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Financing constraints of Small and medium-sized enterprises (SMEs) in Northeast China

Ziyi Li

Business School, Sichuan University, Chengdu, China
Email: marywang0301@foxmail.com

Abstract: *Small and medium-sized enterprises (SMEs) are an important part of regional economies and play an integral role in encouraging development. When we discuss north-east China, it is often in reference to Heilongjiang, Jilin and Liaoning provinces. For historical reasons, the economic policy inclination in this area mainly points to public enterprises and state-owned heavy industrial operations. As a consequence, small and medium-sized non-public enterprises have been restricted and this negatively impacted localised economic activity and development to a certain extent. Financial constraints naturally restrict the development of small and medium-sized enterprises, as is the case in north-east China. In this paper, focus will be placed on SMEs and the nature of economic systems in the aforementioned region. Through extensive research and analysis of enterprises, financial institutions and guarantee companies, this paper will serve as an intimate analysis of the financial status in addition to the difficulties faced by SMEs in north-east China. In turn, It will also make appropriate suggestions or identify specific counter-measures.*

Keywords: *north-east China, financial constraints, counter-measures, small and medium-sized enterprises (SMEs).*

1. Research background

Small and medium-sized enterprises are a valuable source of local economic vitality and innovation, whilst playing an important role in regional economic as well as social development. By the end of 2017, there were more than 40 million small and medium-sized enterprises in China, accounting for 99 per cent of total enterprises in the country whilst simultaneously providing 80 per cent of urban-based employment. Also, it equates to more than 60 per cent of GDP, more than 75 per cent of technological innovation and 50 per cent of overall tax revenue. Sustainable development of small and medium-sized enterprises has become a decisive factor as to whether China's economy can undertake necessary reform in an effort to diversify its economic structure.

Due to historical reasons, the regional economy in north-east China has been dominated by state-owned enterprises for a considerable period of time, resulting in reduced development or success of small and medium-sized enterprises. More importantly, it has left the region lagging behind the areas in the south and east of China which have faced fewer obstacles with regards to small or medium-scale business operations. Of course, there are disadvantages such as unreasonable industrial structure, uncompetitive products and a supposed lack of talent. Against the background of difficult transformation within state-owned enterprises and reduction in economic benefits, it becomes apparent that economic development throughout the region has seriously slowed due to the insufficient development of small or medium-sized enterprises. Surprisingly, negative growth has been recorded and this is one notable reasons behind it. In order to solve these difficulties with regards to the economic development of north-east China, the healthy development of small and medium-sized enterprises must be encouraged. This will not only rationalise the economic structure of north-east China, but also play a pivotal role in providing employment, optimising resource allocation and promoting technological innovation whilst maintaining an optimum socio-economic structure.

One of the main problems faced by small and medium-sized enterprises in their own development is difficult and expensive financing, which is decisive in restricting sustainable development. Therefore, it is of great significance to solve the financing constraints of SMEs in north-east China and find a way in which investment can reach those with an entrepreneurial spirit to ultimately safeguard regional social stability.

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Based on national macro-economic policy at present, combined with the current potential for solving financing difficulties, this paper studies the characteristics and development laws of such businesses. In order to solve the financing constraints of small and medium-sized enterprises in north-east China, this paper puts forward a feasible scheme with practical significance

2. Financing constraints of SMEs in Northeast China

In May 2016, the CPC Central Committee and State Council issued opinions on comprehensively revitalising the north-east as well as other old industrial bases, marking the beginning of a new development strategy. As an initial phase of north-east revitalisation, it proposes an industrial structure adjustment that breaks the so-called ‘one pillar dominating the sky’ or ‘two people's turn’ so that the region can meet the needs of a market economy. Additionally, it suggests this with an understanding of national economic and social development which requires an industrial structure but also an optimum environment for smaller business. In accordance with the spirit of this document, the three provinces in north-east China have issued a series of important policies and measures to speed up the adjustment of their respective industrial structures. In particular, many new attempts and experiments have been made in an effort to solve the financing difficulties of small or medium-sized enterprises. However, compared with the eastern and central provinces where SMEs are active, financing constraints in north-east China still remain.

2.1 The lack of endogenous financing capacity restricts the development of small and medium-sized enterprises

Financing channels of enterprises include internal and external forms. Endogenous financing refers to that which the enterprise obtains through internal means, including an increase in shareholder investment or retaining a portion of profit for operational expansion. Using Shenyang as an example, the data shows that 65 per cent of the capital demand from SMEs depends on their own accumulation, 28.5 per cent from bank loans and other forms such as private lending account for just 6.5 per cent. Reliance on endogenous financing is simply not sustainable on small scale, given the efficiency and inherent weaknesses of small or medium-sized enterprises. On the one hand, external financing channels for enterprises are limited and they mainly rely on intelligent accounting practices to solve the problem of capital shortage. On the other hand, internal accumulation and the strength of shareholder funds are limited which means it is not possible to generate large capital investment with the intention of using it for broader expansion. Hence, this is a serious and unavoidable restriction that continues to restrict the development of small or medium-sized enterprises.

2.2 The external financing channel is single and over dependent on banks and other financial institutions

External financing refers to the enterprise and related economic entities as an additional source of funds. It includes both direct and indirect financing, with the former involving the acquisition of funds by issuing company stocks or corporate bonds whereas the latter requires engagement with financial institutions or the use of guarantees.

According to wind data, as of the end of 2017, there were 3468 listed companies in the A-share market and this included 74 from Liaoning, 42 Jilin-based businesses and 36 in Heilongjiang. Also, there were 152 across three provinces and this accounted for 4.38 per cent of A-share listed companies. According to the National SME share transfer query system, there were 10691 enterprises listed on the national new third board by the end of 2018 and this included 223 in Liaoning, 94 Heilongjiang-based businesses and 85 from Jilin. In addition, there were 402 across three provinces which accounted for 3.76 per cent of A-share listed companies.

Compared with other economically developed areas, the national average level is far from satisfactory. As discussed, there are very few SMEs that are able to obtain direct financing through stocks, bonds or equity transactions. Most of the enterprises with financing needs can only obtain indirect or more specifically external financing from banks and other financial institutions. For those engaging in financing by acquiring debt, banks usually become the first choice for SMEs because of comparatively low costs and relatively mild treatment in case of late payments. Accounting for 85 per cent of the total, existing financing channels are narrow and the mode is relatively singular.

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2.3 The traditional bank loan business threshold is high, the financing success rate is low and the amount is limited

When it comes to indirect financing, the willingness of SMEs to borrow from banks is significantly higher than that of other means. However, the traditional method of mortgage loans is too high for small and medium-sized enterprises. Enterprises are often difficult to successfully finance due to a lack of collateral, inability to provide detailed financial data or the lack of qualified guarantors. Over the last three years, due to an increase in support policies for SMEs by the state, regulatory authorities have put forward specific requirements for commercial banks to approve financing at a policy level. In turn, this greatly improved the situation for those with financing needs who could not previously acquire loans due to a shortage of credit. However, there are still many SMEs that do not even meet more recent requirements in terms of company policy towards risk control. For example, a lack of collateral is an unassailable problem and even if the bank approves a loan with prior knowledge of this fact, a smaller business will still be unable to obtain sufficient capital demand which ultimately results in a contradiction between fund shortages and a relative abundance of bank credit. From 2016 to 2018, the lending habits of financial institutions to small and micro enterprises increased by 10 per cent year-on-year. However, according to a recent survey of 123 SMEs with financing needs entrusted by the Shenyang Business Management Department of the People's Bank of China, only 58 enterprises met the criteria and successfully obtained financing. In short, this equates to a financing success rate of less than 50 per cent. Additionally, due to a shortage of traditional mortgage and pledge transactions, only 15 per cent of enterprises successful in obtaining financing received more than 50 per cent of total funds. Even more surprisingly, 60 per cent of the enterprises who applied for financing could only obtain loans that amounted to less than 20 per cent of the total. Based on this survey data, we see that the dual influence of their own strength and high thresholds is a determining factor in the success rate of obtaining financing from institutions. Often, financial packages which are approved do not meet the requirements of such businesses and therefore highlights the predicament of those trying to create a profitable enterprise.

2.4 High financing cost and heavy burden on enterprises

Due to the fact that small and medium-sized enterprises in north-east China are generally short of funds and ultimately have lower levels of fixed assets, be it land or real estate as well as other forms of collateral, decisions by financial institutions are in part understandable. In order to avoid risks, banks often increase interest rates or require other companies to provide a guarantee as a means for controlling risk. Also, loan terms are often one-year long. Most enterprises still need to continue using funds following the timely maturation of loans and in order to continue obtaining such credit, repayment of existing loans is necessary which leads many to apply for high-interest ‘bridge’ loans. This undoubtedly increases costs for an enterprise, leading to additional burdens or the eventual descent into a vicious cycle of poor credit and a lack of funds. Even if the enterprise can afford the interest of so-called ‘bridge’ loan, it can still be difficult for the bank to collect this payment.

Taking a wholesale small and medium-sized enterprise with a loan of 1 million yuan and a term of one year in Shenyang as an example (sufficient collateral worth 2 million yuan was provided), the following fees were paid: evaluation fee 1 million yuan * 5 ‰ + 1 million yuan * 2.5 ‰ = 7500 yuan, notarisation fee 1 million yuan * 4 ‰ = 4000 yuan, plus bank interest 1 million * 4.35% * (1 + 0.4) = 60900 yuan, totalling 72400 yuan. Comprehensive annual interest was 7.24 per cent. It is evident that if an enterprise is not capable of providing sufficient collateral and requires a guarantor, the fee is usually about 2 per cent of the guaranteed amount then the annual interest borne by the enterprise will be approximately 10 per cent, which is a considerable burden for small or medium-sized enterprises whose average profit margins are around 3 per cent.

Private lending has become another important financing channel for small and medium-sized enterprises, due to relatively simple procedures and flexible time limits. However, the cost of private lending funds is higher and the annual interest rate generally ranges from 15 to 30 per cent. Such high-cost funds can only meet the emergency needs of an enterprise, rather than being a long-term or permanent solution for circulating funds and fixed-asset investments.

2.5 The financing demand is urgent, frequent, less and high

Small and medium-sized enterprises are generally small in scale, with an obvious lack of capital accumulation. Most of these belong to labour-intensive industries. Management personnel are not

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professional, with procedures not being of an adequate standard and a lack of financial awareness or risk control exacerbates the problem. When short of funds, most small or medium-sized businesses have the characteristics of urgency and frequency. For example, small and high when applying for loans, meaning loans should be urgent as the demand is frequent. Naturally, as the amount of approved loans is low, credit risk is assumed to be high. It is these characteristics that financial institutions consider in relation to risk, hence a generally lower willingness to lend.

3. Conclusion

This paper maintains that the financing constraints of small and medium-sized enterprises in north-east China are not only due to the disadvantages of businesses alone, but also the lack of attention paid by governments at all levels in addition to the imperfection of China's financial services system. First, small and medium-sized enterprises have narrow financing channels which ultimately limits overall progress. As the cost of private capital is high, it is difficult for small businesses to accept such an arrangement. Secondly, there is information asymmetry between theses businesses and financial institutions which means there is no open or transparent process. There are few qualified institutions that provide financing services for SMEs, even though their costs are high. Additionally, extensive management and random business models as well as the lack of a credit concept for small or medium-sized enterprises lead to a perception of risk. Last but not least, the legal system that supposedly guarantees the financing of small and medium-sized enterprises is not fit for purpose in its current form.

Of course, financing difficulties for small and medium-sized enterprises in north-east China were not created overnight, nor can it be solved in such a short time. It requires a joint effort on behalf of the government, enterprises and financial institutions to realise its potential. Small and medium-sized enterprises should improve their management practices and operational capacities, therefore standardising corporate behaviour as well as improving credit awareness.Government departments should also continue to increase the support for small and medium-sized enterprises, whilst simultaneously implementing supporting policies that give those in north-east China a notable role in determining the future of their localised economies. Through analysis and discussion of the current financing situation for small and medium-sized enterprises in north-east China, this paper has established the present issues whilst recommending potential solutions that will also serve to diversify an integral part of the Chinese economy.

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