of a company objective financial statements are required when the company is applying for a bank loan. However, Chinese private enterprises' financial information is often opaque, and lack of transparent and audited financial records is common in Chinese private enterprises (Fontes, 2005). In this way, the asymmetric information between banks and Chinese private enterprises can be a significant obstacle for Chinese private enterprises to obtain loans from banks.

Lack of private property protection is also an obstacle for Chinese private enterprises to get access to external sources of financing. Given the fact that nearly all Chinese organizations were state-owned before 1978, there were no laws about private property protection until March 2004 in China (Bai et al., 2005). The protection of private property can not be ensured by the existence of a single national law only, and strong enforcement of the law is also required. However, Bai et al. (2005) maintain that the enforcement of private property protection law varies from provinces to provinces in China. Asian Development Bank (2003) also writes that governments have been tardy in protecting private properties of private enterprises in China. This indicates that Chinese private enterprises faced the absence of formal protection of private property before March 2004, and even now they still have the problem of insufficient protection of private property. This leads to Chinese private enterprises face the risks of expropriation by various parties especially by public authorities, such as government officials, and discrimination, thereby difficult to get access to external sources of financing (Bai et al., 2005). For example, as a result of uncertainty about private property protection Chinese banks do not want to extend loans to domestic private enterprises and are quite careful about lending to them (Zhou, 2006).

Besides the external factors, unreliability of Chinese private enterprises is also a significant restriction for them to get access to external sources of financing. Firstly, most domestic private enterprises in China belong to small to medium-sized enterprises, and a large number of them are family based. This makes their potential suppliers of external funds, such as banks, have less confidence on them compared with large state-owned enterprises. Zhou (2006) declares that firm size is negatively associated with bank financial obstacle including interest rate, bank collateral and paperwork requirements. That is, small firms have higher bank financial obstacle, in terms of obtaining loans from banks, than large firms. Then, Chinese private enterprises tend to provide unreliable and unaudited information on their performance to their potential suppliers of external funds. Asian Development Bank (2003) explains that Chinese private enterprises disguise their profits and overstate the value of their assets so as to obtain loans from banks. In order to hide from tax officials and pay lower tax many Chinese private enterprises run different versions of accounting books for one single company (A private affair, 2000). Generally, Chinese private enterprises, especially small ones, do not maintain the accounting standards and transparency required to meet the requirements of banks and other formal financial institutions (Tam, 2004). Admittedly, this makes Chinese private enterprises unreliable in the eyes of their potential suppliers of external funds, and these suppliers will be very conservative in their dealing with Chinese private enterprises. In addition, it is common for Chinese private enterprises to borrow a certain amount of money from banks for one purpose and actually use the money for something else (Gonzalez, 2006). All these findings show that unreliability of Chinese private enterprises, to a large extent, restricts their access to external sources of financing.

IV. Implications for Chinese Private Enterprises to Improve Their Access to External Financing

Owners of Chinese private enterprises are recommended to obtain political position and higher social status in China so as to improve their access to external sources of financing. It has been proved that the membership in the Chinese Communist Party and political position in national and local People's Congresses and national and local People's Political Consultative Conferences facilitate Chinese private enterprises' access to bank loans (Zhou, 2006). Li et al. (2007) agree, pointing out that party membership plays an important role in Chinese private enterprises' obtaining loans from banks and other state institutions. Zhou (2006) further explains that political position in national and local People's Congresses and national and local People's Political Consultative Conferences can significantly enhance the organizational legitimacy and institutionalized social capital of Chinese private enterprises, thereby ease the process of getting access to external financing. Moreover, as a member in a political organization, such as national and local People's Political Consultative Conferences, it is likely for an entrepreneur to establish connection with people who have high social status, for example, politicians, bureaucrats, bankers etc.; this would assist the entrepreneur in obtaining bank loans (Zhou, 2006). A political position can also increase the probability of an entrepreneur to get higher social status. Besides this, participation in charitable activities is also an important way to improve an entrepreneur's social status (Bai et al., 2005). Bai et al. (2005) make the point that, generally, those entrepreneurs who have higher social status enjoy better protection of private properties. This implies that high social status can assist Chinese entrepreneurs in terms of external financing, since poor protection of private properties is an obstacle for Chinese private enterprises to get access to external sources of financing. Therefore, in order to improve Chinese private enterprises' access to external finance, entrepreneurs should try to obtain political position and higher social status in China.

Furthermore, establishing good relationships with banks and other relevant institutions or individuals is required for Chinese private enterprises in order to improve their access to external financing. Close relationships are greatly valued in Chinese society. Thomas (2002) maintains that close relationships can assist organizations to get access to sources of resources, including bank loans, in China. However, according to the research conducted by Hussain et al. (2006), 55.3% of the Chinese entrepreneurs interviewed state that they do not have regular contact with banks and other financial institutions; only 11.1% of the entrepreneurs interviewed say that they have good relationships with their banks; more than 30% of the respondents claim that they have poor relationship with banks in China. This indicates that most Chinese private enterprises do not have close relationships with banks. This should be one of the reasons why they feel difficult to obtain loans from banks. Therefore, Chinese private enterprises should try to cultivate good relationships with banks and other related institutions or individuals. Fontes (2005) also recognizes this, pointing out that Chinese private enterprises need to communicate with their credit providers in a better way.

Except informal finance, Chinese private enterprises should seek alternative external sources of financing, including foreign investment, venture capital, trade credit and even financial support from International Financial Corporation. Bank loans, stock market and informal finance are perceived as three major external sources of financing for Chinese private enterprises. As has been discussed previously, Chinese private enterprises face various constraints in obtaining bank loans and entering stock market. So, most Chinese private enterprises are forced to rely on informal finance, such as loans from private lenders (Leggett, 2000). Allen et al. (2005) state that extremely high interest rates and a large amount of collateral are required on loans from private lenders. Moreover, Gonzalez (2006) indicates that it is likely to offend against the law when borrowing money from private lenders since a large number of them are illegal institutions that intermediate between Chinese savers and borrowers. Thus, Chinese private enterprises should search for other channels of external financing. Allen et al. (2005) claim that investment from "ethnic Chinese" which refer to people from Hong Kong, Taiwan and overseas Chinese is an important external source of financing for Chinese private enterprises. Also, there are many Chinese private enterprises have tried to attract foreign investment (Gregory & Tenev, 2001). Similarly, Huang (2006) points out that foreign direct investment is an important alternative financing channel for Chinese private enterprises. Kumar et al. (2004) further point out that venture capital is another alternative external source of financing for Chinese private enterprises. Besides, trade credit, especially overdue trade credit and long term trade credit, also plays an important role in the development of Chinese private enterprises (Ge & Giu, 2007). Additionally, it is reported in International Financial Corporation (IFC) in China (2007) that Chinese private enterprises can also obtain financial support from International Financial Corporation in China. It seems that all the above financial channels can be alternative external sources of financing for Chinese private enterprises.

Most importantly, Chinese private enterprises should enhance their management and try to be bigger and stronger, in this way it would be easier for them to get access to external sources of financing. It is written in A private affair (2000) that expansion and development are needed for Chinese private enterprises so that they may have more opportunities to access to external financing. To achieve this, first of all, Chinese private enterprises should improve the quality of their management and corporate governance (Munro et al., 2005). According to the data obtained by Hussain et al. (2006), most Chinese entrepreneurs are not highly educated and the majority of them do not have good financial knowledge and skills. Also, most private companies in China are small to medium-sized enterprises and a large number of them are family based. It is not easy for them to recruit qualified and skilled managerial personnel since these people prefer working in large companies over small ones. Thus, not only trying to attract and maintain qualified managers but also trainings for Chinese entrepreneurs themselves are needed for the development of Chinese private sector. Furthermore, Chinese private enterprises should improve their financial information system (Fontes, 2005). These include adopting proper financial accounting system, disclosing adequate and objective financial information and adopting external auditing. This can not only improve the reliability and reputation of a firm but also enable banks and other potential suppliers of external funds to be better informed about the performance of the company and assess its repaying capability in a more accurate way (Fontes, 2005). In short, it will be easier for a company to get access to external sources of financing when it becomes larger and has better performance. Thus, Chinese private enterprises are encouraged to be bigger and stronger.

V. CONCLUSION

Although Chinese private enterprises represent an increasingly important part of Chinese economy, they are confronted with constraints in getting access to external sources of financing in China. This paper has introduced the major external sources of financing for Chinese private enterprises, and they included bank loans, stock market and informal finance. Then, the reasons why Chinese private enterprises have difficulties in accessing to external financing have been highlighted. These reasons can be summarized as unfavourable government policies, Chinese banks' discrimination against domestic private enterprises, the complicated, costly and time consuming procedures, the presence of asymmetric information, poor protection of private property and unreliability of Chinese private enterprises. In order to help Chinese private enterprises to improve their access to external sources of financing, this paper finally provided Chinese private enterprises with some suggestions. These included obtaining political position and higher social status, establishing good relationships with banks and other relevant institutions or individuals, seeking alternative external sources of financing and enhancing their management and trying to be bigger and stronger.

Therefore, it can be concluded that the constraints Chinese private enterprises face in accessing external sources of financing is due partly to government policies, partly to factors within the financial system and also partly to the nature of Chinese private enterprises. This implies that not only Chinese private enterprises should put effort in improving their access to external financing but also Chinese government and financial institutions, especially banks, should make certain modifications so as to support the development of Chinese private enterprises. Thus, researches on what Chinese government and financial institutions can do to provide more support to Chinese private enterprises which lies outside of the parameters of this paper could be done in this area. This would provide certain assistance for Chinese government and financial institutions on how to improve the external financial environment for Chinese private enterprises.

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