



温州肯恩大学
WENZHOU-KEAN UNIVERSITY

A research study on SMEs funding problem in Wenzhou

In Partial Fulfillment of the Requirements
for the Bachelor of Science in Finance

by

CHEN Yujun

1025574

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Chen Yujun

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Abstract

SMEs means small and medium-sized enterprises. The SME sector plays an extremely important part of the modern economy, proving to be the most attractive and tremendous innovative system. In Wenzhou, such a strong city with private economy in Zhejiang province, SMEs also play a more and more significant role in the economy. They involve in job creation in this modern-day economy. Out of the SMEs' contribution, there is a significant growth in GDP and proper money flow across the economy is noticed. SME charges lower rates to its clients by providing a quality business. When the state economy is in healthy condition, the SMEs will flourish. If the economy is volatile, the SMEs will face a risk of going down, as they survive within a small budget. Enough and steady funding can decrease the pressure of SMEs when they are in terrible situations. Understanding the importance of SMEs in the economy and finding reasonable ways to solve the funding problem are worth for economy.

Key words: SMEs, fund, private economy, China, Wenzhou, bank, private lending registration center, interest rate, risk, cash flow, Wenzhou Index.

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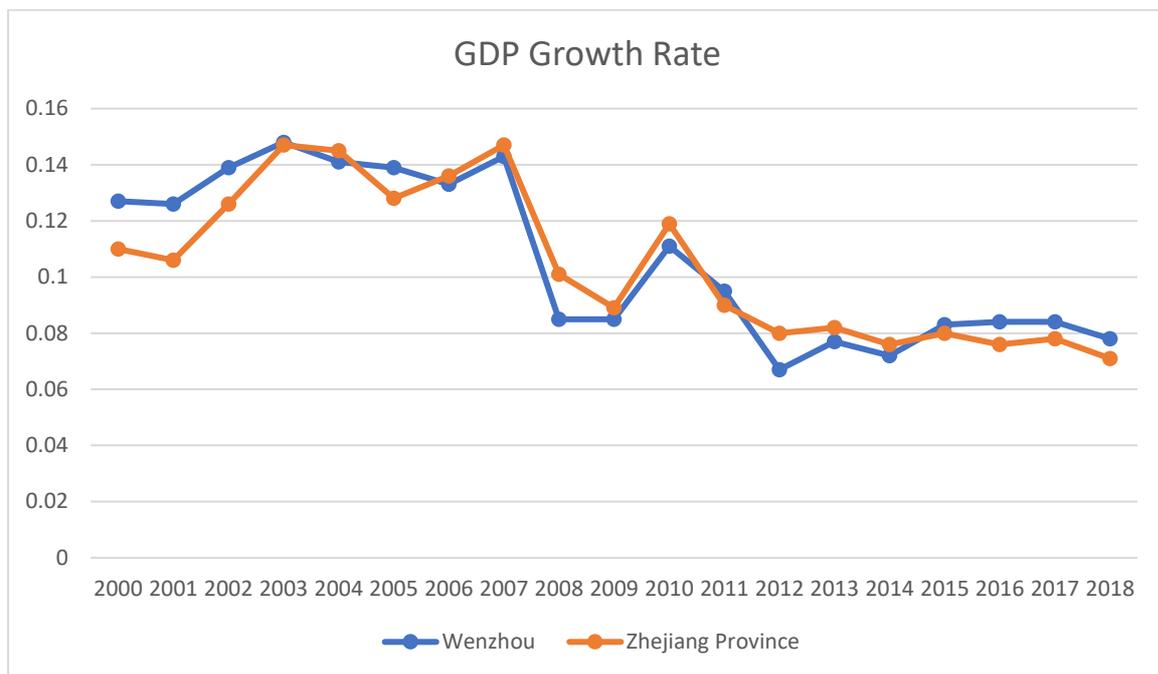
Introduction

For healthy and steady growth, the global economy has new challenges in the past years, like Britain out of the EU, the spread of terrorism and trade war. It is more difficult for the economy to achieve new and more growth. As members of the economy, SMEs also faces new pressure. With the expansion of the market economy, the position of SMEs is becoming more and more significant.

In Zhejiang, SMEs are one of the most valuable parts of the economy. SMEs also represent the private economy as a whole. Subordinate cities of Zhejiang province all have similar models of economy, including Wenzhou. The private economy has irreplaceable status in any city in Zhejiang province. Wenzhou is the most representative of these cities. Because the statistics of Zhejiang Province are completer and more authoritative. From the overall statistics of Zhejiang Province, we also can feel the strength of Wenzhou's private economy. Zhejiang province, as the most advanced private economy province, SMEs are a major economic growth engine. By the end of 2018, Zhejiang had 6,542,300 various market entities, including 6,273,500 private economy market entities, accounting for 95.9%. Last year, the added value of the private economy in Zhejiang was 3.68 trillion yuan, accounting for 65.5% of GDP. The private investment was 2138.31 billion yuan, accounting for 63.1% of the province's fixed-asset investment. The total import and export of private enterprises were 204.52 billion yuan, accounting for 71.6% of the whole province. The private economy is the biggest highlight of Zhejiang's development, and it is also the most prominent feature of Zhejiang's economy. It has become the main force in the province to accelerate economic transformation and promote high-quality economic development. At present, Zhejiang's private economy has created 56% of the province's tax revenue, 65% of GDP, 77% of foreign

trade exports, and 80% of jobs. Among the top 500 private enterprises in China, Zhejiang accounted for nearly 1/4 of the total, ranking first in China for 19 years consecutively, and the world-famous unicorn leading enterprises such as Alibaba, H3C, Hikvision, and Concentration Technology were born. The private economy can directly give back to the public and let the people share the fruits of economic growth. This is why the people of Zhejiang province are the richest in China, except Beijing and Shanghai. The data show that in 2017, the per capita disposable income of urban residents in Zhejiang increased from 11,716 yuan in 2002 to 51,261 yuan in 2017, and the per capita disposable income of rural residents increased from 4,940 yuan to 24,956 yuan. The per capita income difference between urban and rural residents was reduced from 2.37 to 2.37. 2.054, smaller than the national (2.71), also smaller than Shanghai, Jiangsu, Shandong, Beijing, and Guangdong. Rural residents' disposable income has been in the provinces outside the municipality for 33 consecutive years. This is the result of the advanced private economy. The economic development level of Wenzhou is more than the average level of Zhejiang province. Wenzhou's private economy contributed 90% of tax revenue, 92% of industrial added value, 95% of foreign trade exports, 93% of employees and 99% of enterprises. One can imagine Wenzhou's economic development strength depend on the data.

Figure 1.



The GDP Growth Rate of Zhejiang Province and Wenzhou Between 2000-2018

In the new century, the private economy in Wenzhou encountered terrible crises and bottlenecks. For SMEs, funding is very difficult for them when their enterprises are very good and outstanding. SMEs ask the fund for banks or investors is limited by the size of their enterprises. The funding problem promotes the development of private funding in Wenzhou. Private funding has lower standards for borrowers and is more flexible for borrowing loans from banks. Private funding ushered development in a high-speed. In 2011, a serious financial crisis broke out in Wenzhou. Since April, due to the inability to repay huge debts, more than 90 business owners in Wenzhou have fled and enterprises have closed down. Only on September 22, 9 companies have lost their main liabilities. The 9 companies all belong to SMEs. The influence of shutting down enterprises has inflicted heavy losses on the individual. The phenomenon is known as Wenzhou private lending crisis. Many investors can't recoup the investment. According to a survey conducted by the central bank's Wenzhou Central Branch, 89% of households or individuals and 59.67% of enterprises in Wenzhou

participate in private lending, and their market size reaches 220 billion yuan. At the same time, documents from Wenzhou officially confirmed that local private lending accounts for the private sector. The total amount of capital is about 1/6, which is equivalent to 1/5 of the total bank loan in Wenzhou. The financial crisis even startled the Chinese central government, premier Wen Jiabao visited Wenzhou several times to help local government to deal with the terrible crisis. Now, the government of Wenzhou handled the crisis, but the system of private funding was destroyed. Small individual investors don't trust SMEs again. The amount of investment was much less than the amount of demand. Now the situation has become more serious. The market needs to find or make a new system that bases on the old private funding system to solve the funding shortage of SMEs. SMEs can have a much better environment and situation to develop when they have enough funds. Helping SMEs to overcome and handle a shortage of funds is very urgent and necessary for the government of Zhejiang or Wenzhou.

Literature Review

With the development of global economy, SMEs are becoming more and more important in the economy. Meanwhile, SMEs met a lot of problems or challenges in the process of developing. Therefore, many scholars study the development of SMEs and the problems which SMEs met in development. And scholars help SMEs try to find available methods to deal with the problems.

SME is an advanced and dominant power in the economy

Thorsten, Liping, and Rudai (2015) think that SMEs have been a significant power in the economy in most countries. Their “World development” introduces the function of SMEs in China well. SMEs create a lot of jobs to help society reduce unemployment. The flexible and quick responses of SMEs to market changes make themselves have a strong life in an economic crisis. SMEs also can benefit common people directly. In Wei, Ranran (2015) and Ronglin’s (2018) essay, they trace the function of SMEs in Zhejiang province and Wenzhou. Zhejiang province is a developed province in China, and Wenzhou is an advanced city in Zhejiang province. Wenzhou has the same economic model as its province. Their essay shows SMEs are the absolute dominant force in their economy. If the development of SMEs is good, Zhejiang will have high economic growth. If the development of SMEs is bad, Zhejiang will have low economic growth. Their economic growth depends on the performance of SMEs entirely. The point of these scholars demonstrates how important SMEs are in the economy of Zhejiang province and Wenzhou. The problem of SMEs will

cause problems in the economy of Zhejiang and Wenzhou. Keeping SMEs in a healthy and steady status is a significant task for the government of Zhejiang province and Wenzhou.

SMEs raise fund difficulty in market

Jaroslav, Lubos, Beata, and Jan (2018) also find SMEs also are delicate when they have problems in funding, especially in a terrible economic environment. SMEs don't rely on a large pool of liquid assets and their short-term solvability largely depends on bank loans. The activities or assets of SMEs have a higher risk than big enterprises'. Therefore, the bank will set very strict standards for SMEs. Besides, the demand for investment or cash is much higher than the supply of investment or cash. SMEs raise funds from banks very difficultly when they have the need. Even if some SMEs can meet the requirements of the bank for loans, the process of cash arrives at the account is long and deadly for SMEs. The article of Fang (2015) indicates many SMEs of Wenzhou have similar problems in funding. The SMEs of Wenzhou also can't overcome the shortage of investment. Most investors are interested in the items of big enterprises because these items are not too risky and these enterprises have a huge asset to deal with problems when items have a loss. The two results indicate the terrible situations of many SMEs which have financial problems. Some of the scholars think many SMEs can receive great success if these enterprises have enough investment. The fact is that many enterprises died because of the shortage of funding.

Funding problem of SMEs is a global problem

Satoshi, Naoyuki, Megumi and Farhad's literature (2016) says financial problems of SMEs not only exist in China but also happen in Japan. The article suggests that big companies are more popular for banks or other institutions. Japanese SMEs have the same situation as the Chinese SMEs. Many SMEs have closed down because the fund breaks. For other survival SMEs which have the need for fund. Fund shortage limits the development of the SMEs terribly. Market or government have realized the problem, but there is no action is to change or improve the environment of SMEs for funding. Any results of the study about SMEs funding not only benefit the SMEs of China, but they also benefit SMEs in other countries.

The necessary of new financial reform for Wenzhou

Xiaowen and Zongjie's literature reviews (2016) says the reform of financial systems is necessary. The article thinks Wenzhou's financial system is not mature enough. There are still many loopholes in many aspects of the financial system. And private lending lacks government supervision, so the government was unable to recover investor losses promptly when some crisis occurred. The government needs to standardize and legalize private lending so that private lending can operate through formal processes. At the same time, the government needs to help small loan companies or other kinds of companies to absorb funds reasonably and effectively. Then these companies can provide adequate funding support for small and medium companies.

Conclusion

Combining the above viewpoints, SMEs are a significant and necessary part of the market. SMEs will become more and more dominant in economic development. Market and government need to help SMEs to finish the process of funding. Financial reform also is key and necessary to find reasonable methods to improve or change the financial situation of some SMEs which have funding problems. Wenzhou's financial system can't meet the need of economic activities. Although Wenzhou's financial system has accepted one reform. However, the reform can't rid the old existing problems completely. Private lending is still not standard, legal, and transparent. The problem of funding still limits the owners of SMEs in Wenzhou. The market still needs a better financial system. The SME owners also need to use their brains to find ways to see what manner by what means to bail out a new path. Enough investment will contribute SMEs to become big and successful enterprises. Broken cash flow is a huge challenge for any company.

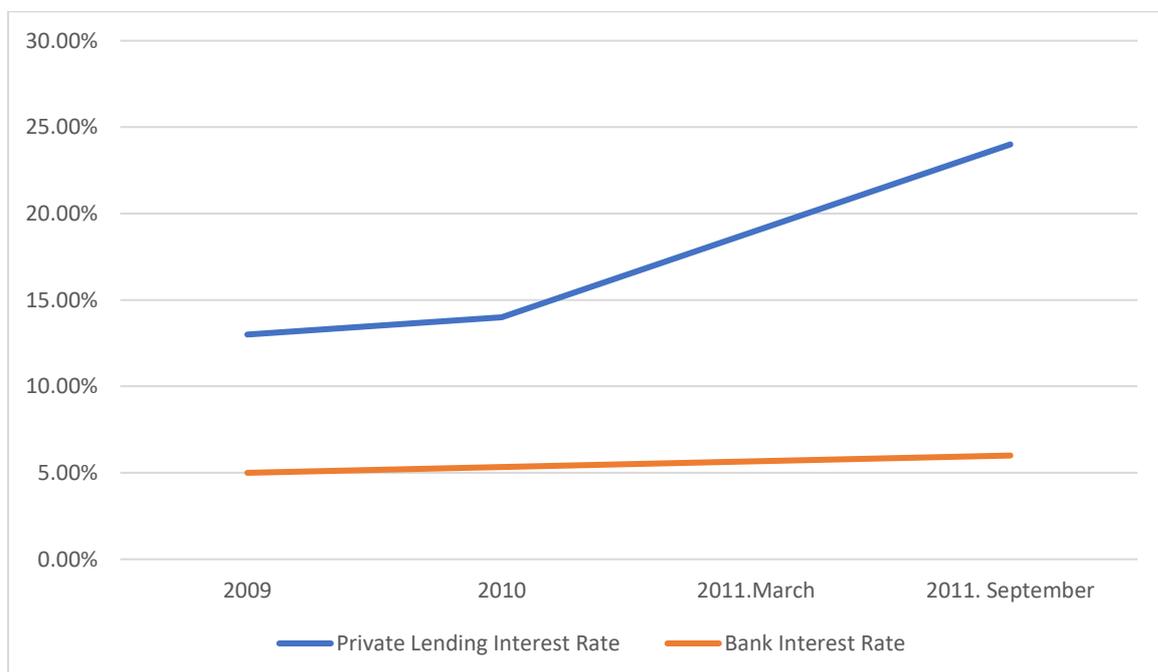
Methodology

The researchers analyze the difference in the status of private lending before and after the crisis. The researcher also needs to know the effect of policy financial reform in Wenzhou and the psychology of investors and borrowers to conduct this study. Borrowers and lenders are the key participants in private lending. Firstly, researchers analyze the psychology of investors and borrowers, because the lending or borrowing are individual behaviors. For individuals, the feeling in psychology will affect the decisions of them seriously. Many factors will affect the behaviors of borrowers and lenders. Researchers need to find and understand the need of borrowers or lenders, whatever they want, including new policy or new lending systems. In the research, people should know why these participants are so willing to join the activities of private lending that prompt private lending to become unreasonable. Secondly, the government policy decided the size, range, volatility and so on, so researchers need to analyze whether the policy of the government is reasonable. If the policy has disadvantages or weaknesses, researchers need to advise the government on how to modify or changes the rules of defective policy within a reasonable range. The research needs to collect the data about private lending around 2011 when the Wenzhou financial crisis broke out, like interest rate, scale, the situations about participants and so on. Researchers should figure out the situations of private lending and know how crazy private lending is. And the data about the interest rate and composition of borrowing methods after the financial reform is also key. These statistics not only can show the instability of interest rate during the period around the Wenzhou financial crisis but also can indicate the effect of the Wenzhou financial reform. Thirdly, researchers need to find a balance between the two subjects. And researchers can put forward a serious of suggestions to improve or modify the current financial system.

Data and information

1) The interest rate of private lending is much higher than the interest rate of bank. High interest rate is very attractive for investors with low level of education, who easily ignore the risk behind the high interest rate. Three to five times interest rate is alluring and dangerous.

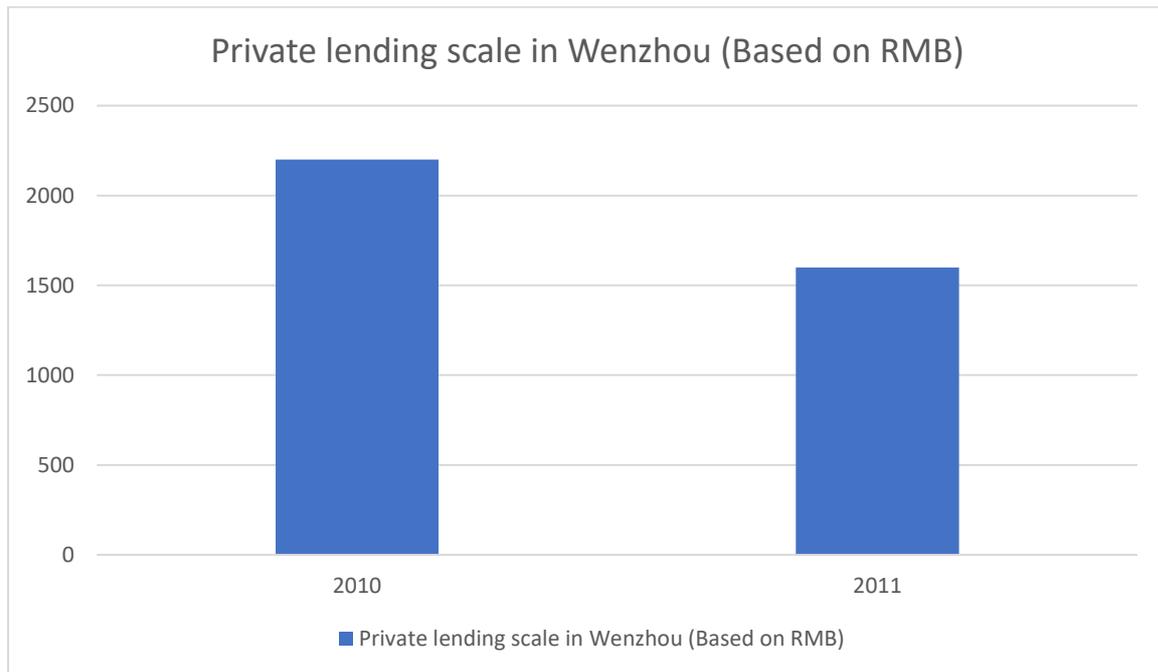
Figure 2.



Private Lending Interest Rate and Bank Interest Rate

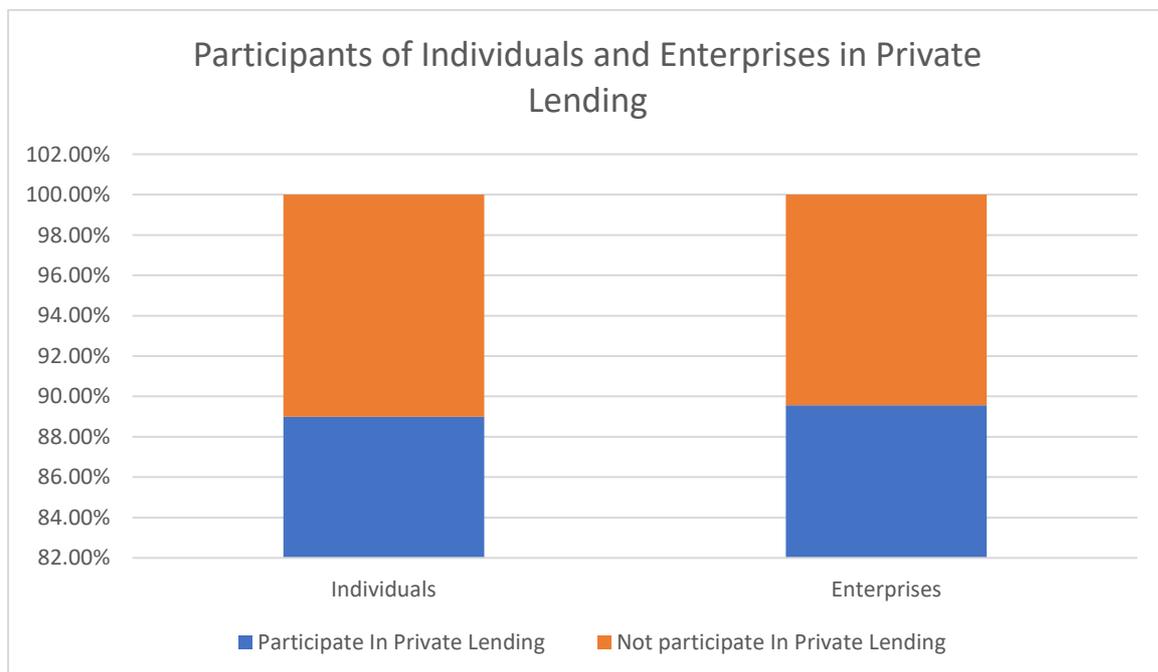
2) Private lending attracts a lot of investors and absorbs huge money depend on the high-interest rate. Most families and individuals joined in the activities of private lending in Wenzhou, so the scale of private lending reached a very amazing level.

Figure 3.



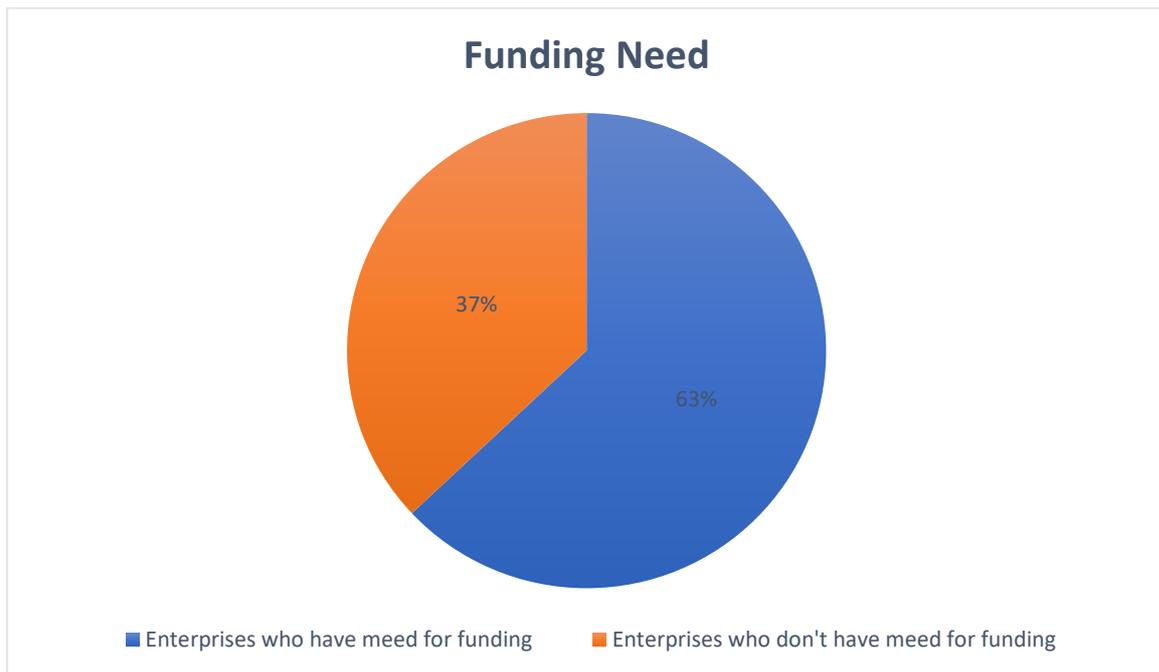
Private Lending Scale in Wenzhou

Figure 4.



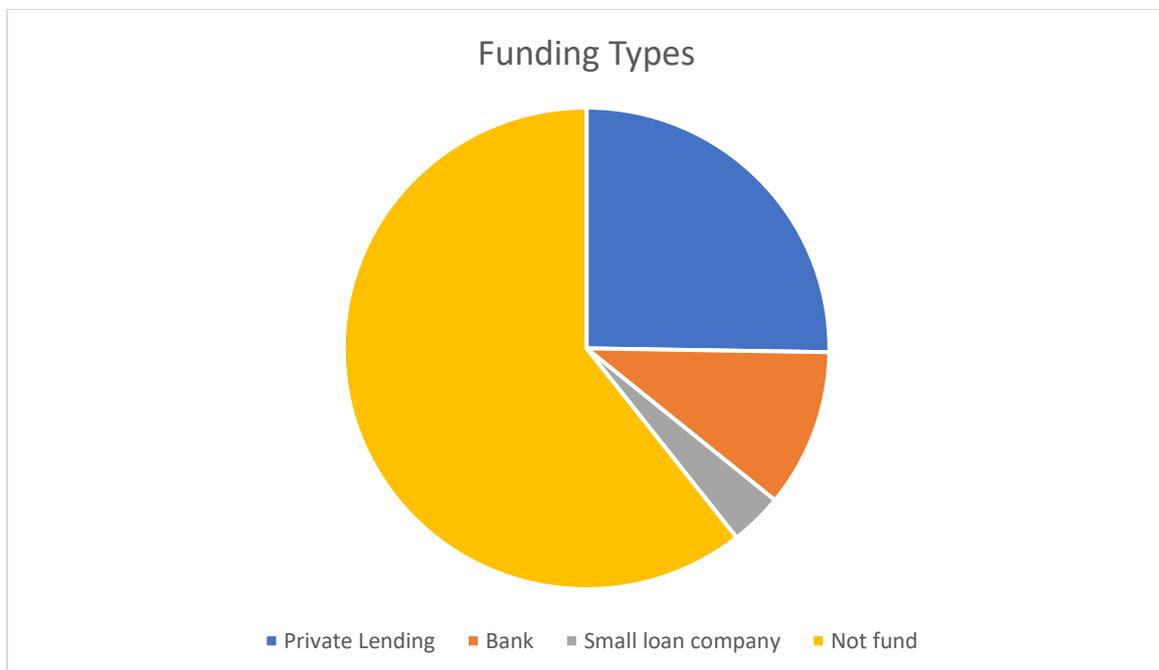
Participants of Individuals and Enterprises in Private Lending

Figure 5.



Funding Need

Figure 6.



Funding Types

3) High-interest rates persisted until the financial crisis erupted. Chinese center government and Wenzhou government realized that the current financial system can't meet the requirements of economic activities and financial reform followed. Then the interest of private lending starts coming back to a normal level. It also becomes stable and reasonable. The research uses the Wenzhou Index that is a kind of index that was born in Wenzhou financial reform.

Profile of the Wenzhou Index

Wenzhou Private Finance Composite Rate Index, Wenzhou Private Finance Index, in short, is an index system created to reflect the tendency and fluctuation of the private financing in a certain region periodically, under the auspices of the Wenzhou Municipal Government, carried out by the Wenzhou Finance Office. Wenzhou Private Finance Index consists of both the national version and the regional version. The Private Finance Index for Wenzhou district was released by Wenzhou Financing Office officially on December 7th, 2012, updated daily since Jan 1st, 2013. The Wenzhou-China Private Finance Index (national version) was put into internal trial operation since 28th June 2013, and officially released on September 26, 2013. With the assistance of the system above, Wenzhou aims to build a “barometer” for the regional private financing market, promote information transparency in the process of private lending, and optimize the allocation of resources in the private financing market.

Components of the Wenzhou Private Finance Index

Using rigorous Statistical Method for index construction, Wenzhou Private Finance Index reflects the level, tendency and fluctuation of capital price in a certain region, including

different entities, financing periods, and financing methods. The following graph illustrates the basic composition of Wenzhou Private Finance Index on the current stage:

Graph 1.



The role and significance of the Wenzhou Private Finance Index

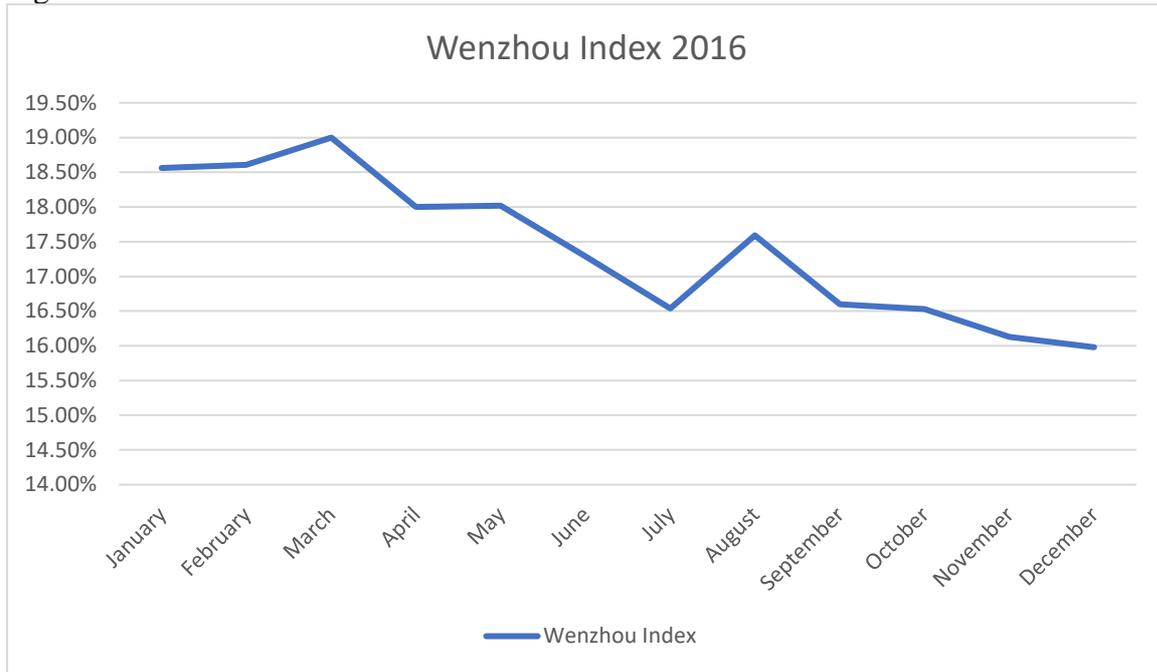
Wenzhou Private Finance Index plays a very important role in facilitating the Wenzhou Comprehensive Financial Reform, which effects may be far beyond the city itself. Three mainly aspects can explain the reason: First, it can directly reflect the trend of the private lending market, give guidance and evidence for the pricing and decision making of each participant. Second, it can monitor the dynamic information of the private finance market and avoid financial risks. For the last, it gives a market-based price that reflects the supply and demand of private capital. Therefore, provides a reference for the nation's monetary policy. The following line charts show the Wenzhou Index from January 2011 to October 2019 except the Wenzhou Index between May 2012 and January 2016 because Wenzhou private lending registration center has archived this part of the data. Wenzhou's financial reform was not implemented in the period of the missing part. Therefore, the missing part only has little effect on the final results.

Figure 7.



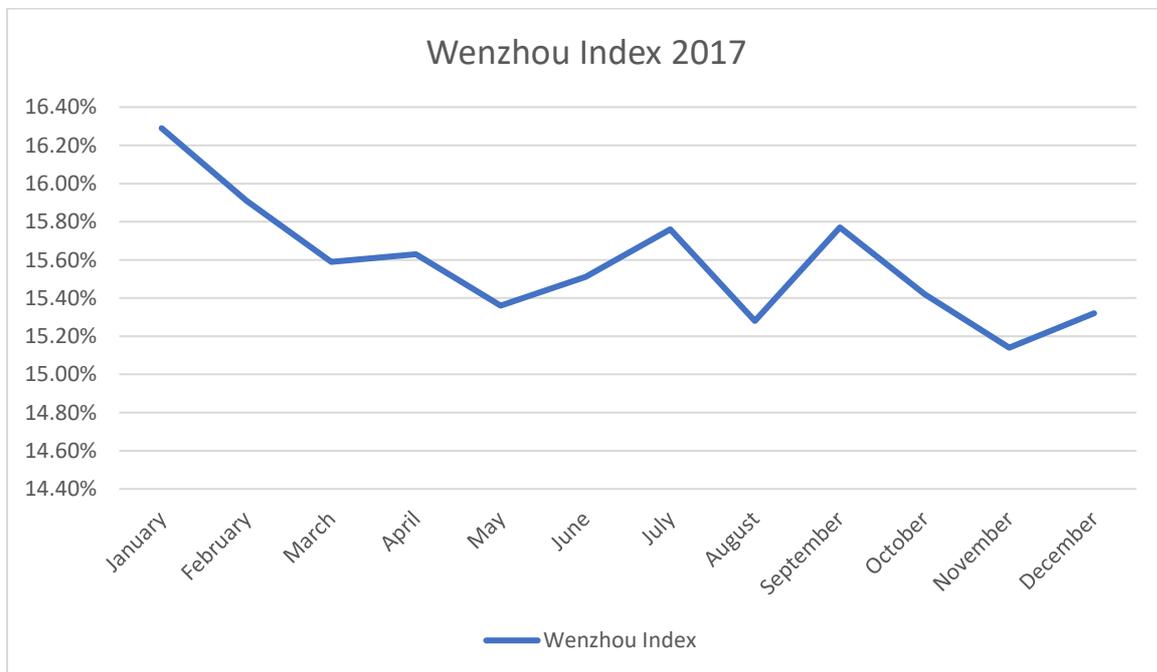
Wenzhou Index 2011.1-2012.4

Figure 8.



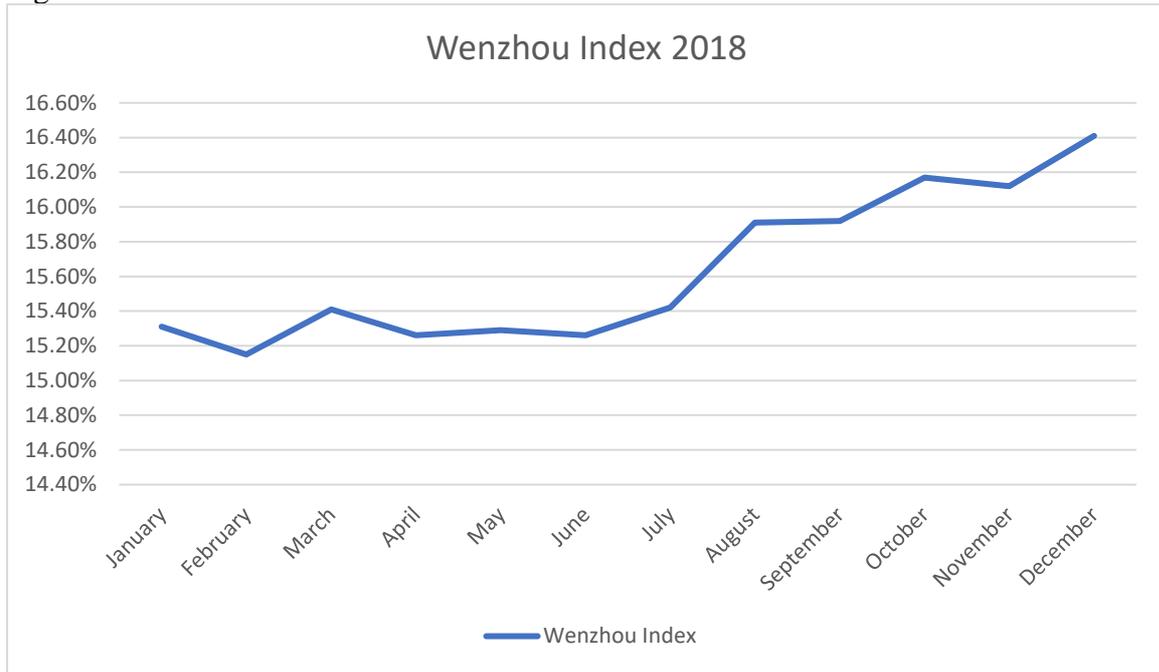
Wenzhou Index 2016

Figure 9.



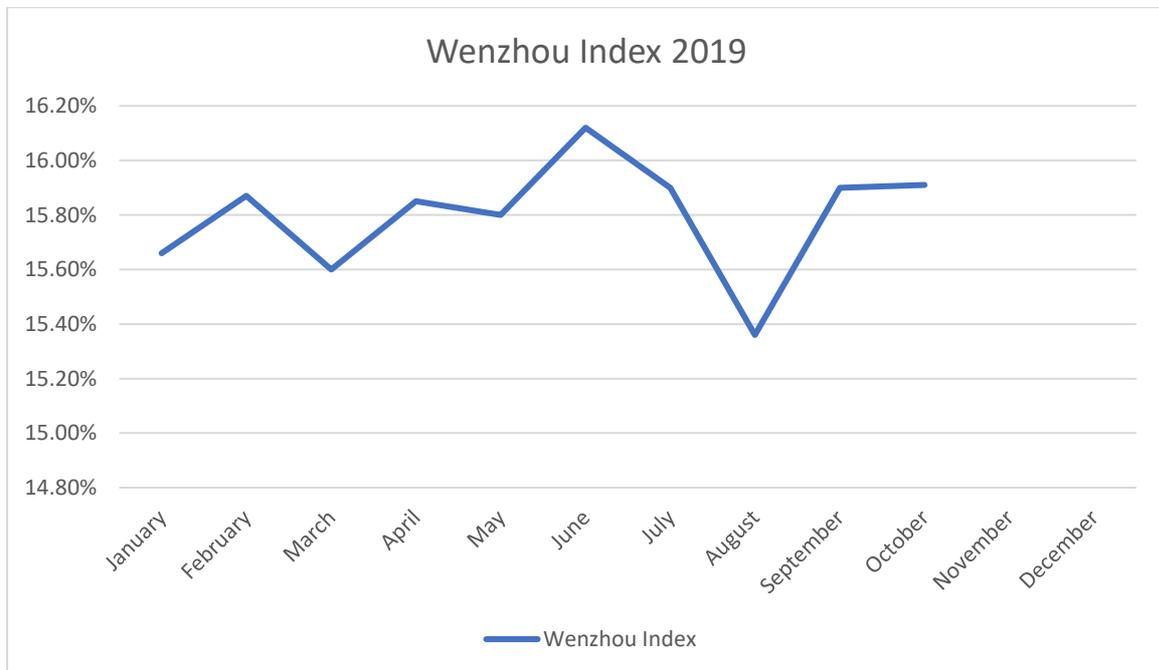
Wenzhou Index 2017

Figure 10.



Wenzhou Index 2018

Figure 11.



Wenzhou Index 2019

4) The policy and rules of Wenzhou financial reform point out the shortcomings of Wenzhou's financial system and the direction of reform. However, financial reform is challenging for Wenzhou government even with the support of Chinese center government. The following is the twelve rules of Wenzhou financial reform:

1. Standardize the development of private financing. Carry out a pilot of private lending service centers, introduce a number of intermediary agencies to settle in, provide private lending registration, notarization, and asset evaluation services, and guide the sunny and standardized private financing. Establish and improve the monitoring system for private financing, form the Wenzhou Index of the comprehensive interest rate index for private financing, and do a good job of tracking and risk early-warning of private financing.

2. Speed up the development of new financial organizations. Explore the issue of private placement of small and medium-sized enterprises by small loan companies.

3. Develop professional asset management institutions. Actively carry out pilot projects for private capital management companies, and achieve full county (city, district) coverage by the end of 2013.

4. Carry out pilot projects for personal overseas direct investment. Under the unified deployment and leadership of the State Council, explore the use of Renminbi to carry out personal outbound direct investment, and formulate Wenzhou's individual outbound direct investment management measures and implementation rules.

5. Deepen the reform of local financial institutions. Promote the Bank of Wenzhou to introduce strategic investors, increase capital and expand stocks, and go public for financing. Strive to establish non-bank financial institutions such as finance companies, financial leasing companies, trust companies, and consumer finance companies in Wenzhou. Support private capital to enter the fields of securities and investment consulting, strive to establish securities companies in Wenzhou, and support more

securities, funds, and futures companies to establish branches in Wenzhou. Encourage local financial institutions to explore comprehensive operations by way of holding or equity participation.

6. Innovative development of financial products and services. Actively develop micro-credit businesses such as technology loans, micro-guaranteed loans, operating rights pledge loans, equity pledge loans, intellectual property pledge loans, forest rights mortgage loans, and maritime use rights mortgage loans. Actively explore pilot mortgages for pollution discharge rights, mortgages for farm houses, mortgages for land contractual management rights, mortgages for agricultural facilities and agricultural machinery, etc.

7. Cultivate and develop local capital markets. Actively carry out trials of property rights trading markets, establish property rights trading markets such as intellectual property rights, corporate property rights, financial assets, pollution rights, water rights, carbon emission rights, low-carbon technologies, rural land contracting rights, forest rights, etc., and develop non-listed companies Pilot of stock transfer, and explore the pilot of private placement of small and medium-sized enterprises.

8. Actively develop various bond products. Using the local government debt ratio as a control indicator, explore eligible local financing platforms to issue private placement bonds. Actively strive for innovative products such as high-yield bills in Wenzhou.

Nine, broaden the field of insurance services. Support qualified private capital to initiate the establishment of regional and professional insurance companies or share insurance institutions.

10. Strengthen the construction of the social credit system. Formulate opinions on strengthening the construction of the social credit system, and actively promote the

collection, exchange, and application of credit data in the financial, administrative, social, market, and accounting fields.

11. Strengthen local financial management mechanisms. Formulate and implement opinions on the implementation of local financial supervision, strengthen management of institutions such as small loan companies, financing guarantee companies, and private capital management companies.

12. Establish a risk prevention mechanism for comprehensive financial reform. Further strengthen and improve the investigation of financial crimes, establish a system for the supervision and handling of major non-governmental financial cases, and strengthen the prompting of non-governmental lending risks.

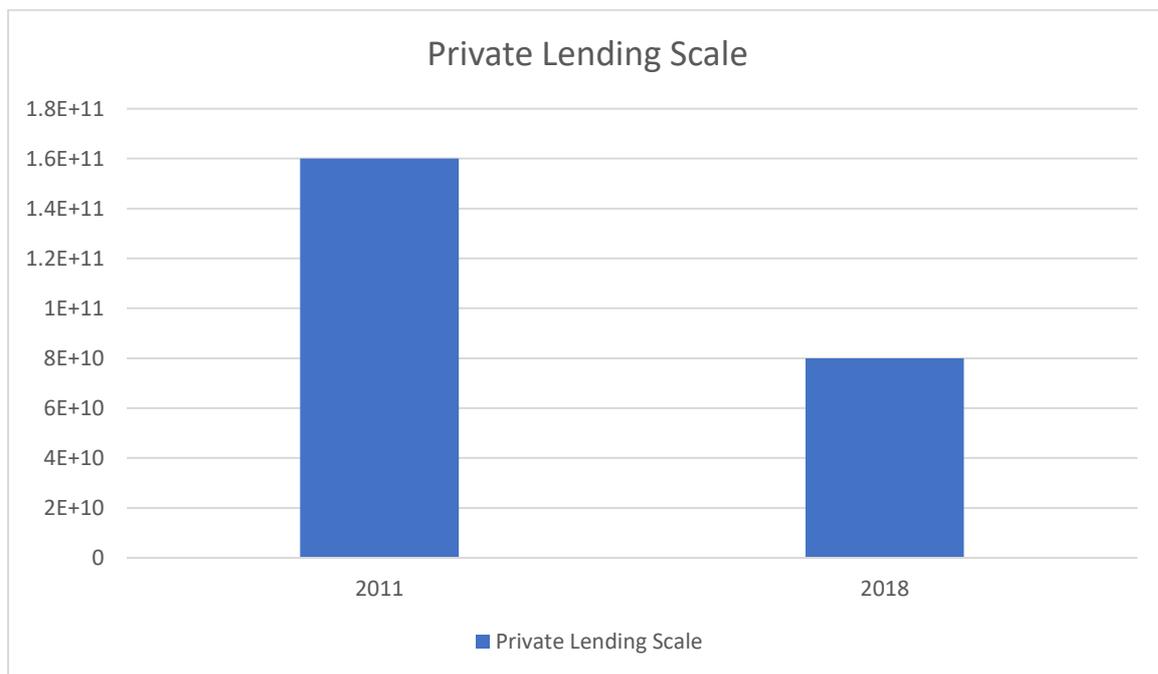
Results

Around 2011 when the financial crisis broke out, the interest rate of private lending remains high. During the period, Wenzhou's economy entered the fast lane, countless enterprises grow very fast and they also need more funds to increase output at the same time. Everything boosted interest rates and local house prices in Wenzhou. Private lending is three to five times the bank interest rate. Investors are profit-seeking. Therefore, more and more investors and capital join in the activities of private lending. Compared with the bank, private lending has lower requirements for loan applicants. More and more borrowers are willing to borrow money from private lending although the interest rate is high because the high-interest rate is much more friendly than the shortage of funds. However, the seemingly reasonable market behavior has been unnormal. Investors whose average education level is low can't detect this. For the high-interest rate, many financial criminals who are under the guise of financing and expanding businesses start to absorb money illegally. When these financial criminals achieve their goals, they will run away with the money of many investors. By that time, many investors need to suffer from the loss. Not only investors are affected, but many families are also fragmented as a result.

When the policy of financial reform was implemented, the orders of Wenzhou financial systems start coming in the right way. After the reform, the interest rate of private lending was becoming lower and relatively stable. (Figure 13) However, in financial reform, the policy remains slightly conservative. The new policy still largely limits the participation of ordinary investors. This is why the scale of private lending in 2018 much smaller than in 2011. (Figure 12) And the government's supervision is not strong enough, and it still leaves a lot of room for financial criminals to operate. The events

about P2P (peer to peer) loan companies broke and run away have proved it. Therefore, the reform helps the market improve the financial environment, there are many disadvantages and weaknesses in Wenzhou financial system. The financial reform should be bolder in the field of absorbing participants and stronger in regulatory aspects.

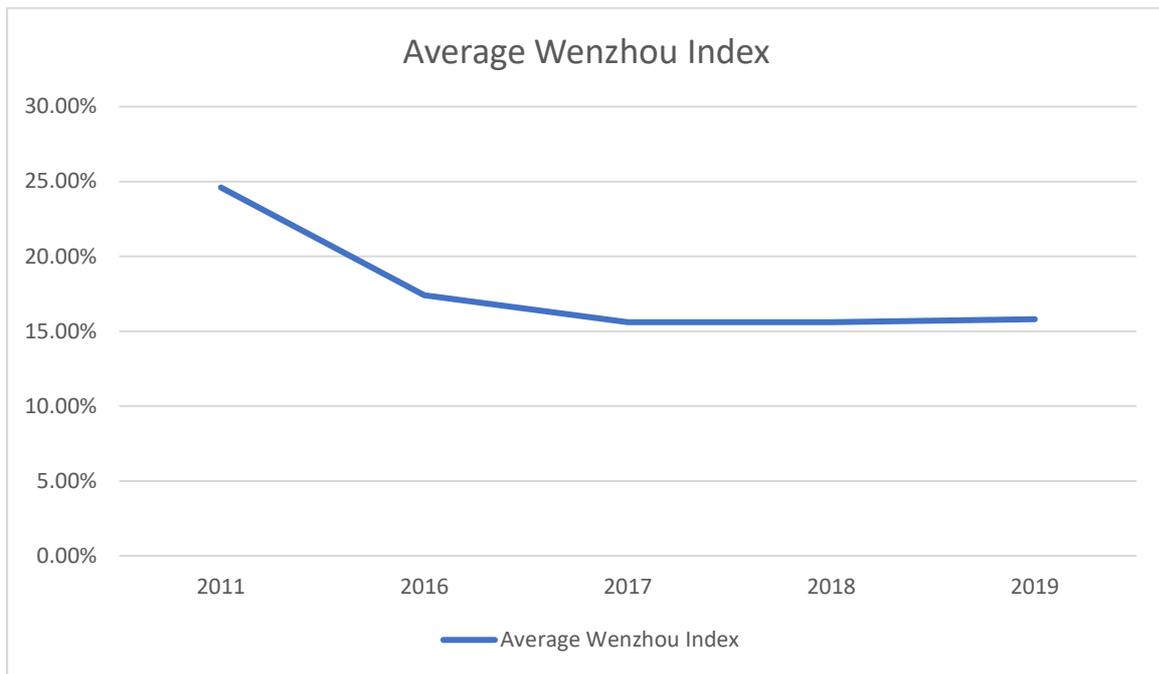
Figure.12



Private Lending Scale

Note: The scale of private lending of 2018 is only half that of 2011

Figure 13.



Average Wenzhou Index

Note: There is a significant decrease from 2011 to 2019

Conclusion

Under Chinese law, loans with interest rates below 30% are legally protected by law. Therefore, private lending is a legitimate market economy behavior. The financial crisis in Wenzhou was caused by the immature and planned financial system of Wenzhou at the time. A large number of participants lack financial knowledge, including government. This caused the final crisis to hit Wenzhou's economy and the private credit system. The collapse of the credit system on which private lending depends has led to a serious shrinkage of private lending. The development of private lending has stalled. For SMEs that rely heavily on private lending to solve financing problems, this is disastrous. These SMEs can only go to bankruptcy because of the fracture of the capital chain. China's first financial reform aimed at the issue of private lending followed, but this reform was slightly conservative. This reform policy has, to a certain extent, allowed some lenders to control the use of funds, which has made these companies the same as banks. And government supervision is not strong enough. This has led to a large number of P2P companies illegally absorbing investor funds. To this end, the researchers propose an idea for this study: establish a government-controlled private loan transaction platform that is controlled by the entire government. The government's non-profit guarantees the relative fairness of the platform, and at the same time appropriately reduces the tax on this transaction. Income from borrowing is rarely taxed. Lower taxes can encourage platform people to pay taxes in accordance by the law, and because it is a government platform, investor confidence will be higher, which will help increase the size of funds and facilitate supervision.

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