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Challenges Faced by Small and Medium-sized Enterprises in China When Seeking Low-cost Financing

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Abstract: SME (small and medium-sized Enterprises) financing has been difficult in recent years. But, SMEs are vital to the economy and must be helped to thrive. China calls SMEs "Five, Six, Seven, Eight, and Nine" since they account for more than 50% of national tax revenue, 60% of GDP, 70% of technological innovation, 80% of jobs, and 90% of enterprises. SMEs drive long-term, sustainable economic growth that benefits everyone. But, reducing SMEs' breathing space will hurt China's economy. Thus, SMEs' problems are the economy's problems, and it is worth investigating and trying to solve them. Most studies examine SMEs' finance dilemma's causes, while others focus on a specific solution. This paper examines these finance issues and weighs the pros and cons of various solutions. This paper uses a literature review to explore China's economy, the problem, risk perception, and its effects. The study also discusses possible solutions and future development.

Keywords: SMEs, financing dilemma, asymmetric information, financial efficiency, the Chinese economy

1. Introduction

The Macmillan Gap is the capital allocation gap that develops during the expansion of small and medium-sized enterprises (SMEs) due to the lack of long-term access to financial resources. Even when an economy's total supply of funds is adequate, it has proven difficult to reconcile this phenomenon due to the flawed capital distribution system. The total amount of credit loans borrowed reached 12,06 trillion yuan in the first quarter of 2022 [1], while SMEs continue to grapple with this funding dilemma. This suggests that a misallocation of financial resources, which hindered their expansion, is the core cause of the issue.

Instead of extending these creditors' rights to SMEs with extreme financial fragility, most banks choose to provide loans to larger and state-owned businesses in order to lower their default rate. Hence, SME access to financial resources is restricted (difficulties to access). In another scenario, banks charge SMEs a risk premium in the form of higher interest rates (expensive financial resources). Yet, most SMEs cannot be directly financed through the stock market because the majority are not publicly traded. Clearly, this exacerbates the difficulty in gaining access to financing. Thus, several SMEs attempt private lending with high deposit percentages and associated risks. In addition, numerous Chinese SMEs produce finances through retained earnings and discounted depreciation, as opposed to obtaining external financing. This would impede the expansion of small businesses even further.

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2. Analysis of the Problem

SME funding channels must be improved. This aim requires understanding why this problem exists. Financial institutions are reluctant to provide financial services to SMEs, even though they could expand their business and profit.

2.1. Status of the Problem

SMEs' financial fragility prevents them from becoming the bank's core businesses. They have no credit rating or asset to pledge. SMEs are credit-risky due to their corporate capital structure, accounting information system, operational size, and human resource level. As SMEs lack track records to meet banks' lending criteria, banks and firms have asymmetric information. Banks would choose less risky and profitable creditor's rights sellers. As such, most commercial banks need extra time and incentives to investigate SMEs' operations. However, Chinese Businesses still rely on cash flow and bank credit loans.

State-owned enterprises in China have better information transparency and risk tolerance due to their property rights that share government credit, therefore this financial resource misallocation is mostly political. State-owned firms get most of the financial resources, even when they have enough. This might spiral. Unfair competition may make SMEs less active in the financial sector, reducing their chances of formal financing. SMEs, commercial banks, and guarantee corporations cannot grow, exacerbating the allocation among different-sized businesses. Due to insufficient credit and financial systems, financial guarantee institutions could improve their credit-rating services. These entities would inefficiently transmit monetary policy. Due to high credit risk and little economic return, guarantee registration and evaluation would cost more. Commercial banks prefer lending to larger enterprises despite SMEs' high transactional costs. Most banks view lending to SMEs as an additional service, thus they will likely stop doing so if the economy tanks.

The flawed credit system will exacerbate the foregoing issues. Hence, financial institutions would pay high information costs to identify credit risk because SMEs require more administrative resources to give a credit report. To ensure this is an effective demand, banks must assess a company's credit risk (ability and willingness to repay the loan) before investing. By 2020, 1.84% of China's gross loans will be non-performing, according to the World Bank [2]. The bank also has less risky funds that pay the same interest. Banks want creditworthy companies because they are risk-averse. Due to significant processing costs and the danger of non-performing loans, banks establish rigorous criteria when funding SMEs (NPL).

Despite the issues all SMEs face, other short-term variables should be considered. Similar-sized enterprises with similar qualities may have variable financing viability in different geographical locations of the same economy due to marketization levels. A more developed regional economy, credit system, and marketization will assist firms have better information transparency, lowering financial institution-business transaction and information costs. Hence, SMEs in these regions have better financing access. SME performance also varies by economic cycle. The COVID-19 pandemic and worldwide wars have made investors wary of investing. Credit loan demand exceeded supply.

Government activities also affect SMEs. Despite the government's desire to expand SMEs' funding channels, China's enterprises must follow a stringent set of laws. First, the Rules on the Administration of Corporate Bonds and the Shanghai Stock Exchange's Announcement on Problems Concerning the Issuance and Implementation of the Pilot Measures for Private Placement Bonds of Small and Medium Companies limit private placement bonds. The entity's placement and bond face value control are severely restricted. Second, government administration departments tightly regulate bond interest rates. Thirdly, to promote private financial investment, the Chinese corporate bond

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circulation market needs more activity. Large enterprises and government platforms crowd out Entrepreneurs.

2.2. Extension of the Problem (Further Consequences)

Because businesses believe financialization would increase profits, SMEs' financial difficulties might create economic hollowing. Big companies can supply financial services to smaller ones to reap interest rate differentials and regulatory arbitrage. Shadow banking 1-year interest rates ranged from 12.23%-13.81% in 2019, with a spread of 7.4%-8.9% compared to regular bank loans [3]. China has stricter rules than other economies. In the shadow banking system, major companies make money from other companies instead of their own. Hence, they are sacrificing long-term success in their major business domains for short-term financialization rewards. This shows management' myopia or compromise to investors who value a company on its face. Due to reduced administration, businesses favor this, but their financial instruments have higher leverage and maturity mismatch.

These financial services are linked to stock market collapses and market shocks, jeopardizing the economy's growth. In particular, business profit volatility rises with profitability, lowering information disclosure quality. Consequently, information openness becomes more difficult, and firms may even give misleading information to cover up. Investors may misinterpret the firm's or shares' value. So, businesses are doing differently than investors expected. When misleading information is promptly identified, this discrepancy between reality and interpretations may shock expectations and enhance stock price crash risk. Hence, tail risk could no longer be controlled, and financial misery from concealed debts and guarantee networks would enhance financial risk contagion. This domino cascade would have unmanageable effects. Even off-balance-sheet risk was unavoidable. The financial instruments these corporations use make them intrinsically unstable. Financialized organizations must still assume debt and guarantee liability when the risk happens [4].

Moreover, this process can result in the hollowing out of the real economy, which would lead to other negative economic problems. While this financialization process is a transition from real trade to virtual trading, it may have negative effects on the firm's balance sheet. This indicates that this behavior may result in the loss of firm value, particularly when a business is financialized and management attempt to fulfill the demands of outside investors or advance themselves at the expense of long-term growth. Hence, financialization is more probable if the enterprise has low allocation efficiency and inadequate management. This is due to the fact that the whole board of directors' authority is vested in a single individual. If the exclusive attention hypothesis of business is accurate, it is apparent that earnings in the primary trade region would decrease as yield receives less focus. For instance, corporations spend less money on innovation than they do on sustaining the financial services they offer. The end of short-term profit growth will occur when the stock market bubble bursts due to the increased risk of stock price crashes.

As previously discussed, the characteristics of these financial instruments will also reduce the effectiveness of government programs [5]. As a result, monetary interventions may be unable to repair market failures. Namely, market volatility and risk are on the rise. In these conditions, if the invested capital were to be withdrawn, the market risk of the widespread subprime mortgage crisis may potentially jeopardize the economic and financial system's healthy and sustainable growth. China is attempting to establish a real economy, but in recent years financialization has greatly extended the shadow banking sector. This is discouraged by the government since it may expose the economy to greater financial risk. As a result, the government recently proposed a number of new policies to rectify the situation.

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3. Countermeasures for the Problem

3.1. Micro-level Proposals for the Problem

Supply chain finance may help. If firms collaborate, they can solve their finance issues and save money. They would get working capital-optimized short-term borrowing. The main business supports all group SMEs with finance and coordinates upstream and downstream operations in the supply chain. Large enterprises' superior credit ratings allowed SMEs to get cheaper bank loans. The core firm might negotiate better terms with SMEs, including extended payment terms, which would benefit both parties. Days Payable Outstanding (DPO) increases cash flow and working capital, enabling for additional short-term investment. As they understood financial trading risks, the deal would be more transparent. Supply chain trading involves information, logistics, and cash flow, which controls SMEs' default risk and supports financing and trading prices [6].

Large companies may dominate the market, making this financial innovation risky. This firms' absolute advantage over SMEs may skew supply chain and financial models. When the core business leverages SMEs upstream and downstream, the siphoning effect may arise. Hence, large firms would prosper while SMEs suffer.

Joint liability groups guarantee each other's credit, which is similar. SME members would be similar in size, making this a superior alternative. The collateral's credit buys the borrower's financial risk. This new way could increase collective relation integration and data augmentation, giving financial institutions more information to measure risk instead of just sales, liability, and operating leverage. Both instances require transparency and business engagement management.

3.2. Government Intervention & Regulation

Since only the central government can and is incentivized to optimize the financial environment and accelerate market reform, it is regarded to be the Government's responsibility. The government should take market-oriented steps to increase financial institutions' risk tolerance, optimize their credit system, rationally allocate credit resources, and resolve asymmetric information.

Indirect subsidies, tax benefits, or low-interest loans could help Entrepreneurs access financial resources. Governments could use financial inclusion to aid certain industries or SMEs. The Chinese government has eliminated stamp duty for small businesses and given venture capital firms tax credits [7]. Yet, improving risk tolerance and subsidizing some Businesses without prioritizing short-term profit-maximizing aims or offering financial guarantees is crucial. These measures cut SME financing costs and have a signal effect because financial institutions prefer to invest in government-subsidized SMEs. Capital access and financial competence will rise. This short-term bail-out may cause the corporation to overestimate its value and make poor financial judgments. These policies have only been applied in sustainable businesses like high-tech and green finance. Consequently, these measures simply benefit particular SMEs, not the problem.

The government might also incentivize financial institutions to help Businesses. Loss compensation and credit rate cuts would incentivize financial institutions to lend to SMEs. Then financial institutions and the government would share SMEs investment costs and risks. Due to SMES' high credit risk, the government would cover some of the loss, encouraging financial institutions to deal with them [8]. Yet, only SMEs with longer operation durations and larger cash flow may benefit. If the government reduces financial institutions' trade price setting power, they may be less likely to lend to SMEs. This makes financial access worse. Since SMEs may have a tighter interaction with small financial institutions, the government may reduce their reserve ratio. These incentive schemes must be intensive to work since creditor's right is oversupplied. Even with more money, consumers choose higher-quality products.

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Together with encouraging commercial banks, the government may clarify and legislate private lending legislation and establish a supervision apartment. It would help drive private capital into the actual economy that follows Chinese government policies to grow SMEs and other critical initiatives. The government must gradually lower private lending interest rates and lessen market volatility produced by these entities while still driving capital into the banking sector. To assure legal private lending, governments could regulate intermediaries like financial guarantee businesses and credit rating organizations [9].

Yet, laws that limit corporate growth should be discouraged, especially as the Chinese government needs to deregulate the financial system. It could improve bond-issuing and corporate bond regulation. Deregulate the interest rate regulation to allow enterprises to determine fair interest rates based on their credit ratings, debt-paying ability, and market factors. The government could also expand corporate bond kinds and improve off-exchange trading.

The Chinese government took action, but their mindset may have hampered it. Due to all SMEs' financial fragility, reforming the financial market is more important than fiscal support for financial institutions. The market operates on each entity's self-interest, hence the government's fiscal policy cannot be efficient. Alternatively, improving fundamental issues like information asymmetry that impedes the lending system may be useful. As the paper said, the government might promote and publicize different financing methods.

3.3. Macro Level Proposals for the Problem

SMEs' high credit risk is the underlying cause of the problem, hence financial institutions are hesitant to lend to them. Building and improving the corporate social credit system is an apparent option. Increasing the default cost, such as through pledging, is a typical risk management approach for controlling firms' desire to repay. Yet, because SMEs have limited assets, this cannot be used to compensate for their lack of access to financial resources [10].

The reduction of credit risk can be separated into risk detection and risk management. Risk identification is the initial step in problem resolution, and access to the company's operating data is essential. There should be no restrictions on the collection of non-public information between financial institutions and the company, yet SME credit records are lacking. Thus, SMEs must maintain public records reports that represent their current business status.

One solution would be to create a new system for credit lending. Hence, small and medium-sized enterprises could lessen the significant levels of information asymmetries they experience when evaluating risks and returns. This new loan arrangement is an appropriate strategy for helping SMEs distinguish themselves from larger banks. Although private money frequently maintains tight relationships with enterprises, this is also the primary reason why it would be beneficial to guide private capital into the financial market. Also, this aids in preventing huge and state-owned organizations from monopolizing the credit loan market, preventing them from squeezing out smaller businesses in this distinct credit loan market. Also, smaller enterprises and banks would find it easier to match their resources. They will have a better understanding of organizations' operational capacity and willingness to repay loans (enterprise credit rating) [11]. Specific measures may include the need for small and medium-sized financial institutions to specialize, as outlined in the "Several Opinions of the State Council on Further Promoting the Development of Small- and Medium-Sized Enterprises" issued by the Chinese state council, which aims to advance the construction of credit information collection mechanisms and an evaluation system to improve the financing environment and reduce inefficient resource allocation. In China, for instance, state-owned firms overused financial resources. This issue should be eliminated by isolating major state-owned firms from small and medium-sized enterprises (SMEs) so that they are not in direct competition. Independent financial markets could provide SMBs with access to more financial resources. Government should always be

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in the lead position, as financial institutions lack the motive and small and medium-sized enterprises lack the capacity.

The second phase is risk management, when banks accurately modify the default cost based on risk detection. Typically, the default cost would be increased, but this method of risk identification could also prevent an overestimation of the risk. To minimize the default rate, it is essential to share regulatory information on important market participants and to apply more shared punitive mechanisms for dishonesty, with the cooperation of the federal government. UnionPay is one such successful example. Hence, this will boost the willingness of SME borrowers to repay the loan, and reduce the credit risk of financial institutions. This will provide these banks with additional incentives to offer financial services to SMBs [8].

Allowing financial institutions to specialize by dividing the financial transaction into two halves is another factor to consider. Then, they are able to distinguish between asset transactions and risk trading and assign a price to each transaction. Consequently, risk might be assigned properly, and the efficiency of financing transactions would increase. This efficient market for trading hazards permits stakeholders to better identify and manage risk in order to generate a return on risk holding. This affords financial institutions the opportunity for profit, encouraging them to invest in SMBs. Creating professional financial guarantee organizations that specialize in reducing the cost of risk detection and verification would be a great method to achieve this.

3.4. Financial Technology

Recent advancements in financial technology could assist with the implementation of these recommendations. For instance, digital inclusion would increase SME access to needed financial resources. The online credit report public record also facilitates the exchange of information between enterprises and the government, so contributing to the growth of a comprehensive financial system. This enables firms' implicit data to be known, hence reducing the degree of information asymmetries between financial institutions and enterprises. This results in reduced costs associated with identifying risks [12].

Despite this, fintech also expedites the examination of small business credit loans, reducing the transactional and bureaucratic costs of online finance. Internet finance is a digitalized method of financing in which requests and necessary information are sent online. Using an intermediate platform to apply for a loan enhances the efficiency of loan examination and approval. This will factor the internet performance of users into loan-granting decisions. Hence, numerous restrictions will be lifted. For instance, businesses depended solely on fixed assets and financial company assurances. Thus, SME investments could become more appealing to financial institutions such as commercial banks. This would generally improve the situation. Simultaneously, the government and intermediary platforms should keep a constant emphasis on the significance of information security, thereby fostering an atmosphere conducive to SME growth.

4. Conclusion

In conclusion, this study has explored the problem's historical context, the variables behind risk perception, and the challenges that have resulted, including a comparison of several funding solutions for the difficulty faced by many SME's. These potential solutions are discussed in light of the underlying cause. To evaluate the viability of these concepts, however, empirical study has yet to be undertaken, which the following research could enhance.

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