5

Finance

Finance is a big problem for private firms in China as is clearly revealed in responses by the sample firms. This chapter discusses the financial position of the sample firms including enterprise arrears, access to formal loans, the role of informal loans, overseas financing, access to equity financing, and possible reforms to the financial sector to accommodate private sector development.

The financial position of the sample firms

Table 5.1 reports sources of the initial capital of the survey firms based on the CEO questionnaire. The majority of the survey firms started predominantly on self-financed capital. In Beijing, Wenzhou and Chengdu more than 90 per cent of the surveyed firms relied on self-financed capital to begin their businesses, including banks and other financial or non-financial institutions. Other sources of financing including banks, other financial and non-financial institutions played a minor role, except that bank loans were significant in Mianyang, Deyang and Shunde.

The amount of capital financed by entrepreneurs themselves tended to be lower for firms that had been operating longer. This may reflect the situation in privatised and *gaizhi* firms, in which entrepreneurs generally needed to inject less initial capital into business operations. These firms tended to rely more on funding from banks and other institutions over time. This is shown in the increases in percentages of firms operating for 5–10 years, and more than ten years, that relied more on these sources of financing.

Table 5.2 reports information on business financing by years (1995 and 1998), and by cities and firm size in 1998. First, like the situation of firms' initial capital, a considerable number of private firms continued to rely mainly on self-financing and retained profits for business operations. Together these two have become dominant sources of business financing for firms in all areas except Mianyang where loans from both SOBs and credit unions played quite important roles in financing private firms.

Second, the percentage of firms relying on retained profits fell from 1995 to 1998 while the role of self-financing increased during the same period. Also, except for selling equity, which increased slightly from 1995

Table 5.1 Sources of firms' initial capital (% of firms with valid data)

	Self-financed	Bank loans	Institution	Other
All	90.5	4.0	2.6	2.8
By city				
Beijing	96.1	0.3	2.0	1.1
Shunde	87.1	6.5	6.5	–
Chengdu	91.5	2.8	2.1	3.6
Wenzhou	97.3	1.1	0.1	1.6
Mianyang	73.2	17.9	–	8.3
Deyang	82.8	7.1	5.7	4.6
By years of operation				
<= 3 years	92.4	2.7	2.2	2.7
3–5 years	92.1	3.5	–	3.8
5–10 years	89.0	6.3	1.5	3.0
>10 years	83.1	5.7	9.9	1.3

Source: CEO questionnaire. Gregory et al., 2000. *IFC Report*, Table 5.3, p.48

to 1998, the percentages for all other sources of financing including loans from SOBs and credit unions, bonds and informal channels, fell over this period. The fact that private firms had to rely more on self-financing during the late 1990s suggests there were increased difficulties for private firms in obtaining formal sources of financing over this period.

Third, there are variations across regions in terms of private firms' access to loans from formal sources. For example, a relatively high percentage of firms in Mianyang obtained loans from SOBs, and lesser percentages from Wenzhou, Chengdu and Shunde. There were only a small number of private firms who obtained loans from SOBs in Beijing which has the highest proportion of firms that relied on self-financing (45 per cent). Credit unions were quite active in Mianyang, Deyang and Shunde. Informal channels for financing still played relatively important roles in all the surveyed cities especially in Beijing. There was no financing from foreign sources for the surveyed firms. The results seem to indicate that the more firms can rely on formal sources of financing, the less they depend on self-financing.

Finally, the results by firm size suggest that the larger the firm, the less it depends on self-financing and informal financing, and the more it relies on formal channels of financing and issurance of shares on the market.

Discussions of the financial position of the sample firms should be linked to the issues of enterprise arrears, which is a problem for private firms in China. Although the firm and CEO questionnaires did not collect information on the size of the arrears owed to a firm, interviews with CEOs revealed that arrears were common among the sample firms and had serious

Table 5.2 Sources of capital financing (% of firms with valid data)

	Stock Shares	Enterprise debt bonds	Loans from SOBs	Loans from foreign banks	Loans from credit unions	Informal channels	Profit retaining	Self-financing
Total								
1995	1.0	1.0	12.2	–	10.4	12.6	30.2	21.9
1998	1.3	0.3	9.7	–	8.3	9.0	26.2	35.8
By city (1998)								
Beijing	0.6	–	3.0	–	5.3	11.1	23.1	45.6
Shunde	–	–	15.9	–	14.1	7.8	19.6	28.8
Chengdu	5.0	2.1	17.2	–	8.3	6.2	30.4	28.6
Wenzhou	2.3	–	19.2	–	1.7	6.5	44.5	29.4
Mianyang	–	–	26.2	–	23.0	9.6	14.1	11.7
Deyang	0.6	–	3.0	–	16.7	6.3	27.2	26.0
By firm size (1998)								
< 51	1.1	0.6	3.4	–	6.3	10.4	22.4	45.0
51– 100	0.3	–	7.8	–	11.3	6.1	32.9	31.7
101– 500	2.8	–	16.0	–	10.5	7.7	35.2	21.8
> 500	2.3	0.4	25.0	–	9.7	4.2	30.2	23.6

Note: For 1995, there are 147 firms providing valid data; for 1998, 363.
Source: The firm survey. Gregory et al., 2000. *IFC Report*, Table 5.5, p.50.

Table 5.3 Turnover rate of working capital: 1995 and 1998

City	1995		1998	
Beijing	2.8	(22)	5.3	(154)
Shunde	4.8	(15)	5.6	(25)
Chengdu	6.7	(13)	3.1	(38)
Wenzhou	7.1	(20)	7.1	(30)
Mianyang	7.7	(11)	9.1	(17)
Deyang	1.0	(22)	8.3	(35)
Total	5.3	(103)	5.3	(299)

Note: Turnover rate is defined as frequencies of yearly working capital rotation. The number of valid entries is listed in the parenthesis.
Source: Firm survey.

their increased turnover rates between the two years could only be explained by a tighter liquidity constraint. However, the decreased turnover rates in Chengdu and Deyang could be caused either by a worsened situation of enterprise arrears, or by a not so tight liquidity constraint.

The above analysis showed that the liquidity constraint was indeed a factor that affected the sample firms' working capital. This was evident from the CEO interviews. For example, one of the major reasons that firms were very cautious in selecting customers was to avoid the breakdown of their cash flow because the consequence was catastrophic.

Many firms operated on the initial capital raised by their shareholders. For example, a large garment company in Beijing started business in 1992 and caught the wave of the overheated demand and accumulated a considerable amount of wealth in a very short time. As a result, it did not use outside financing at all in its course of development. However, not all firms were as lucky as this one in striking a peak of the business cycle. For most firms, operating on shareholder-provided capital was hard. For example, a Beijing firm specializing in building Intranet for logistic firms had five shareholders and 5 million yuan of capital. However, to complete a project, it had to use its own money to buy computer equipment for the project as well as pay its employees. It could only be paid back after the project was finished. The 5 million yuan of its own capital was just enough to sustain its business. If the project failed, the firm would go bankrupt.

The lack of funds did not stop at the lack of liquidity. Firms that are in an expansion phase need outside sources to finance their investment. For example, a Shunde firm specialising in making porcelain equipment had grown very fast since its founding three years before. It invented a new set of equipment that could compete with the best product made in Italy, the world leader in the industry. To put this new technology into production, it needed 60 to 80 million yuan to construct a new building and buy new equipment. However, it was not possible to find this amount of money in the country. It then considered listing on the Hong Kong H share stockmarket. Even in capital-rich Wenzhou, sufficient finance for large projects is hard to obtain.

The Chinese economy at the time of the Survey was stranded by sluggish aggregate demand. At the time, the government's expansionary fiscal and monetary measures had not given a lift to the economy. In particular, although interest rates were lowered several times to below 4 per cent for one-year loans, there was still no sign of expansion in demand for credit. This sharply contrasted with the lack of capital in China's vibrant non-state sector, and revealed structural problems in China's banking system.

Access to formal loans

In China, formal bank loans are controlled by the four major state commercial banks, the Industrial and Commercial Bank of China (ICBC), the Bank of China, the Construction Bank of China, and the Agricultural Bank of China (ABC) as well as local rural and urban credit unions. The lending policies of these banks are tightly controlled by the central bank, with little flexibility left to the state commercial banks. While the ICBC plays a major role in providing credit to China's SOE sector, ABC plays a major role in the development of China's TVE sector. Before private firms were officially recognised in 1988, it was impossible for them to get formal loans. This was one of the major reasons for the emergence of the 'red hat' firms. In early 1998, the central bank lifted the credit cap on each commercial bank and asked them to be responsible for their own profits and losses. This was a good start for China to establish a truly commercial banking system. How friendly were the state commercial banks to private firms?

Table 5.4 presents some statistics of loan applications submitted by the sample firms to the four state banks in the last five years. Among the 500 firms providing a usable answer, 33 per cent have applied at least once for loans from the four banks. The total number of applications is 1247. Among them, 1029 succeeded, so the success rate is 83 per cent. The average size of the loan is 1.02 million yuan. The high success rate is in stark contrast to the low percentage of firms having ever made an application. Clearly, there was self-selection when firms decided whether to make a loan application. We will leave to a latter stage the discussion of the factors that determined this self-selection process, as well as whether a firm could get a loan.

We now turn to the geographical pattern of the distribution of the applications. In Beijing only 14 per cent of firms had made an application.

In contrast, in Wenzhou the proportion was 70 per cent. Beijing also had the smallest number of times an application was made, and Wenzhou also had the largest. However, it was Deyang and not Beijing that had the lowest success rate. In addition, its average loan was relatively large. In contrast, Wenzhou's average loan size was quite small although it had the highest success rate. This shows that firms in Beijing that made an application were likely to be larger firms while those in Wenzhou were smaller.

Table 5.5 shows the loan applications by firm size. It is clear that both the percentages of firms making an application and the success rate increased as the firm size increased. For firms with no more than 50 employees, only 17 per cent of them ever made an application, but for firms with more than 500 employees, 83 per cent of them made an application. The success rate for the former group of firms was 76 per cent whereas it was 88 per cent for the latter group.

The average size of loan also increased with firm size, with one important exception. The exception was that firms with no more than 50 employees had much higher average loan size than the firms in the two higher size categories. How this exception came about needs further exploration. This size-related pattern of distribution shows that larger firms possessed significant advantages over smaller firms in terms of the probability of getting a formal bank loan.

The above statistics reveal several important factors that determine whether a firm can get a formal bank loan. For example, the availability of credit counts (firms in Wenzhou were more likely to get a loan), and firm size also counts. In what follows, we will present a more comprehensive discussion of these factors.

The first factor is that the bureaucratic process of making an application for a formal bank loan itself is very costly. Paperwork is a burden. Among 254 firms with usable answers, 70 per cent said that paperwork was a moderate or major obstacle to their application for a formal loan. Firms not only have to do the paperwork with the bank, but also with the office of notary public, the asset evaluation agency, and other related government agencies in order to enable them to use their assets as collateral. To complete this paperwork takes both time and money. It would be regarded quick if a loan could be issued in one month. However, many private firms need urgent money. In addition, they also tend to want to borrow short-term money which banks are reluctant to lend.

Finally, there are many 'under-the-table' constraints. For example, a firm without a good relationship with bank employees may have problems in getting a loan. Among 207 firms, 69 per cent said that not having a good relationship with the bank was a moderate or serious constraint to

Table 5.4 Applications for formal loans by city

City	Number of firms	% of applied	Times applied	Number	Successes Ratio	Ave. size
Beijing	273	14.3	188	165	0.88	1033.2
Shunde	42	52.4	140	126	0.90	1987.0
Chengdu	70	45.7	252	187	0.74	1035.0
Wenzhou	50	70.0	472	452	0.96	661.5
Mianyang	25	60.0	142	122	0.86	1775.1
Deyang	40	55.0	144	72	0.50	343.8
Total	500	33.0	1338	1124	0.84	1027.3

Note: In 1,000 yuan. Gregory et al., 2000. *IFC Report*, Table 5.6, p.52

Table 5.5 Loan applications by firm size

Size	Number of firms	% of applied	Times applied	Number	Successes ratio	Ave. size
< 51	235	0.17	209	159	0.76	1048.1
51–100	72	0.46	274	214	0.78	478.8
101–500	82	0.63	449	391	0.87	634.5
> 500	29	0.83	227	199	0.88	2282.6

Source: Firm survey.
Note: In 1,000 yuan. Gregory et al., 2000. *IFC Report*, Table 5.6, p.52

their ability to get a bank loan. Of course, there were regional differences. Only 20 per cent of the firms in Wenzhou shared this opinion, compared with 79 per cent in Deyang.

However, little can be read into the regional difference as it is not only caused by the different styles of the banks but can also arise as a result of the difference in the availability of credit. Nevertheless, the importance of a good relationship with the bank is obvious. Many firms are forced to create such a relationship (Box 5.1). Because of these extra costs, many firms, especially small firms, are put off even trying to apply for a bank loan.

The second factor is that many firms cannot provide the necessary collateral or find a guarantor for their loans. This was the most frequently quoted reason by the sample firms for not being able to get a bank loan. Guarantees provided by local governments and by firms to each other were common until two years ago. However, this kind of guarantee created serious problems. Government guarantee was a major reason for the soft-budget constraint problem in both public and private firms, especially those in semi-urban and rural areas. For example, the provincial ACFIC in Sichuan Province organised a kind of loan scheme to provide guarantees for private firms a few years ago and could not recover the losses it made from the experiment.

Firm-to-firm guarantee in many cases led to disputes. The firm that provided the guarantee usually asked the firm that took the guarantee to deposit part of the loan obtained in its own account. However, this money was usually retained by the former as a service charge (Box 5.1). If the two firms could not sustain their relationship, this led to disputes. As a result, the central government has recently prohibited local governments from providing guarantees to their firms, and firm-to-firm guarantees have been discouraged by the central bank. Therefore, providing collateral has become the only way for almost all the firms to get a bank loan. Yet many firms do not have the capacity to provide adequate collateral.

Amongst 248 firms providing usable answers, 62 per cent regarded collateral as a moderate or major obstacle to their ability to get bank loans. However, there were large regional differences. In Wenzhou, only 32 per cent had that opinion. In contrast, 73 per cent in Beijing had such an opinion. Other cities fell in between. Since the requirement for collateral is uniform across the country, the regional differences were mainly a result of the different levels of wealth held by private owners in different regions. The contrast between Wenzhou and Beijing is not surprising.

The central bank requires that the amount of loans with collateral in a commercial bank have to be at least 70 per cent of its total volume of loans. In the survey, the research team found that various forms of collateral were accepted by the banks. These included land, buildings, houses, apartments, cashable saving instruments (savings certificates, government bonds, etc.), equipment, and sales contracts provided by credible buyers (buyer-guaranteed bank loans). However, real estate assets, i.e., land, houses, apartments, and other buildings were the most common, and in some cases, the only kind of collateral that a bank accepted. Equipment was frequently rejected as collateral because of its speciality. There were only a few cases of buyer-guaranteed bank loans. One involved a foreign trade company as the guarantor.

There are two key issues which are directly related to collateral loans. First, many private firms do not have their own land or buildings to use as collateral. Owners' houses or apartments could be used as collateral, but people are usually reluctant to put their shelters under risk. In addition, the value of their houses or apartments is usually small compared with the amount of loan they want. There are some impediments even when a private owner wants to use his house as collateral. In rural areas, a frequently observed phenomenon is that an owner only has the property rights of his house,

Box 5.1 Firm Y's journey to get a bank loan

Firm Y, located in Beijing, specialises in the export of Beijing ducks to industrial countries. Its owner told the research team of a six-step procedure for getting a bank loan.

First, you need to find a bank that believes you have the repayment capacity. Besides the requirements asked by the bank, you have to have an extensive social and information network.

Second, after locating a bank, you have to meet with the bank's manager, vice manager in charge of your industry, vice manager in charge of corporations, and vice manager in charge of lending. Of course, you have to spend money and time on this.

Third, after you have met with the managers, you have to convince the lending committee that you have the right credentials to get a loan. The committee will not send people to your firm, but just make its decision based on the credentials you send them.

Fourth, you have to meet with the lowest manager in charge of your loan in one of the bank's branches. He also has the power to stop your loan.

In the above four steps, you have already invested a considerable amount of money and time. Some officials may even ask to borrow from you a car or an apartment. However, the long-march to get a loan does not stop here.

Fifth, you have to find a firm that is willing to deposit its money in the bank that will provide you with the loan. This is required by the bank. However, no firm will do what you want for free. You have to pay extra interest to the firm in the amount that is comparable to the interest it will get from the bank. Of course, to find a firm that is willing to provide the savings, you also need to spend money.

Sixth, you have now entered the last step, to get a firm that is willing to provide you with a guarantee because you do not have enough collateral. No one wants to provide a guarantee for you for free. You have to lend part of the loan you get to the guarantor. However, do not expect that it will return the money to you.

You finally get the loan, but you have already spent part of it before you even begin to use it. In addition, the term of the loan is one year, and you have to worry about its payment by the end of the first half-year.

Source: Gregory et al., 2000. *IFC Report,* Box 5.2, p.56.

but not the rights of the land occupied by the house because the latter is owned by the village. Under such circumstances, the bank is reluctant to accept one's house as collateral. As a result, many firms cannot get loans because of the lack of transferable collateral.

It is noteworthy, however, that private firms have begun to acquire land use rights under terms ranging from 50 years to 70 years. This happens in all the cities covered by this study, but is more common in Wenzhou and Shunde. With land in hand, firms avoid the problem of the lack of collateral. Because only relatively large firms can afford to buy land, lending inevitably is biased against smaller firms. Therefore, the ability to afford collateral is one of the significant factors that has contributed to the size-related distribution presented in Table 5.5.

Second, even if a firm has adequate assets to put down as collateral, it is costly for it to get the necessary credentials regarding the value of the assets.

Asset appraisal is usually delegated by the related government branch of land or real estate management to a commercial real estate appraisal firm. After the appraisal, firms have to register the assets with the government branches in charge. In both steps, firms have to pay.

Appendix Table 5.1 in this chapter shows the different types of fees a firm can incur in a province. These fees usually take a percentage out of the total value of the assets. If there is no cap to a fee, a firm could end up paying a huge sum for collateral credentials. For example, a firm in the province cited in the appendix had to pay more than 300 thousand yuan in order to get the collateral credentials for its 37 million yuan loan. In addition, firms are required to renew their asset registration by each loan on a yearly basis and have to pay the full or part of the registration fee annually. Last, in many cases, the base of the fee is the value of the property, giving the appraisal firm a big incentive to inflate the value of the property and creating a potential risk to the bank. Repeated and arbitrary fees have greatly reduced firms' incentive to apply for a loan.

The third factor that impedes a private firm's ability to get a formal bank loan, especially small firms, is the information asymmetry between the firm and the bank. The asymmetry can be caused by several factors. First, most private firms are small and cannot survive severe market fluctuations. Therefore, they have a larger risk of default than larger firms do. Second, private firms usually do not want to reveal their information to outsiders. A typical private firm has three kinds of accounting books— one for the owners, one for the tax bureau, and one for its customers, investors, and the bank. Therefore, the bank has a legitimate reason to question whether the records presented by a private firm really reflect its financial position. Third, information asymmetry can also be attributed to the bank's inability to collect and process information. Finally, the lack of clear ownership and management structures also poses constraints to borrowing.[2]

Risk management had just been introduced into China's banking system in 1999, and banks had not accumulated the necessary experience for handling it. Most importantly, bank employees lack the incentive to collect information because they are not rewarded for doing so. For example, the City Credit Union of Shunde has an office in every village. Through personal contacts, employees in each office know fairly well the firms in the village. But they do not bring the information obtained in these personal contacts into the formal process of loan approval because they will not be rewarded for successful lending, but will be severely punished for default.

The fourth impeding factor is the central bank's restrictive policies on bank lending, interest rate management, and loan defaults.[3] Because of the policy issued by the central bank, a commercial bank has to be responsible for receiving the repayment of every loan; that is, it has to reach zero risk on its lending. To harden enforcement, the central bank requires each bank to implement a policy called 'responsibility to individuals' that requires each employee to be responsible for each loan that is issued. The research team learnt that in a major state bank, default of more than 50,000 yuan would be sufficient for the person in charge to be prosecuted. Such a zero risk policy has severely limited bank employees' incentive to initiate lending. To avoid personal risk, banks prefer to put their customers' savings into their accounts with the central bank, that pay a higher interest rate than the savings interest rate they pay their customers. This action makes sense in terms of generating profits without risk.

In addition to restrictive regulations on bank lending, the central bank also enforces a uniform interest rate on the state banks. This is currently at 3.73 per cent for a one-year loan. Credit union interest is allowed to be 50 per cent higher than the basic interest rate, and loans to medium and small firms are allowed to be 20 per cent higher. However, the research team found that the average interest rate on the informal financial market was 10 per cent for a one-year loan, or two and a half times the basic official interest rate. This large gap indicates that the market for formal loans is in serious disequilibrium.

The research team found that neither the state banks nor the credit unions were honouring the central bank's regulation with all their loans and were charging interest rates closer to the informal market rate. The average interest rate charged by the state banks was 7.9 per cent, and that of the credit unions 11.5 per cent. These rates, especially after taking into account differences in transaction costs, are comparable to the market rate (the difference is not statistically significant). The variation of the interest rates charged by the state banks was the smallest; the CV was only 0.36. The variations of the interest rates charged by the credit unions and the informal market are comparable, being 0.76 and 0.74 respectively. Therefore, both the state banks and the credit unions are moving towards the informal market equilibrium, but the latter have gone further towards unifying with the informal market.

The rationale behind this movement is clear— financial institutions need to price the risk of loans, but the price of the risk is demonstrated by the informal market because its equilibrium is driven by market forces. Private firms are generally perceived as being more risky, because of their survival uncertainty and their reluctance to release internal financial information. Therefore, it is reasonable for the state banks and credit unions to charge a higher interest rate to them. The uniform interest rate set by the central bank ignores the different degrees of risk on loans to different group of customers. That is why the central bank rule is ignored by all the financial institutions.

The following conclusions can be drawn about the problems of formal lending. First, the application procedure is too complicated and time consuming, deterring private firms from making an application in the first place. Second, the collateral requirement has severely limited a private firm's ability to get a formal bank loan. While the requirement is necessary in many circumstances, several government policies that impede a private firm's capacity to use its assets as collateral. Third, information asymmetry is a serious problem in banks' lending to private firms.

However, it seems that the last problem can be coped with by a flexible interest rate system that allows banks to price the risk associated with the information asymmetry. Banks and credit unions, to various degrees, have already followed the informal market in this. The uniform interest rate regime set by the central bank has not been honoured by the commercial banks and credit unions. It has been found that the two kinds of formal financial institutions have moved toward the informal market equilibrium.

Other forms of private firms' financing

While formal bank loans play an important role in private firms' finance, other forms of finance are more important. Among the sample firms with a usable answer to a question on their source of capital, 44 per cent used loans from the four state banks, 42 per cent used loans from credit unions, 49 per cent found finance in the informal market, 61 per cent used their retained profits, and 78 per cent used their own savings. In addition, 1.1 per cent and 0.5 per cent said they used issue of equity and enterprise bonds, respectively. None of them said they had ever used foreign capital.

The informal market

The informal market plays an important role in private firms' finance, especially for working capital. Lending in the informal market has several characteristics. First, it usually happens among friends or family members, who form a closely-knit network. Reputation is an important factor in social life within the network. This has two effects on informal lending. One is that the problem of information asymmetry is reduced considerably because members of the network know each other well. The other is that the risk of default is also reduced because members want to maintain their reputations. As a result, informal lending is usually made without collateral. This is one of its significant advantages over formal lending.

Second, informal lending is usually for short-term loans. To a large extent, this is caused by the tight liquidity constraint faced by each individual and also driven by high interest rates. However, making short-term loans also reduces the risk of default. As a result, it is often observed that firms only use informal loans to buy materials for an order and pay them back after the order is settled.

Third, informal lending is more flexible than formal lending with regard to the terms of the loans. While formal loans are usually issued for a term of half a year or one year with no grace period, the term of an informal loan can vary from several days to a year and grace periods are allowed. Private firms only need money to fulfil a production cycle which can be as short as several days in some industries. Because orders are not stable, there is no need for continuous financing. In addition, borrowers may not be able to pay back loans in time because payments for orders have not been received in time. Grace periods then enable them to work through the difficulties. In fact, the rigidity of the term of the formal bank lending is a significant factor that deters a private firm from applying for a formal bank loan because default on a loan payment may lead to bankruptcy.

Finally, informal lending does not require much time for application. A private owner can get a loan from friends or family members in one day. This is important for a private firm to solve short-term liquidity problems.

Consequently, the informal financial market possesses significant advantages over the formal financial market in terms of convenience to private firms. In addition, there is a tendency for the formal financial market to match its interest rates to those of the informal market, reducing the disadvantage of the informal market in this aspect.

However, the informal financial market also has serious problems when its scope extends beyond friends and family members. Among them, default and cheating are the most prominent. On the one hand, people cannot resort to laws for protection because most loans do not have a written contract. On the other hand, government cannot effectively enforce regulations in the informal market. The CEO survey reveals that only 14 per cent of the CEOs wanted to use informal borrowing in the future, sharply contrasting with 49 per cent that had used informal borrowing in the past. This finding reflects a weakness of the informal financial market.

In the last few years, semi-formal financial institutions have emerged in rural areas. One of them was credit associations that were usually organised by county and township governments. They attracted savings by offering high interest rates and made loans to local firms. If these associations had been managed properly, they would have been a very effective substitute for some aspects of the informal market. However, they ran into serious problems, many related to the involvement of local governments.

One major problem was that these associations had accumulated a large amount of bad loans. Since the associations were managed by local governments, many loans were issued to the local TVEs that shared the soft budget problem with their state counterparts. This was the major reason for the bad loans. As the bad loans increased, a major crisis developed, as the associations' liquidity became a serious problem.

To avoid a crisis, the central government issued a decree to shut down all credit associations. Almost all the credit associations have now been closed and their debts taken over by local governments. However, the research team found in Wenzhou that its credit associations were still operating. Wenzhou has a long history of informal financial markets and had private banks in the 1980s when government policy was more amiable. Its credit associations had less government influence, and their loans were issued to private firms whose budget constraints were tight. Their good record of management largely explained their survival. While the closedown of most of the credit associations is necessary to avoid a major crisis, the finding in Wenzhou has shown that semi-formal financial institutions are viable with good management. The vacuum created by the closedown has to be filled by new semi-formal institutions otherwise private firms resort to the informal market.

The stockmarket

The two stockmarkets in Shanghai and Shenzhen play only a very limited role in private firms' finance.[4] Among the 628 sample firms, only three or four firms are listed on the stockmarket. However, 15 per cent of the CEOs expressed an intention to finance their business through the stockmarket. Nevertheless, the central government implements a strict quota system on the number of firms to be listed in each province, and SOEs have priority. To circumvent the restriction, some of the sample firms adopted a strategy called 'to borrow the shell for the egg', that is, to get listed by buying a listed firm. This was observed in Chengdu and Shunde.

Private firms are generally cautious in making the decision to list. The stockmarket can provide capital to a private firm, but also exposes it to the risk of being taken over by outsiders. In addition, many private firms are reluctant to reveal their internal information as required by the regulations on listed firms. This also reduces their incentives to list. As a result, a private firm may not want to be listed on the stockmarket unless it needs large amounts of long-term capital. This condition, however, is frequently met by firms that are experiencing fast growth.

Several regional stockmarkets have emerged for small and medium-sized firms in the last several years. These regional stockmarkets were recognised and managed by local governments, and many of them were running quite well and played a significant role in helping the local firms finance their growth. Regional stockmarkets were shut down by the central government in the process of restoring order to the financial market in recent years.

Box 5.2 Bank finance in Wenzhou

Wenzhou Branches of the Agricultural Bank of China (WABC), Industrial and Commercial Bank of China (WICBC), Construction Bank of China (WCBC) are three of the four major state banks in Wenzhou City. The following is their story.

WABC now has 13 billion yuan in deposits and 7 billion yuan in loans, with the ratio of credit to deposits 55 per cent. In the 1980s it had a deposit deficit. However, in recent years the deposit surplus has been growing.

Wenzhou is an experimental zone for interest rate system reform. The interest rates of loans to private firms are allowed to float. The highest monthly rate recorded was 1.92 per cent. That was in the late 1980s. From 1998, the floating rates for private firm loans were no longer applied. Now it is allowed to float slightly, only according to firms' creditworthiness. The normal rate is 0.56 per cent monthly, but for firms which have a good reputation a 0.4 per cent or 0.42 per cent monthly rate can be applied. Now the rate is basically flat between the state owned and private owned enterprises. For individual business it is 0.657 per cent per month. The current market rate is 1-1.5 per cent.

About 70 per cent of the WABC credit is extended to private firms. This is an exception from the usual case in other areas. The return rate is acceptable. Problem loans account for 10 per cent, which is far lower than the national average. WABC started to lend to private firms relatively early, at a time when it was not really legal or even semi-legal. Now the creditworthiness of private firms is better.

In Wenzhou, there are also Rural Credit Co-operatives that have eight billion yuan deposited and six billion credit. The same interest rates apply. But for local branches that are below county level, interest rates may float up to 50 per cent.

Other non-bank financial organisations in Wenzhou include the Rural Funds or Financial Services. Admitted by the ministry of agriculture or the state committee of economic system reform, they have now become privately owned. Each absorbed one or less than one billion of deposit. Because their interest rate is high, they competed with WABC. Recently development has slowed down as they are considered less creditable and have a high risk.

WICBC: All banks in Wenzhou City have a total of 70 billion yuan in deposits and 30 billion yuan in credits. In general there is no shortage of funds. Four categories of private firms exist using bank loans:

1. Firms in good situation and having high efficiency that do not have difficulties in finance. We can extend loans to them without guaratee

2. Firms operating in a stable situation that basically can solve their problems in finance.

3.& 4. Firms in a worsening situation, or firms that have been newly established, and may have serious difficulties in gel

WCBC: Middle and small enterprises have difficulties in external finance. This is mainly due to the following problems.

1. How much are private property rights protected? This is still not very clear. This has hindered firms' development

2. Firms' management quality is still not satisfactory, particularly in accounting. Some firms were found to have three different account books for different purposes. Their credit grades were lowered by bank

3. Accountant and auditing services are usually rubber stamps. They provide certificates for money.

These increased the risk of bank credit, and result in the conservative operation of banks.

In early 1999, a major state bank organised a nation-wide survey on fees collected from clients in the process of collateral appraisal and registration. Presented here is a table of 17 types of fees a firm may incur when assets are appraised and registered for collateral. Firms may need to pay up to six to seven fees. For example, a firm that wants to use its land as collateral needs to pay items 4, 5, 6, 7, 8, and 16 (Refer to Appendix 5.1). The seven fees add up to between 0.9 per cent and 1.37 per cent according to the lower and upper boundaries. For the same item, several different and conflicting standards issued by different government branches at different levels are used. For example, for land appraisal fee, whilst one standard was issued in 1999 by the region's Bureau of Prices, at 0.12–0.16 per cent, another much higher standard of 0.32 per cent was issued in 1998 by the region's Bureau of Land Management, the government branch that collects the fee! In city L, an outdated standard of 0.16–0.32 per cent issued by the region's Bureau of Prices in 1998 was used.

Source: Gregory et al., 2000, *IFC Report*, Box 5.1, p.53

The survey demonstrated that private owners intended to use public offerings as a tool to improve internal management. When a private firm becomes large, morale issues arise amongst employees. As the size of the firm increases, employees aren't bonded by friendship. High and medium-level managers have more power and play a more important role in the firm's operation. Without shares in the company, it is easy for them to develop a feeling of being deprived. Private owners tried to facilitate share ownership by high-level managers to overcome this problem.

However, when a manager wants to leave the firm, his shares have to be cashed out, and the firm incurs a loss and sometimes encounters a liquidity problem. For example, a Beijing firm owner gave a vice president 1 million yuan of shares when the latter joined the firm. However, he left the firm in only half a year, and the owner had to cash out his shares.

In Shunde, the owner of firm J, introduced in Box 4.1, wanted to keep employees by selling them shares. However, only a few employees bought shares. Because the shares could not be circulated outside the firm, their values were severely diluted. In the end, the owner had to buy back the shares already sold. He expressed a plan to get his firm listed if policies allow him to do so. His intention was not to get capital, but to improve his internal management. The morale problem is more acute in high-tech firms because they rely more on the human capital of their employees. A software company in Beijing decided to list on the stockmarket just for the purpose of solving its internal incentive problem.

Overseas financing

Overseas financing plays a limited role for sample firms. However, this limited role is increasing. The CEO survey found that 23 per cent of the firms wanted to enter joint ventures with foreign firms in order to get capital in the future, and 11 per cent expressed their willingness to borrow from foreign banks.Currently, Hong Kong plays a significant role in providing credit to mainland firms. For example, MD in Shunde was first listed in the Hong Kong stockmarket as H shares before it was listed in Shenzhen as A shares. It also borrowed foreign money through its subsidiary in Hong Kong when the anti-inflationary measures were at their peak in 1995. Some fast growing firms in Shunde were also considering being listed in Hong Kong as H shares. However, financing through Hong Kong is not limited to Shunde. The research team found that a firm in Chengdu was also listed in Hong Kong as H shares.

To a large extent, the limited role of overseas financing can be attributed to China's restrictions on foreign banks' operation in its territory. Right now, foreign banks are only allowed to have an operating office in Pudong, Shanghai. Only recently have they been allowed to issue renminbi denominated loans. In addition, renminbi is not a fully convertible currency. As a result, it is hard for a firm to repay a foreign currency denominated loan if it does not export.[5]

One way for a firm to use a foreign currency denominated loan is to get the central government's approval for loan to be taken into the country's foreign reserve management plan. Then the firm can get foreign currency by exchanging its renminbi with the State Bureau of Foreign Reserve Management. However, since it uses the country's foreign reserve, it is very hard to obtain approval for this method even for a SOE, not to mention a private firm. Finally, even if they can, private firms may not want to use foreign currency denominated loans because of the exchange rate risk.

Reforming the financial system

The financial system is the sector that has been subjected to the least reform in China so far. However, it is also a sector in which there has been considerable spontaneous testing of reforms, especially in the rural areas. China has a long history of informal financial institutions. In the reform period, voluntary co-ops, semi-formal credit unions, private banks, and local stockmarkets have also been tried out at the local level, without any being sanctioned by the central government. In this subsection, we present a discussion of possible ways to reform the financial system to accommodate the development of private firms.

The state banks are private firms' preferred source of loans. The CEO survey shows that 62 per cent of the firms wanted to borrow from the state banks in the future although they had a lot of complaints about them. To accommodate the demand of the private firms, the state banking system should take several reforms. First, lending management should be made flexible to accommodate risk management. The current policy of zero risk lending is not practical because doing business means taking risk. There is no business without risk.

The zero risk management should be replaced by portfolio management. By portfolio management, banks and employees are evaluated by performance on a certain amount of resources allocated to them. They can lose one or two loans, but so long as they maintain a profit for their total portfolio, they should not be punished. However, risk management requires each bank to invest heavily to improve its employees' human capital as well as to import advanced management techniques from developed countries. This is a major task for any state bank.

Second, related to risk management, banks should be allowed more discretion in deciding the interest rate. Although a very high interest rate hurts the economy by increasing the cost of borrowing, an interest rate below the market is a source of moral hazard. China has witnessed this with the soft budget problem when low interest rates led to a serious waste of resources. Giving banks more discretion does not necessarily mean complete freeing of the interest rate, but banks should be allowed enough room to price the different risks that their different groups of clients possess.

Third, while the collateral requirement is necessary, there would be value for private firms in extending the scope of unsecured loans. Can this be done without increasing moral hazard in ways that cannot be justified? In the study, it was found that large firms were granted non-collateral loans although they could also afford collateral. It is not clear how small and medium firms can get non-collateral loans. In Shanghai, Minsheng Bank is working with local entrepreneurs to create a guarantee fund. The local government put seed money into the fund, and firms have to contribute to the fund in order to get a guaranteed loan from the bank. A firm's contribution to the fund cannot be lower than 30 per cent of the amount of the loan it takes. The fund is managed jointly by the bank and the member firms and is running quite well. Therefore, firm-managed guarantee funds may help overcome small and medium firms' financing problems.

In Chengdu, the provincial government is in the process of preparing to set up a guarantee fund for lending to private firms under the scheme initiated by SETC. Apart from firms' contributions, governments also inject a certain proportion of capital into the fund, making the lending to the private sector based on 1:3 (three yuan can be leant on the basis of one yuan in the fund). However, there are management concerns about such schemes. Since such schemes will be implemented nation-wide, it is important to conduct some experiments in some areas before they extended across the nation.

One of the reasons that the current expansionary measures aimed at boosting the domestic economy have had only limited effects is that the most dynamic sector, the non-state sector, cannot benefit much from these measures. This can be amply demonstrated with the stagnant nature of private sector borrowing for investment in recent years. Because of banks' reluctance to lend to private firms, lowering the interest rate has little effect on their borrowing behaviour. The reforms proposed above will remove the structural barriers faced by private firms and help the expansionary measures to have an impact on the economy.

Concurrent with the reforms in the state banking system, formal or semi-formal financial institutions outside the state realm should also be allowed. Right now, these have been eliminated, leaving only the informal financial market. The economy does need such financial institutions to function but to avoid past problems, private banks are a better choice in terms of supervision and management. On the management side, private banks have hardened their budget constraints and are responsible for their own performance. On the supervision side, private banks can be included in the same supervision network designated for the state commercial banks.

Currently, China has only one state-recognised private bank, Minsheng Bank. It is not private in terms of the word's true meaning because its 50 or so shareholders are all state-owned corporations. The introduction of private banks will increase competition in the financial sector and improve its efficiency. However, this would require the central bank to improve its supervision to accommodate numerous small banks should they be allowed to exist. On this aspect, international experience in setting up private banks and bank supervision and regulation will provide valuable help.

Finally, China should seriously consider giving private firms a platform for them to acquire non-bank equity. The two national stockmarkets should be more accommodating to private firms by treating them more equally alongside SOEs. In addition, the admission criteria should be more performance-oriented than needs-oriented. However, to rely on the two national stockmarkets will not solve the problem faced by numerous small and medium-sized firms. The feasibility of integrated regional stockmarkets should be explored.

Notes

1. Caution needs to be taken in this calculation since increase (decrease) in turnover may be due to the changes in the sample structure in favour of industries that have higher (lower) turnover. The data provided here really reflect the average in the sample.
2. It was relatively easy for many former TVEs to get funding from banks since local governments provided some kinds of guarantees for borrowing. Banks would be more cautious towards those firms who have been converted from TVEs to private firms with the knowledge that these firms are no longer supported by local governments.
3. See Appendix table 5.1.
4. Domestic investors are restricted to the A share markets, B share markets are exclusively for foreign investors. Foreign investors can also invest in Chinese firms through H shares listed in Hong Kong. N shares listed on the New York Stock Exchange and Red Chip stocks listed in Hong Kong, which are Hong Kong firms with most of their cash flows derived from mainland Chinese operations and are essentially considered Chinese stocks by the market (Hasenstab 1999:139).
5. Even a firm that exports cannot retain foreign currencies if it does not have the right.

Appendix 5.1 Central Bank policies towards management of bank loans

In the *General Lending Rules* issued by the central bank in 1996, there are stipulations regarding loan defaults.

Article 42: Establishment and improvement of Credit Responsibility System: Loan management sections at various levels shall delegate loan management responsibility at each stage to section, position and individual. Responsibility at different levels shall be clearly defined.

Article 65: Any responsible person of the lender who acts in breach of the Rules shall be disciplined and fined; anyone who engages in serious or repeated violations shall be dismissed from the working position and removed from his or her job qualification, and criminal procedures shall be followed if such violations brought serious losses or constituted economic crimes.

(The above is directly quoted except for several small language improvements) from the translation provided in *General Lending Rules*, a book published by Xinan Finance and Economics University Press, 1996)

Appendix Table 5.1 **Fees collected for collateral appraisal and registration in G autonomous region**

	Fee name	Collector	Authorising document	Standard (%)	Remark
1	Building appraisal	(1) Real estate appraiser	State Planning Commission and Ministry of Construction: 1 (1995)97	0.03–0.4	
		(2) Bureau of Building Management	Regional Bureau of Prices: (1999)086	0.2	
		(3) Municipal Building Company	Y city Bureau of Prices: (1999)42	0.01–0.4	In Y city
		(4) Municipal Real Estate	Regional Bureau of Prices: (1996)001	0.06–0.2	In L city
		(5) Municipal Building Appraisal Centre		0.1–2	In Q city
2	Building collateral registration	Bureau of Building Management	Regional Bureau of Prices: (1997)078	0.3–0.8	
3	Building collateral certification	Building company	Regional Bureau of Prices: (1997)078	0.3–0.8	
4	Land appraisal	(1) Bureau of Land Management	Regional Bureau of Prices: (1999)086	0.12–0.16	
		(2) Bureau of Land Management	Regional Bureau of Land Management: (1998)40	0.32	
		(3) L city Real Estate Appraisal Centre	Regional Bureau of Prices: (1995)274	0.16–0.32	
5	Land collateral registration	(1) Bureau of Land Management	Regional Bureau of Prices: (1998)345	0.16	At least 300 yuan
		(2) Bureau of Land Management	Regional Bureau of Land Management: (1998)40	0.03–0.3	

6	Land collateral registration	Bureau of Land Management	F county Bureau of Land Management: (1998)40	2	Returned after loan repaid
7	Land transaction registration	Bureau of Land Management	Regional Bureau of Prices: (1998)345	0.25–5	
8	Land collateral certification	L city Bureau of Land Management	Regional Bureau of Prices: (1995)274	0.15	In L city
9	Equipment appraisal	L city Asset Appraisal Institute	State Bureau of State Asset Management and State Bureau of Prices document	0.4	In L city
10	Equipment collateral registration	Local BICM	National BICM and Ministry of Finance: (1999)001	0.1	
		Local BICM	L county Bureau of Prices: (1998)03–2	0.05–0.2	In L county
11	Equipment collateral registration	Local BICM	L county Bureau of Prices: (1998)03–2	0.1	In L county
12	Property appraisal	Bureau of Building Management	Regional Bureau of Prices: (1997)066	0.4	
13	Property registration	Bureau of Building Management	Regional Bureau of Prices: (1997)066	0.1	
14	Building transaction registration	Local BICM	Regional Bureau of Prices: (1997)066	0.2	
15	Building transaction registration	P county Real Estate Transaction Centre		0.32–0.8	In P county
16	Contract certification	Local BICM and Bureau of Finance	Regional Bureau of Prices: (1994)002	0.1 %	Max. 3000 yuan
17	Collateral property insurance	Y city Insurance Company		0.43	In Y city

Source: *IFC Report*, 2000, Table 5.9, p.58