Chapter 1 : Chinaâ€™s Emerging Private Enterprises: Prospects For The New Century

Prospects for the New Century Washington: The relative importance of different sources of financing among surveyed firms depends on firm size. Internal sources tend to become less important as firms grow larger. External sources for the smallest firms are mainly informal channels, but their share tends to decrease as firms grow bigger, while the share of commercial bank loans increases with firm size. Commercial banks are the second most important source of funds for the largest firms, after retained earnings. This seems to indicate that banks provide more support for larger and relatively successful private firms. But, on average, Chinese banks tend to play a relatively small role in financing private firms. Only 29 percent of surveyed firms had secured loans in the previous five years. Chinese firms rely more on internal sources of financing than do firms in transition and developed economies. A recent World Bank survey on the business environment in transition economies finds that the share of internal funding is significantly lower in advanced reformers such as Estonia 33 percent , Poland 34 percent , and Lithuania 37 percent. In the United States, a far smaller share of financing is internal; even for small and medium-sized enterprises less than two years old, internal financing reached a maximum of 54 percent of total financing. Factors affecting access to financing The difficulty private Chinese firms face in obtaining financing is due partly to factors within the financial system and partly to the nature of Chinese private enterprises. Through recent reforms, China has made significant progress in reducing government interference in bank lending. However, there is ample evidence that local governments continue to encourage bank lending to state-owned enterprises by extending explicit or implicit guarantees or through other means. Furthermore, banks still do not consider a bad loan to a state-owned enterprise to be as serious as a bad loan to a private enterprise. Expectations, reinforced by recent experience, are that when a state-owned borrower fails to service a loan, the government will almost certainly bail it out. Private borrowers do not benefit from the same kind of expectations. Until this asymmetry in the risks banks face in making loans to firms with different types of ownership is eliminated, banks will discriminate against private sector firms. Banks therefore need added incentives to lend to private enterprises. One such incentive could be higher returns, but most banks in China are state owned and face limited competition, with the result that the profit incentive is weak. Furthermore, financial sector reforms focused on reducing the accumulation of nonperforming loans in the system are making banks more averse to risk. Banks concentrate on avoiding losses and show little interest in sharing the rewards of projects that may be riskier but have higher expected returns. Indeed, the central bank requires all banks to implement a policy known as "responsibility to individuals," which makes credit officers personally responsible for loans, thereby discouraging them from making loans for private sector projects. In addition, there are controls on interest rates and transaction fees, although the government has been gradually relaxing some of them. Interest rates are capped. On loans to small and medium-sized enterprises, they are allowed to be 30 percent higher than prescribed rates, and rural credit cooperatives are allowed to charge interest rates up to 50 percent higher. Banks are taking advantage of this more flexible interest rate regime, but interest rates need to be liberalized further to encourage more lending to private firms. For the time being, banks and credit unions have found creative ways to circumvent interest rate controls, such as requiring compensating balances and charging false late payment fees. As a result, according to the firms surveyed, state banks charge effective interest rates that are comparable to those in the informal market. At the same time, most of the mechanisms used to circumvent restrictions on interest rates entail additional transaction costs, discriminate against smaller firms, and are too blunt to reflect differences in the risk profiles of projects. Chinese banks often complain about the poor quality of projects seeking financing. What they consider "bankable" projects, however, depends in part on the procedures they use in screening them. The procedures, both formal and informal, rely on collateral and personal relationships rather than on project appraisal. Furthermore, they are inflexible and tailored, partly for historical reasons, to the "typical" state-owned enterprise. According to the firms surveyed, applying for a loan is a bureaucratic and costly process. About 70 percent said that paperwork was a moderate or major obstacle to their application for a formal loan. Collateral requirements, the cost of the application process, and relationship banking tend to make it especially hard for smaller firms to gain access to financing Chart 2. According to the surveyed firms, the inability to meet collateral requirements is the most frequent reason for not being able to obtain a bank loan. Although a number of assets qualify as acceptable collateral in theory, in practice real estate assets appear to be the most commonâ€”in some cases, the onlyâ€”kind of collateral accepted. Yet, because of the legacy of public and collective ownership of land, many private firms do not have land-use rights or buildings that can be used as collateral. The fees may amount to a percentage of the total value of the assets. Furthermore, firms must renew their asset registration yearly and pay an annual registration fee. Repeated and arbitrary fees have greatly reduced the incentive of firms to apply for loans. Information problems, endemic in financial markets, are especially severe for private firms in China. Having developed in an unfriendly political and economic environment that only recently put them on the same official footing as state enterprises, private firms have developed in ways that make them particularly opaque. Many had to present themselves as collectives or as foreign enterprises to be allowed to operate or to obtain better treatment from the authorities. The resulting lack of clear ownership and management structures imposes obvious constraints on borrowing. To add to the problem, banks are unable, and lack the incentive, to collect and process relevant information. At present, the interactions between financial institutions and private firms do not encourage the use of transparent financial and accounting systems. By avoiding formal accounting systems or keeping several sets of books, firms can make it impossible to audit them. Banks are naturally reluctant to accept financial statements that cannot be trusted. Recent revisions to the accounting law, which stipulate that every business unit must have only one set of account books, testify to the severity of the problem. Recently, the central bank made it mandatory for corporate borrowers to register in a national database. This will make the central database more comprehensive and prevent companies with poor records from getting loans or using the same collateral for multiple loans. An important step would be to strengthen profit incentives through private ownership and competition. At present, the ownership structures of the real sector are out of balance with those of the financial sector, where private ownership is practically nonexistent. The government should allow the entry of new domestic private financial institutions, especially in view of prospective WTO membership, which would open up entry opportunities to foreign financial institutions. To alleviate regulatory concerns, stricter entry and prudential requirements could be applied to new private financial institutions in the initial period. Private financial institutions are less likely to be swayed by political considerations and more likely to be profit oriented. New banks tend naturally to focus on underserved market niches, especially younger and smaller firms, which constitute the bulk of the private sector today. They tend not to discriminate among customers on the basis of existing relationships and, in their struggle to establish themselves in the market, are more prone to trying new and innovative ways of doing business. The big state-owned banks are likely to dominate the domestic financial landscape for the foreseeable future. Corporatization, listing, and strategic partnering with foreign financial institutions are some of the ways to reach this objective. Further liberalize interest rates. Such a measure is not likely to have a significant impact on the borrowing costs of these firms. Most private enterprises that are able to borrow already pay effective interest rates that are significantly higher than the ones prescribed by the central bank. Entrepreneurs also indicate that access to financing is more important than the cost of funds. Allow banks to charge transaction fees. Banks find that lending to private companies, most of which are smaller and informationally more opaque than state-owned enterprises, carries higher unit transaction costs. If banks are not in a position to cover these costs, they are likely to discriminate against small firms. Transaction fees would therefore encourage banks to consider more proposals from small firms, develop a more service-oriented culture, and promote greater transparency and better accounting standards. Develop alternatives to bank lending, such as leasing and factoring. Leasing and factoring are underdeveloped in China. Yet they are useful ways to deal with insufficient collateral and, in the case of leasing, with the enforcement of collateral. However, the development of leasing faces obstacles in China: This is the first time either national or regional legislation has covered the fundamental principles of finance leases. However, the legislation is not a substitute for a special leasing law, which is needed to address the issues identified above. Liquidity and arrears problems are common among private enterprises in China. Provisions in the new contract law that make it possible to assign contractual rights independently of the assumption of the corresponding obligations and without the consent of the debtor may stimulate the growth of factoring. Create a framework for the development of private equity markets. Private equity markets in China are at an embryonic stage of development. Indeed, offshore venture funds appear to be a far more important source of capital for start-ups in China than domestic ones. Recognizing the importance of private equity markets for the high-tech sector, the government has stepped up efforts to stimulate their development and is preparing legislation on venture capital and investment funds. At present, no regulations cover the organizational structures that can be used to establish private equity funds, known in China as "industrial investment funds. These corporations must abide by the company law, which does not permit more than 50 percent of capitalization to be invested in subsidiaries or other legal entities. Certain legal instruments must be in place before private equity funds can develop. The most important ones relate to the legal organization of such funds, the use of a fund manager, the need for trustees to protect investors from adverse actions of the fund manager, and tax treatment to avoid double taxation. The development of private equity markets also depends on the ability of investors to use a variety of financial instruments to structure investments. In China, however, the lack of provisions for the issuance of different classes of shares and quasi-equity securities seems to deny private enterprises the flexibility they need in their financial arrangements. Improve access to public equity. The availability of exit mechanisms is a key condition for the development of private equity markets. In that sense, the evolution of private equity markets in China depends to a large extent on the state of the public equity market. The latter has been virtually closed to private firms, but in March the Chinese Securities Regulatory Commission announced that the quota system on listings would be abolished. This suggests that private firms would have greater opportunity to acquire long-term funding through the equity market. The expected establishment of the Second Trading Board in would have a profound effect on private equity markets by enhancing the exit mechanisms for pre-listing investors. This would represent progress, although the need for such a high minimum level of capital can still be questioned. Conclusion Macroeconomic and survey data suggest that the impressive growth of private enterprise in China over the last decade has been financed overwhelmingly from internal sources. International evidence suggests that this is not sustainable. As firms mature and grow larger, their need for external finance will grow.

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