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Japan International Cooperation Agency (JICA)  
Chinese People's Bank, People's Republic of China

**THE STUDY**  
**ON**  
**REFORMING SME FINANCE SYSTEM**  
**IN THE PEOPLE'S REPUBLIC OF CHINA**

**FINAL REPORT**

**Summary**

**January 2005**

**International Development Center of Japan**  
**Mizuho Research Institute**

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## Preface

In response to a request from the Government of the People's Republic of China, the Government of Japan decided to conduct "The Study on Reforming SME Finance System in the People's Republic of China," which was implemented by the Japan International Cooperation Agency (JICA).

JICA sent a study team, headed by Dr. Jinichiro YABUTA of the International Development Center of Japan, to the People's Republic of China six times, between March 2003 and January 2005.

The team held discussions with the officials of the Government of the People's Republic of China and conducted related field surveys. After returning to Japan, the team conducted further studies and compiled the final results in this report.

My hope is that this report will contribute to the promotion of reforming the SME finance system in the People's Republic of China and to the enhancement of friendly relations between our two countries.

I want to express my sincere appreciation to the officials from the Government of the People's Republic of China for their close cooperation throughout the study.

January 2005

Tadashi Izawa  
Vice President  
Japan International Cooperation Agency

January 2005

Mr. Tadashi Izawa  
Vice President  
Japan International Cooperation Agency  
Tokyo, Japan

## Letter of Transmittal

Dear Sir,

We are pleased to submit to you the report for the Study on Reforming the SME Finance System in the People's Republic of China. This report compiles the results of the study, which was undertaken by the study team, and jointly organized by the International Development Center of Japan and Mizuho Research Institute.

While SMEs have been playing an increasingly great role in the growth of the Chinese economy, the development of the SME sector remains an important policy issue to the Government of the People's Republic of China. Among the many challenges for sound development of SMEs, the difficulty in procuring funds is recognized as one of the most fundamental problems yet to be solved. Therefore, this study was conducted with the objective of making recommendations for the improvement and reformation of the Chinese SME financing system, so that it will enable the expansion of SME financing. The study team presented recommendations from a broad perspective, based on the view that it is indispensable to consider both the lenders and borrowers to solve the multi-dimensional problem of SME finance.

During the implementation of this study, the study team conducted a wide range of questionnaire and interview surveys for SMEs, financial institutions and credit guarantee institutions in the target areas, so that the recommendations were made in sufficient consideration of Chinese conditions, SME needs and feasibility. In addition, discussions and knowledge sharing were accumulated among the people concerned, through a series of seminars and workshops held in Beijing and other target areas.

The overall work process of the study was maintained in close cooperation with our counterpart organization, the People's Bank of China. It should also be noted that the People's Bank of China took this opportunity to conduct their unique research on the Chinese SME finance system in parallel with this study, which contributed to the improvement of the quality of the study results.

We acknowledge and greatly appreciate the excellent support rendered by your agency. We would also like to express our deep appreciation and sincere gratitude to all the officials concerned from the Government of the People's Republic of China, particularly those from the People's Bank of China, and all the people concerned from financial institutions, credit guarantee institutions and SMEs, for their kind assistance during the implementation of our field studies.

It is our hope that this report will contribute to the development of SMEs in the People's Republic of China and promote further cooperation between the People's Republic of China and Japan.

Very Truly Yours,

Jinichiro YABUTA  
Team Leader,  
Study on Reforming SME Finance System in the  
People's Republic of China

THE STUDY ON REFORMING SME FINANCE SYSTEM  
IN THE PEOPLE'S REPUBLIC OF CHINA

FINAL REPORT –Summary–

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# Summary and Recommendations

## 1.1 Summary and Recommendations: Possible Solutions to Financing Small and Medium Enterprises

### 1.1.1 Study Objectives

This report aims to contribute to institutional improvement and reform in financing small and medium enterprises (SMEs) in China. For this report, the study team has conducted field interviews and questionnaire surveys in conjunction with its counterpart, the research staff of the People's Bank of China. Based on these surveys and a review of Japanese experience with SME financing, the study team has made a set of recommendations. The study team believes that the recommendations are sufficiently realistic and, at the same time, in line with possible long-term structural changes in SME financing in China.

The recommendations comprise those for lenders (Strategy 1) and borrowers (Strategy 2). Through these recommendations, the study team expects that so-called relational banking will be established on the basis of a relationship of mutual trust between the lenders and borrowers.

The results of the questionnaire survey are described in Chapter 2.1 of this report.

#### Strategy 1: Improving the Performance of Lending Institutions and Promoting Institutional Reform

- (1) Financial System Reform and Capital Market Development
- (2) Improving SME Finance Environments and SME Lending Operations through Commercial Banks
- (3) Establishing Financial Institutions for SMEs
- (4) Reforming Credit Guarantee Systems

#### Strategy 2: Upgrading Managerial Capacity and Promoting Disclosure on the SME Side

- (1) Improving Business Management, Financial Management and Disclosure of SMEs
- (2) Public Support and Human Resource Development for Upgrading Management of SMEs

### 1.1.2 Report Structure and Recommendations

The report is divided into Part 1 and Part 2. Part 1 is an overall summary and recommendation. Part 2 describes the strategy-specific analysis and recommendations with reference to the following items:

- 2.1 The Present Situation and Prospects of Financing SMEs
- 2.2 Financial System Reform and Capital Market Development
  - 2.3.1 Present Management and Financing of SMEs
  - 2.3.2 Financial Issues of SMEs and the Roles of Financial Institutions for SMEs
  - 2.3.3 Human Resource Development for SME Management
- 2.4 SME Lending through Commercial Banks
- 2.5 Reforming the Credit Guarantee System

Chapters 2.1 and 2.2 give an overview of present situation and prospects of SME financing.

Chapter 2.3 focuses on the managerial and financial problems of SMEs and examines possible public interventions such as financing, the provision of information and HRD in order to solve these problems. Chapters 2.4 and 2.5 examine the present situation and possible improvement/reforms with special reference to the lending practices of commercial banks and the credit guarantee system.

## **Strategy 1**

### **Improving the Performance of Lending Institutions and Promoting Institutional Reform**

This strategy is derived from the following policy considerations of the study team:

1. Promoting a market-based economy, reforming banking systems and improving the performance of banks
2. Strengthening strategic public support for SMEs such as capital market development, policy-based lending and a credit guarantee system

#### **(1) Financial System Reform and Capital Market Development (refer to Chapter 2.2)**

Financial needs of SMEs are different in accordance with the stage of development of the enterprise. Broadly speaking, there are two types of financial needs. The first type is the financial needs of initial stage enterprises. Lending to such enterprises tends to be the provision of risk money because their business prospects and management competence are not yet certain. Ordinary financial institutions are not able to satisfy such financial needs. The second type is for post-initial stage enterprises. Financial needs of such enterprises can be met by ordinary financial institutions since their business is usually on track and thus involves relatively low risk.

With these different financial needs in mind, the study team recommends:

- 1) Normalization of bilateral financial transactions
- 2) Managerial reform of banks including those that are state-owned and privately-owned
- 3) Development of lending schemes that correspond to the socio-economic conditions particular to China.
- 4) Acceleration of capital market development
- 5) Liberalization of fund raising by Chinese enterprises in the international financial market
- 6) Reformation of credit guarantee systems

#### **(2) The Present Situation and Prospects of Financing SMEs (refer to Chapter 2.1) and SME Lending through Commercial Banks (refer to Chapter 2.4)**

Financing SMEs as part of economic policy requires the financial institution to be in line with a



spirit of voluntary trust being the foundation of the market economy. Therefore, financial business principles have to be reflected in and duly applied to the operation of commercial banks and control by the financial authorities. This has not yet been fully observed in the present financial institutions.

Under these circumstances, one can hardly design a safety net warranted by economic and financial policies because there is no clear distinction in the responsibilities between the market and government.

The classification of SME is no more than for practical use in policy implementation. A market economy would ideally call for economic activities to be least covered by a safety net. When a safety net is really effective, private commercial banks can expand their operations without worrying about whether their customers belong to an SME or are classified under a safety net.

The financial authorities and institutions should establish a system to monitor actual operations of financing, the needs on the borrowers side and the ideas on the lenders side, especially those from the operational level, so that they are reflected in financial systems and operational rules. Such a system would enable the safety net to function in a timely manner.

### **(3) Establishing Financial Institutions for SMEs (refer to Chapter 2.3.2)**

This study has analyzed issues of financial needs and supply for SMEs based on the questionnaire survey and keeping in mind the possibility of establishing a public financial mechanism for the SMEs including a policy-based lending institution. In analyzing Japanese public financing, attention needs to be paid to the difference in SME policies between Japan and the U. S. despite their economies being closely linked with each other. The SME policy has been a part of industrial policies in Japan but part of social policies in the U.S.

Economic institutions are more prolific and economic policies are more micro-based in Japan compared to the U.S. in response to different industrial maturity and changing economic situations. Policies for financing SMEs have been effective in fostering industries by providing policy guidance and financial incentives.

A policy-based lending institution for SMEs, if created in China, would be effective in:

- 1) Supplementing private financial institutions as a buffer in the phase of tightening money and a safety net in emergency situations
- 2) Encouraging private institutions to finance SMEs through special lending schemes as incentives
- 3) Building the capacity of lending and appraisals for SMEs

Such policy-based lending institutions should fully take into account:

- 1) Cooperation and complementation with private financial institutions
- 2) Possible financial sources/burdens (especially on the government side)
- 3) Financial sources and policy incentives for the field that are complementary to private finance

**(4) Reforming Credit Guarantee Systems (refer to Chapter 2.5)**

Credit guarantee systems have been developed in two ways: under government initiative with the input of public funds and under private initiative with the mobilization of private funds. The government has encouraged credit guarantee institutions to be established all over the country. Their number has exceeded 1,000 over the past few years.

The SME Promotion Law was laid down in 2003. Credit guarantee systems are now graduating from experimentation. They have begun to be operated on a regular basis with the Act for Controlling SME Credit Guarantee, which is a set of subsidiary rules for credit guarantee systems as specified by the SME Promotion Law.

However, current credit guarantee systems have encountered various issues including increasingly divergent objectives, increased pressure for financial sources and a lack of full-time credit guarantee institutions. Taking these issues into consideration, this report recommends:

- 1) Screening and selective support of credit guarantee institutions
- 2) Establishment of nation-wide systems and networks for credit guarantees
- 3) Standardization of credit guarantee systems
- 4) Creation of a re-guarantee system

As a reference for carrying out these recommendations, the report presents a grand design and key target figures towards the reform of credit guarantee systems.

## **Strategy 2**

### **Upgrading Managerial Capacity and Promoting Disclosure on the SME Side**

This strategy focuses on the improvement of the capability of SMEs to manage business and finance, and the promotion of disclosure. To this end, the strategy also refers to public support and human resource development.

**(1) Improving Business Management, Financial Management and Disclosure of SMEs (refer to Chapter 2.3.1)**

The report analyzes external and internal issues of the procurement and management of a Chinese SME. The analysis suggests that overcoming financial problems of SMEs requires not only the improvement and reform of the systems to finance SMEs but also the improvement of business and financial management on the part of SMEs. In particular, the report recommends:

- 1) Balanced finance to be appropriate to replenishment and the utilization of owned capital
- 2) Strengthened financial management based on cash receipt, disbursement and cash flow statements
- 3) Positive disclosure of managerial status and intensified relations with lending institutions

- 4) Strengthened public measures to support SMEs, including a policy-based lending institution

**(2) Public Support and Human Resource Development for Upgrading Management of SMEs (refer to Chapter 2.3.3)**

Management upgrading of SMEs requires human resource development for the following purposes:

- 1) Strengthening the management and human resource base for systematic and unified policy support to SMEs as a whole in the long term
- 2) Meet the shortage of managerial workforce resources of individual SMEs in the short term.

Thus in supporting the SMEs, the report recommends:

- 1) Establishment of a systematic and integrated approach for managerial support and workforce development
- 2) Further use of information technologies by SMEs
- 3) Further use and acquisition of patent by SMEs
- 4) Promotion of businesses with the external market and investments

## 1.2 Summary and Recommendations: Specifics

### 1.2.1 Current environment and future development of finance by SME's in China

We, Japanese Research Group (“Japanese Side”), conducted a questionnaire and hearing (as explained hereafter) regarding financing by SMEs in China. Working in close conjunction with the People's Bank of China (i.e. the Chinese Counterpart (“CP”)), we collected data quantitatively and qualitatively.

Subject to the questionnaire and hearing were SMEs, financial institutions and credit guarantee organizations. The five research areas are: Beijing City (Zhongguancun), Zhejiang Province (Wenzhou and Taizhou), Guangdong Province (Dongguan and Shenzhen), Shaanxi Province (Xian) and Shandong Province (Weihai). They had been chosen beforehand by JICA and CP for being areas regarded as representing typical characteristics in China.

Our questionnaire research was highly appreciated in China, which could be seen as evidence that our technical assistance has been successful. Moreover, our methods of procedure and analysis were especially appreciated for their unprecedented use in China.

Unfortunately, CP could not render its research and analysis complete without reiterating that a few key problem areas still exist. Consequently, these areas need improvement if a better estimation of lead times is to be achieved, and in order to conduct sampling in a broad area. In light of such circumstances, it is not sufficient to have only procedure and analysis technologies. We expect ongoing further efforts.

Reliability of statistical research needs a logical proof that samples represent the mother group. One cannot exclude a possibility that sampling might have been distorted by policy concerns or neglect of certain groups of strata. I really hope such possibility has little to do with our study. Statistics should properly reflect mother groups so that their reliability could be accepted by anyone in and out the country, thereby enhancing their credibility.

The Research Division of the People's Bank of China disclosed a comprehensive report consisting of 21,000 Chinese letters with names of the “Special Assignment Team” on the daily paper, “Financial News,” on June 22, 2004. This report includes a summary and analysis on the results of the research, verification of hypothesis and primitive recommendation for policies abstracted from this analysis. In this recommendation, “result of technology transfer and exchange of experience and knowledge” can be found as supported by many kinds of materials disclosed by the Japanese Side, discussions between the Japanese Side and CP, and collaborations in research activities. In this sense, half of the original purposes of this research project have been accomplished at this time.

And the discussion program, “Dialog,” under the title of “SMEs: Where does the money come from?” was shown on CCTV-2 (FOR ECONOMY, LIFE AND SERVICES) on June 27, 2004, which featured three panelists including Mr. Mu (chief of the Research Department of the People's Bank of China; CP), around 100 general managers of SMEs from all over China and Ms. Liu Ping. The results of our research were introduced at the very beginning of the program. This proves that our research project could not only be useful for the division of the People's Bank of China but also useful for the whole Chinese economy.

Ten years has passed from the beginning of reform of the monetary system for the market economy in China. But current monetary regulations are not suitable for an “economic system

based on a market economy and private economy.” The bank sector in China has to realize its own assignment in society of providing capital to those sectors that need funds based on its own decision on risk. On the other hand companies also have to make an effort to be reliable borrowers from the point of view of financial institutions. The relationship between bank and company should be based on interdependence and mutual reliance. The fundamental principle of a market economy must be “a society with voluntary sincerity.” The modern market economy consists of competitions under rules based on society of sincerity. People who consider a rule to be unjust must debate to improve the rule.

Recommendation of improvements to the government should be a right and a duty of the nation. Furthermore a satisfactory safety-net must be prepared in a modern market economy. It is the obligation of the government or policy authorities to prepare the safety-net. The role of the government in a market economy must be concentrated to such roles as can be realized only by the government. Otherwise private potential cannot be fully used.

On July 16, 2004, the China Banking Regulatory Commission issued a “Guidance for lending operations at commercial banks” (商业银行授信工作尽职指引). Each of the articles of this detailed guidance is the basic fundamentals of bank lending. From now on, both the China Banking Regulatory Commission and the People’s Bank of China have to regularly conduct audits on compliance of this guidance in each financial institution. In each financial institution, an independent audit team has to check compliance of the guidance in daily business.

Japanese banks also have their own territories. Some banks operate all over Japan and some operate in plural regions. Customers of such comparatively large banks are mainly bigger SMEs or medium-sized companies between large companies and SMEs.

In China, financial support to SMEs in a region should also be conducted by regional financial institutions that have working knowledge of the region, too. Branches of state-owned commercial banks that are not suitable as regional financial institutions for SMEs should be transferred to regional financial institutions. This could result in a policy to develop regional financial institutions.

## **1.2.2 Financial System Reform and Capital Market Development**

### **(1) Financial Needs in SMEs**

There are two different financial needs for SMEs. One is the need for risk money in the start-up of business and the other is the need for growth money to sustain development after take-off of the business. The former need is not met in the framework of the ordinary financial system, because businesses in the start-up stage contain various risks, which are not hedged by traditional financial measures since the uncertainty of the business is usually quite large. On the other hand, the latter need is satisfied through both traditional banking and the capital market system.

### **(2) Main Difficulties Facing SMEs in Meeting Financial Needs**

#### **1) Limited supply source of risk money**

In China, the supply channel through venture capital is narrow and most risk money is supplied via the informal sector such as the business originator's relatives and friends. Venture capital requires profits high enough to match its investment risks. High profits could be gained only when the successful venture business is listed in the capital market and capital gains are available for investors who dispose the listed shares at a high price. It is necessary to develop such an environment in which venture businesses can list their shares on a stock exchange as early as possible, at latest within three to four years after origination.

#### **2) Insufficient supply source of funds for business expansion**

##### **a) Underdeveloped capital market**

As for corporate financing channels, there are two markets, namely the financial market (loan market) and capital market. In China, the financial market is still the main channel and the capital market remains underdeveloped. A substantial amount of bonds and shares are issued. However, the main financial products in the bond sector are government bonds and debentures of public financial institutions. The corporate bond market is almost negligible. Three reasons can be cited for this. First, the government controls the size of bonds issued. Second, the issuing procedure is complicated. Third, the requirements to be cleared in order to issue are too strict. These factors lead to high issuing costs. On the other hand, although the stock market is showing vigorous expansion, the channel is still too narrow for SMEs.

Even in both Japan and the U.S., where the financial system has been well developed, the capital market is not a major financing source for SMEs. However, this fact does not imply that the importance of the development of the capital market development as a solution for SMEs financial problems is only marginal. It is true that the principal beneficiaries of capital market development are large corporations rather than SMEs. However, if large corporations could easily access the capital market for their fund raising, these corporations would convert the financing source from the financial market to the capital market and, as a result, it would become easier for SMEs to raise necessary funds through the financial market.

**b) Lack of diversified channels in the financial market**

In the financial market, four state-owned banks hold more than a ninety percent share of total outstanding loans. Even though commercial city banks and regional banks exist in each city and extend loans to local enterprises, their source is too small to meet the great financial needs of SMEs. In this sense, Chinese financial channels are not diversified.

Further, four state-owned banks are still ridden with non-performing loans. Under such a situation, they tend to become reluctant in providing loans to SMEs whose credit risk is relatively high compared to large corporations. They would rather reduce their loan assets for SMEs in order to maintain their capital adequacy level at international standards.

**c) Lack of new financial products and services for SMEs**

State-owned banks are sometimes criticized for a lack of efforts to develop new financial products and services. As a result, the Chinese financial market remains to be a so-called “plain vanilla” market.

The most serious complaint of SMEs is in regards to “non-collateral” loans. It is quite natural for banks to request collateral against their loans to SMEs, because banks are intermediary institutions, which collect deposits and savings from depositors and lend them to borrowers, and they are not allowed to transfer direct lending risks to depositors. A recent survey by the Federal Reserve Board in the U.S. reveals that even in the U.S., while about 30% of loans to large corporations are those with collateral, around 80% of loans to SMEs still involve collateral,

A credit guarantee is a tool to support non-collateral loans. However the scheme is not well developed in China as indicated by the fact that the performance of credit guarantee institutions remain at low levels. In China, the ratio of guarantee to capital accounts is at the highest only 5 times, while in Japan it is 50 times. This is because the guarantee itself seems to be unreliable.

**d) Crowding out by large state-owned corporations**

State-owned banks could theoretically be a major source of finance for SMEs. On the other hand, these banks’ major clients are state-owned corporations. This is a mismatch for the financing of SMEs. State-owned banks tend to extend their loans to state-owned corporations partly because they feel it is their duty to do so but also because they believe their loans to these corporations are not vulnerable to bankruptcy while loans to SMEs are vulnerable to bankruptcy. In addition, state-owned corporations hold ample collateral, which can be extended to banks. Such a situation brings about the crowding out of SMEs by state-owned corporations from receiving finance.

**e) Lack of specialty**

There is much room to be improved in the strategy of state-owned banks for financing of SMEs. State-owned banks have begun to stress the importance of financing for SMEs and have organized a new section for financing SMEs. However, unlike Beijing City Commercial Bank, their efforts do not seem to bear fruit in establishing “financing for SMEs” as new branded products at this moment. This is due to a lack of specialty in financing for SMEs.

**f) Lack of recognition of importance of disclosure**

There are two types of transactions in the financial system. One is “ transaction with no third party” and the other is “market transaction.” In the former transaction, a financial institution, one party, extends funds to an SME, the other party. In this deal, the SME is requested to disclose its financial information only to the financial institution. So long as the institution is satisfied with the disclosure, the deal is going on. In a market transaction, however, SMEs have to please all parties participating in the deal by disclosing financial data and information. SMEs are not very earnest about disclosure of their financial data and information. This leads to the underdevelopment of the capital market.

**(3) New Challenges in the Financing for SMEs in Japan**

How to strengthen financing for SMEs is a hot issue in Japan, too. Many challenges have recently been undertaken in Japan. If China follows in undertaking these challenges with normalization of the” transaction with no third party between a lender and a borrower” which is stated later and appropriate disclosure of financial data on the borrower, they could add fresh dimensions to China’s “plain vanilla” financial markets.

**1) Non-collateral loan: Covenant finance**

A complaint is often heard from SMEs that commercial banks always request collateral on loans. If SMEs are fully cooperative in the disclosure of their financial data, commercial banks will become comfortable with non-collateral loans since they can fairly evaluate the risks involved in these loans to SMEs.

A new type of non-collateral loan has been recently developed in Japan. The loan is called covenant finance. The concept itself is not new and the scheme has been applied for a long time in sovereign loans to developing countries. In the case of issuing of bonds without collateral, as well, the scheme has been followed. Under this scheme the banks do not request any collateral to SMEs but impose some conditions on their financial position. Even though the conditions differ depending on each case, they generally include leverage ratio (outstanding interest bearing debt/operating profit before depreciation and tax), interest coverage ratio (free cash flow/interest to be paid), debt-service ratio (free cash flow/principals and interests to be paid on debt), net assets, outstanding interest bearing debt, sales and ordinary profits.

**2) Securitization of loan assets: Financial engineering in financing for SMEs**

Securitization is an economic activity to convert financial assets into securities products and sell them to investors. Financial assets include not only bank loans but also trade receivables, high yield bonds, vehicle loans and lease receivables, commercial real estate loans, credit card receivables, computer and equipment lease receivables and loans to restaurant franchisees. The economic features are:

- Convert “transaction with no third party between lender and borrower” to “market transaction among securities issuer and investors”
- Transform simple financial transaction to a sophisticated transaction in which many participants are involved



- Convert simple loan products to more sophisticated products having various risk-return structures (for example, to produce “A,” “B,” and “C” rated products from “B” rated loan products)
- Involvement by various types of institutions in various regions instead of the involvement of regionally limited financial institutions
- Risk dispersion: a type of credit derivative
- An important step of access to the capital market by SMEs
- Disclosure of financial data of SMEs to the market, even though it is indirect and partial
- A new tool for expanding the money supply by the central bank when the bank designates them as suitable securities for collateral of commercial banks’ borrowing from the central bank
- Local people’s contribution to the development of SMEs through investment on the securities products

Japanese commercial banks’ reluctant attitude to provide SME loans urged the Tokyo Metropolitan Government to launch the initiative. Facing SMEs’ difficulties in getting sufficient funds to carry out their daily activities, the Government decided to save these SMEs, which are one of the major economic sectors in Tokyo. These SMEs suffered from shortages in funds when the commercial banks were forced to maintain capital adequacy levels at BIS standards and refrain from expansion of their loan assets and, as a result, they began to adopt stringent loan policies towards SMEs, whose credit risks are relatively high compared to large corporations

Since the first launch of securitized products, CLOs (collateralized loan obligations) and CBOs (collateralized bond obligations) amounting to 380 billion yen were issued in five installments with the collaboration of representative financial institutions. Being stimulated by the Tokyo Metropolitan Government’s initiatives and its success, other regional governments such as Fukuoka prefecture, Osaka prefecture and Chiba prefecture followed with similar programs.

In introducing the scheme to China, the following two conditions should be met. One is to secure as many investors as possible and the other is to secure high quality loans to be securitized.

### **3) A new type of equity investment company: Small and Medium Business Investment Consultation Corporation (SMBICC)**

In the course of their business expansion, SMEs need injection of new capital. They face difficulty in gaining such capital with the exception of listing companies. In the start-up stage, they raise such capital via relatives and friends. Since necessary capital injection becomes large at the expansion stage, it is difficult for them to rely on their relatives and friends for the large amount of capital. As institutions that supply necessary capital to SMEs in their growth stage, there exist three equity investment companies called Small and Medium Business Investment Consultation Corporations in Japan. They were established with the assistance and support of the Ministry of International Trade and Industry (now the Ministry of Economy, Trade and Industry (METI)).

One of these three corporations, the Tokyo Small and Medium Business Investment Consultation Corporation (TSMBICC) was established in Nov.1963 and has invested about 70

billion yen in 1,300 SMEs since its establishment. As an equity investment corporation, it aims to maximize capital as well as income gains from dividends. However, it does not necessarily stick to listing of the SMEs invested in. Even when SMEs list in the stock exchange market, TSMBICC does not always dispose their shares to make capital gain. On the contrary, they continue to hold the shares as a stable shareholder upon the request of the SMEs.

#### **4) Tokyo Stock Exchange: Mothers**

Even in Japan, the stock market has been a narrow source of financing for SMEs. To overcome the problem, Mothers, a stock market for innovative SMEs was opened in 1999. The current number of listing companies is 110. A salient feature is that so long as the SME satisfies several conditions, they can list their shares in a short period of time. In the traditional Tokyo stock market, only corporations having operation records of more than three years are entitled to list. The most important condition is to disclose their financial records and to hold investors relations meetings every quarter.

#### **(4) Strategies for Solutions to Problems**

Since many problems are involved in the financing of SMEs and much time and many resources are required for their solution, it is necessary to design well-thought strategies by clearing the structural relations among these problems and clarifying the priorities for solutions.

##### **1) Normalize the” transaction with no third party between a lender and a borrower”**

The real and fundamental problem for financing of SMEs comes from the fact that a transaction between a lender and borrower is not always normalized from a viewpoint of international standards. The top priority to smoothen the financing for SMEs should be addressed to normalization.

To realize normalization, the borrower should maintain corporate governance and full disclosure of their financial data and have a spirit of serious commitment. The lender should also maintain their corporate governance and follow the best practices of loan operation. The government should develop infrastructures necessary for accelerating normalization such as developing a disclosure system for corporate information, a system for smooth disposition of collateral in the event of default and bankruptcy.

In normalization, it is advised that Chinese banks gain the assistance of international banks. There are many foreign financial institutions, which are specialized in financing for SMEs and record favorable performance. It is advisable for the Chinese government to give them free access to the Chinese market. They will stimulate domestic financial institutions through competition. They will bring in know-how in regards to SME financing, develop new products and services and a new business model for the SME financing business.

Only after normalization, can new products and schemes be developed in SME financing. For example, the credit guarantee ratio will be increased and syndicate loans will be easily introduced. In addition, new products such as covenant finance, scoring typed finance and loans based on fiduciary transfer of movable assets will be developed. In the capital market, new financial products such as private placement bonds with warrant or loans with warrant could be introduced.

### **2) Strengthen the management capability of state-owned banks**

For expansion of SME loans, state-owned banks have to strengthen their financial position by injecting new capital and maintain their capital adequacy level at international standards. It is advisable to set up a new financial institution specialized in SME financing within the existing state-owned bank as one of its affiliates. It attempts to specialize in SME financing by separating the financing for SMEs from financing for state-owned corporations.

### **3) Create institutional finance**

It is impossible to solve every kind of problem pertaining SME finance with normalization. This is because there exists a bias between the credibility of large corporations and that of SMEs. Generally speaking, banks tend to evaluate that loans to large companies are less risky than those to SMEs. Therefore under the economic situation in which the economy expands and every company rushes to financial markets to gain funds for expanded business, SMEs face crowding out by large corporations in terms of financing. To mitigate the situation, a special institutional finance scheme should be designed.

As one measure to strengthen SME finance, it is suggested to set up policy oriented financial institutions specialized in SME finance. However, since institutional finance requires a substantial amount of money, the institutions will be set up mainly with private funds, taking into consideration that the fiscal burden should be minimized. The government places some money as a catalyst by extending a part of the equity, dividend guarantee, a part of the loaned money and a subsidy on interest paid by SMEs under strict conditions.

Depending on the necessity and specifying the purpose, amount and term, the state-owned banks extend loans to SMEs. The funds will be supplied by the Ministry of Finance. The finance scheme should be only temporary because it is to be done for some specific purpose such as emergency loans to SMEs for coping with an adverse situation caused by a drastic change of currency value.

### **4) Accelerate infrastructure development for the capital market**

One infrastructure to be developed is a disclosure system. It is not an exaggeration to say that the development of the capital market depends on the maturity and completeness of the information disclosure system. An equity investment institution's function is necessary for SMEs at the organic growth stage that are not yet financially strong enough to list their shares in the traditional stock market. It is also necessary to develop and improve upon a special stock market for SMEs, where they can realize their listing in a shorter period of time.

### **5) Free access to the international financial market by Chinese corporations**

Free access to the international financial market by large corporations facilitates SMEs to access the domestic financial market more easily because they will be able to raise necessary funds from not only the domestic market but also the international market, and it will serve to minimize the above mentioned "crowding out". The similar phenomenon was observed in Japan in the process of deregulation during the latter half of 1980's. If there is any restriction on access, it should be gradually lifted.

**6) Reform of the current credit guarantee system**

For strengthening the existing credit guarantee system and its better use, it must be reorganized and consolidated. In addition, a reinsurance system should be created.

### **1.2.3 The financial problems of SMEs and implications for the establishment of financial institutions specialized in SME financing**

#### **(1) Problems in fund raising and financial management of SMEs in China**

Problems in fundraising and financial management of SMEs in China will be summarized as follows.

- 1) Many SMEs have no experience of fund raising from financial institutions. Many SMEs in need of funds are not aware of banks' requirements on granting loans. Professional guidelines are needed for SMEs concerning various financing methods.
- 2) Almost all small businesses and newly established businesses are procuring funds for their business from private sources and not from financial institutions. Due to a lack of financial sources, SMEs tend to rely on their own funds or support from their friends and relatives.
- 3) In the case where SMEs have transactions with financial institutions, it is limited to short-term loans. It is not easy to raise long-term funds for equipment investment and operations.
- 4) The financing gap between SMEs and financial institutions will be explained by the Chinese corporate ownership system and land ownership system. SMEs have little property for mortgage. Furthermore it is difficult for SMEs to find proper guarantors.
- 5) SMEs are at the first stage of establishing a modern corporate system and internationalization.
- 6) SMEs' lack of credibility from financial institutions and lack of a credit information system.
- 7) Lack of intermediary organizations and consulting organizations between clients and financial institutions.

#### **(2) Financial problems of SMEs in China**

- 1) Almost all private SMEs are newly established businesses in and after the 1990s
- 2) Turnover periods of receivables are about 20 days longer than those of payables
- 3) Positive in business and investment mind without financial support
- 4) 29% of SMEs are operating without cash flow statements
- 5) 60% of SMEs are provided follow up advisory services after raising funds from financial institutions
- 6) Credit guarantee institutions are not favorable for SMEs in credit analysis procedure nor financing costs

SMEs depend heavily upon short-term financing. It tells, on the other side, the difficulty for them to raise long-term funds, which we will see also from the viewpoint of financial institutions. The long-term financing of SMEs is the field in which private financial institutions are most unwilling to be engaged.

The difficulty in raising long-term funds suggests that the lending in the field needs to be fostered from a point of view that involves the development of the national economy.

**(3) Solutions over financial gap of SMEs**

- 1) Sound accumulation of equity capital (capital and shareholder's equity fund)
- 2) Financial management based on cash flow statements
- 3) Disclosure of corporate management and strengthen relationship with financial institutions
- 4) Public support system for SMEs on financial management

**(4) Implications for the establishment of government financial institutions specialized in SME financing**

**1) The financial structure of SMEs in Japan**

The financial structure of Japanese firms depends heavily upon liabilities to outside sources, especially upon current liabilities. In addition, this tendency is much more evident in Japanese SMEs than in large ones. This is a reflection of the fact that SMEs are practically unable to issue stocks and debentures in the public securities market and have little capacity to acquire stable long-term funds through private financial institutions.

Japanese SMEs suffer from managerial weakness, being placed at the bottom of the economic "dual structure" with large differences in capital size, technology, productivity and wage levels compared to large corporations.

Besides, in the course of the postwar reconstruction and high-pitched growth, financial institutions have formed themselves into a very closed system. While the demand for funds has tended to exceed their supply in the business sector, including both large and SMEs, banks have allotted funds with first priority to large enterprises and generally regard SMEs as marginal borrowers especially when the money market is tight.

The Japanese economy has been possessed by such a financial structure that the connection between the large bank and its related group of large corporations has been strengthened.

In addition to the need of modernizing equipment and catching up with the progress of developed countries, the demand for funds is so large on the part of SMEs in adapting themselves to the new socio-economic situation that the financing of SMEs would continue to be important.

**2) The importance of SMEs in Japan**

After World War II, the various entrepreneurships of SMEs were the driving force behind Japan's fast-growing economy. SMEs are an indispensable part of the nation's industrial structure and have developed and diversified in response to environmental changes in the domestic and international economies.

The Japanese government was quick to recognize the economic importance of SMEs and adopted a number of key policies to support their development.

Private financial institutions serving SMEs include city banks, regional banks, second regional banks, credit associations and credit cooperatives. Since they operate on a commercial basis, they are not always able to provide SMEs with appropriate amounts of loans on favorable repayment conditions, particularly in the case of business start-ups.

To solve some of the problems involved, the government established several government financial institutions, including National Life Finance Corporations, the Shoko Chukin Bank and the Japan Finance Corporation for Small and Medium Enterprise (JASME).

Lending to SMEs by these institutions accounts for about 10% of all lending. Such lending tends to increase during recessions, when it is difficult for SMEs to obtain loans from private financial institutions. Government financing thus plays an essential supportive role in the SME business sector, especially during economic downturns.

JASME was originally established to mainly provide SMEs with long-term facility and operating funds.

In order to implement its management philosophy of providing both funding and information on how to use it, JASME endeavors to grow SMEs by continuing to supply information and advice on solving management problems from a fair and impartial point of view, not only when supplying funds but afterwards as well.

SMEs must have access to stable, long-term funding if they are to develop and grow smoothly because of the need to make timely and appropriate plant and equipment investments and strengthen their financial health on a continuing basis.

Compared with large businesses, the fund-raising options open to SMEs are limited because of difficulties in procuring funds from the capital markets and other problems.

Moreover, lending by private financial institutions tends to focus on short-term funding for one year or less, so there is not enough long-term funding available for SMEs. Against this background, it is necessary to establish government financial institutions specialized in the long-term funding that the private financial institutions find difficult to provide.

### **(5) Role and function of government financial institutions specialized in SME financing**

- 1) Supplementing private financial institutions and stable supply of long-term and fixed-rate funds. Serves as a buffer and safety net for SMEs.
- 2) Providing various types of finance in accordance with the government's SME policy. Serves as a pump-primer for private financing.
- 3) Appropriate and efficient financing for SMEs as an expert in SME financing.
- 4) Providing information and advisory service to enhance relationship banking functions and to realize the development of SME.
- 5) Nationwide network with equal loan conditions for SME financing serves as a supplement to private financing especially in local areas.
- 6) Direct financing systems provide new financial opportunity for SMEs in addition to existing private financing, credit guarantees and venture business investing.

### **(6) Key factors for establishing government financial institutions specialized in SME financing**

- 1) Supplementing and cooperation with private financial institutions not to distort private initiative and market oriented economy. Limited share and loan conditions in the SME

financial market.

- 2) Study of administration costs government budgets as a fund source. Study new fund sources such as bonds, private funds and overseas funds.
- 3) Introduce financial schemes in accordance with government SME policy. Provide loans to meet the needs of the times such as loans for new businesses, management innovation, environment protection and local economic stimulus.
- 4) Provide information and advisory services to SMEs with neutral and long-term approaches.
- 5) Cooperate with private financial institutions, local government and industrial cooperatives to enhance relationship banking and to establish an SME support network.



### **1.2.4 Human Resource Development Policy for Strengthening SME Management Capacity**

#### **(1) Major problems identified and necessary perspectives on human resource development**

Public institutions should consider developing and implementing policies for human resource development for SMEs from the following two perspectives:

- a) To design and implement systematic and uniform support including human resource development for SME business management, in order to form a solid foundation of human resources playing an important role in the development of the SME sector in the medium and long term; and
- b) To make up for the lack of resources for management faced by individual SMEs, in the short and medium term.

#### **(2) Human Resource Development Policies and Systems for SMEs in Japan**

##### **1) Support programs for SME management and human resource development**

Taking into consideration the weak management bases of SMEs in comparison to large-scale enterprises, the Japanese SME policy attaches importance on supporting SMEs to secure “soft” resources such as management know-how, technology and other information. Based on this policy, support measures are organized systematically and consistently nationwide. The following two sets of measures are particularly important components of the policy:

- a) Business support centers are established at various levels of government, i.e. national, prefectural, and local levels, so that SMEs can choose the appropriate center to consult with or receive support from, based on the nature of their business and their individual problems. Across the nation, 260 Regional SME Support Centers, 59 Prefectural SME Support Centers, and 8 SME/Venture Business Support Centers are to be established.
- b) Human resource development for SME promotion, including training for persons responsible for SMEs support, is advanced on a national basis by the Institute for Small Business Management and Technology and by the Small and Medium Enterprises Management Consultant (SMEC) system. The nationwide schemes enable SMEs in any region to receive uniform and high-quality support services.

##### **2) Outline of the Institute for Small Business Management and Technology**

The Institute for Small Business Management and Technology is one of the main pillars of human resource development policies for securing SME management resource bases. The Institute is established by the Organization for Small and Medium Enterprises and Regional Innovation to provide practical training in advanced business management and specific subjects for SMEs, as well as training for persons responsible for SME support. The Institute is highly regarded as an organization that renders comprehensive support to SMEs, based on the national policy on human resource development for SMEs.

### **3) Training programs provided at the Tokyo Institute for Small Business Management and Technology**

The Tokyo Institute for Small Business Management and Technology is playing a central role in the activities of the Institute, offering training to about 130,000 people to date.

For example, a wide range of programs have been prepared for training SME personnel at different levels and in different sections. Many programs are organized under a variety of themes, so that persons at all levels of the company such as executive, middle-management and staff can find programs that are appropriate for them. Thus, for individual enterprises that cannot afford to fully provide their own training in response to the various needs of the employees, the programs of the Institute will help them increase their overall knowledge and skill level.

In addition, the Tokyo Institute is providing a training course to foster Small and Medium Enterprises Management Consultants, in order that the candidate students acquire knowledge and methods on business diagnosis of SME management and to be able to propose appropriate measures for improvements in business activities. Since Small and Medium Enterprise Management Consultants are expected to have intensive and extensive knowledge on a wide range of SME management issues as experts in providing consulting services to SMEs, the program of the Tokyo Institute covers a variety of subjects that the students are required to take.

### **4) Effect of measures for securing management resources of SMEs**

The Policy Evaluation Report produced by the SME Agency shows that the above-mentioned measures have played an important role in securing SME management resource bases in Japan. Regarding the support measures carried out by the three types of SME support centers, the majority of users were “satisfied” or “satisfied to a certain degree” with the services provided by the centers. In addition, a substantial proportion of users answered that their problems were “solved” or “solved to a certain degree” by receiving the services.

In regards to training programs for trainees from SMEs as well as government organizations by the Institute for Small Business Management and Technology, more than 90% of the participants highly evaluated the programs on the whole. About 80% of the lecturers in the Institute have been given high value by the course participants, in terms of their level of understandability and usefulness.

### **(3) Future orientation of SME management support and human resource development**

#### **1) Establishment of systematic and uniform support for SME management and human resource development**

It is essential to develop and improve the human resource base in SMEs, for instance, by fostering people with high management capacity or technical skill, in order for SMEs to achieve further growth by acquiring competitiveness and to gain major recognition commensurate with the increasing size and role of the SME sector in the national economy. Establishment of a systematic and uniform support system would greatly contribute to the enhancement of the general level of human resources at SMEs. However, detailed structure and program design of the support system including the degree of uniformity and the division of roles between different administrative levels should carefully be considered in the context of the actual

situation in China.

While sufficient time would be needed for establishing the most appropriate system for China, the following are the important items which can be promoted immediately: the diversification of the service menu for SMEs and the training of persons engaged in SME support. Enhancement of these immediate measures would be advanced in existing public support institutions such as SME Service Centers as a core.

## **2) Response to technological innovation and globalization**

The trend of technological innovation and globalization has rapidly been changing the business settings of enterprises, including business models, the competitive environment, and geographical coverage. How SMEs with relatively scarce management resources can cope with these changes is a common challenge in many countries. In particular, it would be important to strengthen support for human resource development in SMEs in the following areas.

### **a) Support for IT-based systematization in SMEs**

It is important that small-business owners themselves understand fully the effects and problems of IT-based systematization when they consider introducing it. Human resource development in IT should therefore be targeted at managers as well as the staff in SMEs by providing IT seminars or training programs and such. In this case, it is crucial to consider the characteristics of the enterprise in question, such as its line of business and the current progress of systematization.

### **b) Support for promoting utilization and acquisition of patents**

Measures for developing human resources engaged in patent work should be steadily promoted in order to encourage patent acquisition by the SMEs that have developed original technology, and utilization of patent information so that SMEs can efficiently facilitate technology development.

### **c) Measures for globalization of SME business**

While globalization encourages more and more SMEs to pursue business abroad, providing support to these enterprises would be needed more than ever by providing necessary information and strengthening human resources engaged in foreign business.

### 1.2.5 Procedure of Loan for SME's of commercial banks in China

The fundamentals of lending operations are “to understand the facts of the company,” regardless of if the lender is a commercial bank or governmental financial institution. In other words, it is to let all the real facts be disclosed based on any phenomena and information mainly from the points of view of “personnel,” “products” and “money.” Lending procedures to large companies should be “thorough” in terms of correcting any missing parts of such fundamentals or fixing in advance the conclusion of appraisals. Moreover, any parts of the process to investigate “the facts of the company” with all the related phenomena and activities based on frequent visits cannot be neglected. Considering this, requirements in lending procedures to SMEs are no different to the usual requirements in lending procedures.

In Japan, private financial institutions have the largest share in the market of lending to SMEs among various kinds of financial institutions. In addition, the role of policy and governmental organizations is supplementary to such areas, as these cannot be supported by private financial institutions. Lending by governmental financial institutions, institutional lending by regional governments and lending guaranteed by credit guarantee corporations are also executed through private financial institutions.

Considering the above, in order to promote lending to SMEs it is required for private financial institutions to revise and improve lending procedures in private financial institutions. And in order to consider a policy to promote lending to SMEs, including establishment of governmental financial institutions, it is required to gain an understanding of lending procedures in private financial institutions and not to ignore the operations and benefits of private financial institutions.

We found an important fact, which should be a natural fact, that most of the workers of financial institutions correctly understand what is required by lending operations and they are making the best effort as far as policies and public practices admit. And a few small regional private commercial banks have already taken such requirements in their management policy. Unresolved issues are that such results of efforts have not yet reached management of large banks or governmental monetary policies.

The Chinese government has already started monetary policies and governmental bank audits based on what is called “global standards” including BIS regulation, etc. Procedures of credit rating or assessment on assets in Chinese commercial banks are not so different with those of Japanese banks. The governmental department in charge of banking policies, to begin with, has to grasp the daily operations of domestic banks and hear the opinions of lower workers. Then they should begin considering required reform. After that if any issues are unresolved, they should consider experiences in other countries.

In commercial banks, especially state-owned commercial banks and joint equity commercial banks, individuals should not excessively be responsible for results of operation. Assignments and responsibilities of a division or department should be clearly defined in procedures. And such procedures should, whenever necessary, be revised based on opinions by excellent workers. At consideration of introducing operation procedures from other countries, superficial observation is not to be recommended but rather detailed consideration on every operation is required. But we recommend that cooperation with foreign commercial banks should be based

on commercial relationship considering confidentiality and compliance.

We would like to contribute to the development of the banking business in China by introducing skills of Japan and Western countries. But we do not think such skills should be applied to China as is. The Chinese must analyze the situation in China and improve skills as is suitable to China.

As introduced, Japanese banks developed a method to analyze facts of the company based on detailed cash flow long before the concept of cash flow projection was introduced from America. It is an excellent skill for lending to SMEs. In Hong Kong practices, “Local L/C” is adopted for domestic transport. Such skills are developed by bankers in charge of daily operations who made effort to construct practice to minimize risks based on local trade practices.

The people of Shanxi Province developed a system for promissory notes (山西票庄). Some researchers say B/S was used in the Yuan Dynasty (元). It is quite important not to ignore such traditions and to be dedicated to apply skills of such tradition to the modern economy. Private financial institutions (商号·钱莊) were committed to avoid risks and to improve operation control during the confused era from the last stage of the Qing Dynasty (清) to the establishment of the People’s Republic of China. This history should be respected as the process of effort by the Chinese to construct a financing system and should not be ignored as an important event before the revolution. If commercial banks in China make an effort to improve the financing system, they should be a reliable partner of Japanese and Western commercial banks in China and international finance market.

### **1.2.6 Consolidation of the credit guarantee system in China**

#### **(1) Difficulties in the trial period**

Credit guarantee systems in the People's Republic of China are new economic systems that were put in place during the 1990s.

In those days, the market principle was introduced to the Chinese economy, foundation and fosterage of SMEs were actively pursued in various places, and a family of private companies entered the economy, which had been based previously on conventional state enterprises. In the beginning, there were many people who started enterprises with funds borrowed from family, acquaintances or co-workers. Accompanying the growth of enterprises, also, was the increased demand for borrowing funds from financial institutions.

On the other hand, in the financial arena centered on state-owned banks, a new situation arose where private banks gained power and responded to SMEs active demand for funds. While a new system to combine SMEs and financial institutions was being developed, many credit guarantee institutions have been established around the country under the guidance of the State Economic and Trade Commission (SETAC) since 1998. SETAC dealt with matters in this period of new system establishment, under a slogan of "One Body with Two Wings." Concretely, they promoted two kinds of institutions: publicly funded government-driven credit guarantee institutions, and those using private funds and led by the private sector.

With concern drawn to credit guarantee systems, in response to this government's guidance, over 1,000 credit guarantee institutions were established in various locations in China in only a few years. This movement toward credit guarantee systems proceeded simultaneously with an effort to establish policies to foster SMEs, a new economic policy for the People's Republic of China. All were trial-and-error work for any person involved. Actions were hastily started before agreements and preparation had been fully completed in various aspects such as laws, system operation and arrangements of funds.

Naturally, malfunctions and discrepancies arose in various fields and came into the open. Particularly, small credit guarantee institutions were short of funds, and those with a low maximum rate of guarantee lost the ability to guarantee credit even in the early stage and fell dormant. Once the ability to guarantee credit declines, fund-raising becomes difficult and concerned people lose their bearings. Credit guarantee systems came to face such difficulties.

#### **(2) Promotion based on law ( 依法 )**

In 2003, the SMEs Promotion Law ( 中小企業促進法 ), which is the basic law for policies for SMEs in the People's Republic of China was enacted, and the "trial period" is ending now at last. The SMEs Promotion Law recognizes both credit guarantee institutions established all over the country, which are established with government funds, and those established with private funds. As for the latter, shareholders expect, from the beginning of the establishment, profits and

dividends to pay back the capital supply. The latter institutions expect profit earning by priority and are also engaged in other financial-related business, such as capital investments, intermediary services and procurance, from which high-rate profits can be expected.

In parallel with preparation and enforcement of the SMEs Promotion Law, the Division of Small and Medium sized Enterprises(中小企業司) recommended these two kinds of credit guarantee institutions to join the "national credit guarantee system for SMEs" (全国中小企業信用保証体系), and began efforts to grasp and restructure all credit guarantee institutions scattered around the country. Approximately 1,000 institutions have registered now, but there are also many unregistered credit guarantee institutions.

"The Regulations for SME Credit Guarantee Management"(中小企業信用保証管理弁法), which sets concrete provisions for execution of credit guarantee systems based on the SMEs Promotion Law, is being prepared now. Here, credit guarantee systems in the People's Republic of China mark a new epoch in the "trial period" and are entering an age of "promotion based on law."

### **(3) Present issues**

Actual conditions of credit guarantee systems in the People's Republic of China were grasped from this investigation in a comprehensive manner for the first time. In this investigation, interview surveys and opinion hearings through local seminars, as well as questionnaire surveys, were carried out. The investigation was comprehensive and covered financial institutions and SMEs in addition to credit guarantee institutions. As a result, the following issues came into the forefront:

#### **1) The object of systems is not defined**

Credit guarantee institutions in the People's Republic of China are roughly divided into two kinds - 1) those in which government funds are injected, and 2) those in which private funds are injected. In fact, these institutions are further differentiated due to circumstances of the foundation and according to guidance, shareholders, and methods of providing capital. Such differentiation and diversification brought about differences in fundamental understanding and operating policies of credit guarantee systems, and operational discordance is arising among SMEs and financial institutions.

#### **2) Tightness of funds**

Small institutions cannot maintain guarantee funds with high liquidity and an appropriate maximum rate of guarantee. Furthermore, their business structure and work contents lack unity. Needless to say, they have encountered many internal problems. With smaller guarantee funds and a maximum rate of guarantee as low as about five times, undertaking even a small amount of credit guarantee leads to the "limit" of business activities. Moreover, it is difficult to

introduce a large amount of additional funds and, as a result, many institutions have fallen dormant.

### **3) Credit guarantee institutions without other business**

Actually, there is a mixture of institutions engaged solely in credit guarantee and those also engaged in other business. Although it is desirable to reorganize them, "The Regulations for SME Credit Guarantee Management" have yet to be enacted. Incidentally, expectations for credit guarantee institutions are great in the financial scene of smaller enterprises; nonetheless, functions of credit guarantee systems do not work practically because sufficient acknowledgement and evaluation have not been firmly established.

### **(4) Fundamental principles of credit guarantee**

Only East Asian countries such as Japan and Korea have succeeded with credit guarantee systems as a social policy and have realized a massive amount of credit guarantee. A social system will become successful only if it is based on and suitable for conditions of the country, the society, and the economic climate. Fundamental principles of credit guarantee systems are, however, common. Philosophy and fundamental principles cannot be obtained until abundant experience in system operation is acquired. We hope that concerned people in China will pay attention to the "fundamental principles of credit guarantee" drawn from actual achievements in the history of the East Asian region, particularly, Japan.

Those to which attention should be paid especially are basic conditions of credit guarantee systems which are summarized in the following five items:

- 1) Public-service institutions covering the whole country
- 2) Institutions specialized in credit guarantee services
- 3) Institutions open to all SMEs and financial institutions
- 4) Institutions with strong creditability
- 5) Institutions with capable human resources

Work of credit guarantee institutions is unstable; therefore, it is financing for diverse smaller enterprises. This financing always contains "accidents and risks" such as bankruptcy, insolvency, and business depression. Credit guarantee work is work in the anticipation of, and on the assumption, of "huge expenses" of subrogated payment from the institutions own funds.

To continuously develop this work on the assumption of such risks, as a social system and as a stable business, the following must be developed: ability of appraisal and investigation to make appropriate decisions regarding management of smaller enterprises with few real assets that can serve as collateral, active involvement by financial institutions, securement of ample funds for subrogated payments at all times, and benefits which can be enjoyed from the



system equally all over the country covered.

The ultimate objective for this purpose is realization of the "sea of credit guarantee." This means that a stable and continuous business shall be established according to the principle of large numbers where impacts of risks are relatively reduced by a lot of credit guarantee business achievements.

#### **(5) Improvement of credit guarantee systems in the People's Republic of China: Recommendations**

Based on the fundamental principles of credit guarantee, measures for near-term system improvement are observable through this study. However, the reality of credit guarantee systems in the People's Republic of China is that they are still far from perfect.

##### **1) Sharp distinction of credit guarantee institutions**

There are already four kinds of credit guarantee institutions in the People's Republic of China, with consideration given to the main classifications only. Either through government finance or private funds, and whether they are engaged in credit guarantee affairs only or also engaged in other business are key elements for classification. Besides these, there are diverse corporate structures with various kinds of characteristics. In order to make steady progress from the "trial period" to the period of "promotion based on law," it is necessary to improve these business structures. More concretely, there is a task of clarifying the criteria for determining what should be developed preponderantly within the limited financial funds.

It is expected that credit guarantee institutions "without other business" (as targets of national fiscal support) will be sharply distinguished from others and they will be fostered when "The regulations for SME credit guarantee management" is established.

##### **2) Formulation of a national system**

Although credit guarantee institutions are operated as private businesses, often their social role is that of a public institution for public benefit.

Activities of credit guarantee institutions can stabilize the local economy and society, and provide economically beneficial effects to foster vital smaller enterprises and promote sound finance, both of which support an open economy for the People's Republic of China.

Credit guarantee systems should not be considered as mere organs for financial measurements in the local economy, but as important social systems and public-service organs. Benefit of the systems should be enjoyed equally over the whole country covered by the network.

Presently, there are about 1,000 institutions in existence located disproportionately throughout the People's Republic of China, while there are even places without any institutions. Specifically, it is expected that these institutions will be consolidated into 100 institutions with regional monopolies in provinces, autonomous regions, municipalities directly under the Central Government, principal cities or others as a target place for business transactions. These institutions will be newly established to span the entire region. Naturally, a nationwide umbrella organization to control them will become necessary.

### **3) Unification of systems**

Unification of credit guarantee systems is inevitable since it remains a pressing matter of convenience for SMEs, convenience of utilization of guarantee for financial institutions, mutual qualitative improvement of credit guarantee institutions, and penetration of policies. For this purpose, it is necessary to: establish an umbrella organization through coordination between Division of Small and Medium sized Enterprises and the People's Bank of China, set up exploratory commissions with business people as central figures, and standardize work contents, contracts, criteria and forms of credit guarantee affairs.

These operations should be linked with on-going planning of "The regulations for SME credit guarantee management" and there is only a little time left.

### **4) Reguarantee systems**

Once credit guarantee affairs are started fully, current expenditure of subrogated payments corresponding to the size of credit guarantee is inevitable. As a result of this expenditure, liquidity of funds on hand of credit guarantee institutions will be damaged, which will affect the basis of credit guarantee systems. Therefore, active measures, in the form of reguarantee systems, for liquidation of receivables must be prepared in addition to introduction of additional funds and control of maximum rate of guarantee.

The current reguarantee system in Japan, called "credit insurance," is a system where guaranteed debts undertaken by credit guarantee institutions are inclusively reguaranteed. Meanwhile, a certain portion of the amount of subrogated payment is compensated when default occurs, and, eventually, liquidity of receivables held by credit guarantee institutions is maintained. As to collection through recovery of the indemnity right, the equivalent amount is returned to the reguarantee institution.

This reguarantee system has not been formulated in the People's Republic of China. It is reasonable to make haste with its formulation, taking the present time when the trial period of credit guarantee systems is coming to an end as the best opportunity.

### **(6) Ground design**

Improvement of credit guarantee business in the People's Republic of China must be carried out resolutely, carefully, and boldly according to the plan with importance attached to the above-mentioned points. In so doing, it is effective to indicate an immediate ground design showing rough figures to concerned parties and interested parties. (A table of estimated calculation is to be presented in the text.)

Of course, it is a matter of the national policies of the People's Republic of China (now entering the period of promotion based on law) how credit guarantee systems in this country should be formulated and advanced. The following descriptions are our policy recommendations and expected values to overcome the present difficulties, based on the opinions of the specialists who carried out this Study, which have been obtained from the analysis of this Study.

- 1) The more than 1,000 existing institutions shall be reduced through reorganization and restructuring, and 100 institutions with a regional monopoly for each province, autonomous regions, municipalities directly under the Central Government, principal city or other area shall be placed to cover the whole country.
- 2) Institutions engaged solely in the credit guarantee business shall be fostered preponderantly.
- 3) A reguarantee system shall be set up.
  - \* Reguarantee rate: 70 - 80%; Reguarantee fee rate: 0.8%
- 4) Ten billion yuan as resources to support funds of credit guarantee institutions and five billion yuan as funds for foundation of reguarantee institutions shall be invested soon.
- 5) Contents of credit guarantee and immediate goals of percentage of main items
  - \* To achieve the credit guarantee debt size of 2 to 3 times that at present in about five years.
  - \* To realize maximum rate of guarantee of 10 times and further aim for 30 times.
  - \* Credit guarantee rate: 100%
  - \* Rate of increase of guaranteed debts: 120%; credit guarantee fee rate: 1.2%; rate of subrogated payments: 2%; rate of collection: 50%; expense rate: 1%; current ratio: 80%

# **Outline of the Study**

## 1.3 Outline of the Study

### 1.3.1 Background and Objective of the Study

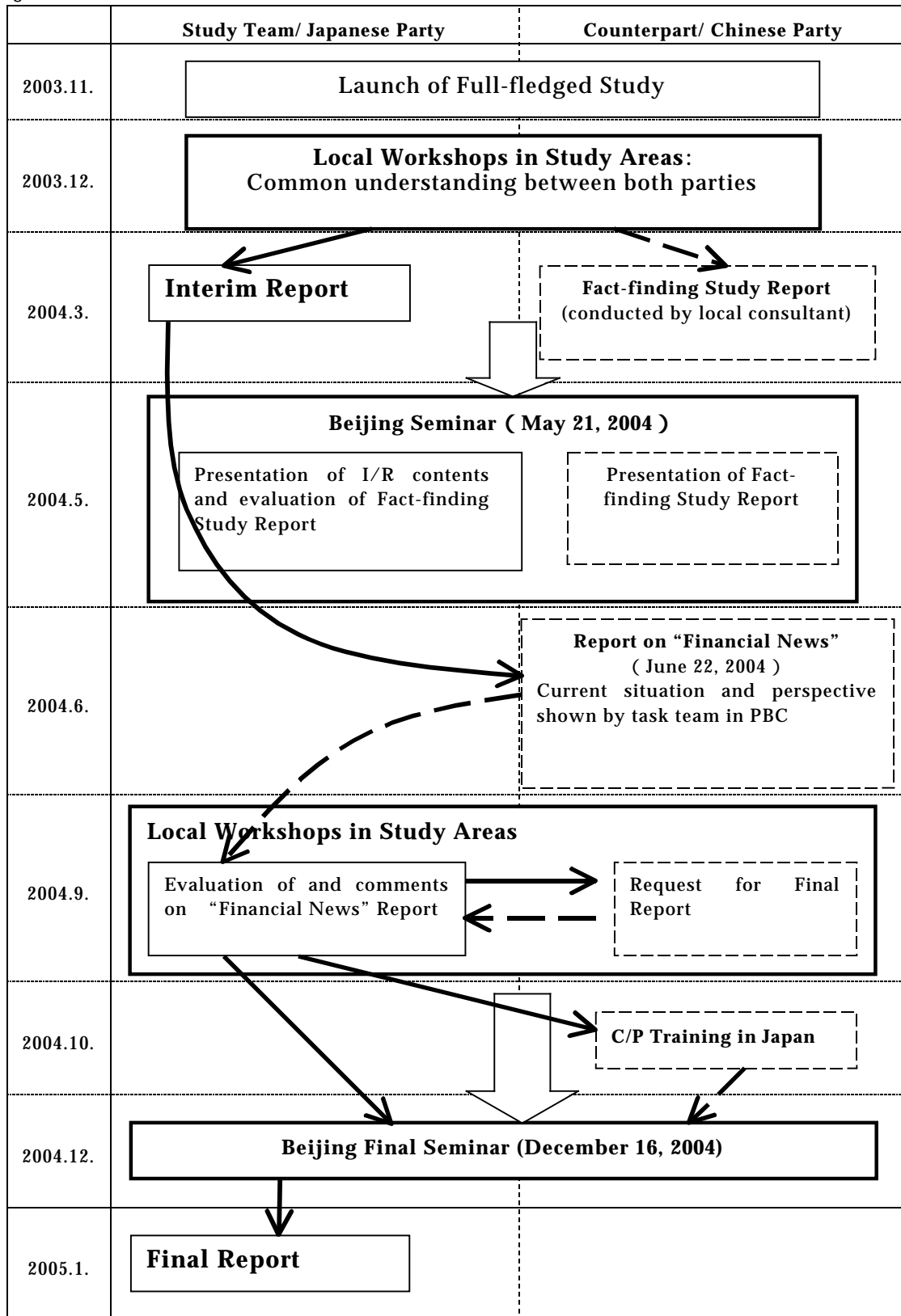
Small and medium sized enterprises (SMEs) account for 95% of the total number of enterprises, 60% of the increased value in industrial production and 40% of the total paid amount of tax on profits in the Chinese economy. SMEs in China widely cover light industries and supporting industries including food, textile, stationary, and IT software and hardware. It is expected that SMEs will play greater roles than ever before in the development of the Chinese economy, along with the shift from a labor force concentrated on agriculture to one concentrated on industry as a result of urbanization, the increased pressure on employment creation due to further reformation of state-owned enterprises in the city areas, the advancing and specializing of industries, and the softening of the economy. However, one major factor that is blocking the development of SMEs is the difficulty in procuring funds in conjunction with the credit crunch of lenders, which has in recent years appeared as an extremely serious problem for the Chinese economy. The People's Bank of China began to tackle this problem by strengthening and expanding financial services for SMEs through a variety of measures. However, these efforts have ironically led to the expansion of non-performing debts due to inadequate risk management for loans to SMEs by Chinese financial institutions, which in turn has created a credit crunch.

The fundamental factor behind the difficulty in procuring funds caused by the credit crunch is the borrower. In other words, the risk of financing SMEs is too high. Simultaneously, backing systems are still inadequate to avoid or absorb such large risks. The problems concerning SME financing are complex and diverse including systematic problems, policy problems, lender risk management problems and SME management fragility. Consequently, there is a need to introduce comprehensive resolutions.

The objectives of this study are described in the following two points with due consideration given to the above conditions concerning SME financing in China.

- What kind of SME financing system reformation needs to be executed to construct a financial system that enables the growth of financing of SMEs? A proposal shall be provided after sufficient consideration of Chinese conditions, SME needs and feasibility.
- The transfer of knowledge and skills via this study to the policy representatives and affiliated support institutions of related Chinese institutions centering on the Chinese People's Bank in order to support improvement of the capacities of parties related to the development of SMEs.

Figure 1.3.1 Work Plan



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### 1.3.2 Task Implementation Methods

This study was implemented based on the work plan shown in Figure 1.3.1. The work items performed are as follows:

#### <First year>

In the first-year of the study, the following preparatory work was conducted in Japan.

#### (1) Collection and analysis of information and materials related to the SME financing system in China

Materials and information on the following items that could be obtained in Japan were collected, analyzed and organized.

- 1) Background and history behind preparation of the SME financing system in China
  - Economic and social background, changes in financial policy, system reformation, implementation of SME promotion measures, etc.
  - Various measures and legal systems related to SME promotion policies and SME financing
- 2) Results of the past study and research on SME finance in China conducted by Chinese or Japanese research institutions
- 3) Status of the support in the SME financing area of international institutions and other donors
- 4) Conditions in candidate locations for the study
  - Economic structure, industrial structure, social conditions, SME characteristics, SME financing characteristics, etc.

#### (2) Collection and analysis of information and materials related to Japan's SME financing system

In order to employ a summary of the SME financing system in Japan and focus on content that will serve as a reference for conditions and themes in China, information on the following items was collected and analyzed.

- History of SME development
- Overview on the history of SME promotion policies
- History of SME financing policies
- Implementation of the SME financing system
  - Overview of the present system
  - Organizational form, fund amounts and source of funds for each player
  - Historical development
- Implementation of measures concerning SME financing

- Preparation conditions of economic infrastructure for supporting SME financing
  - Financing screening environment for financial institutions
  - Corporate accounting system
  - Credit guarantee system

The above study results were organized and a compilation of materials was prepared for the kick-off seminar.

**(3) Preparations for Holding the Kick-off Seminar**

Materials were prepared for the kick-off seminar to be held in China during the second year.

**(4) Establishment of an Overall Plan for the Study**

The content, methodology, schedule, personnel, image of results, skill transfer items, transfer method and requests concerning the People's Bank of China (counterpart institution) concerning the overall study were compiled.

**(5) Preparation for Fact-finding Study on SME Fund Procurement**

An initial preparation was made for the fact-finding study on SME fund procurement. The study intended to survey the actual conditions of SME financing from the side of SME financing institutions (supply side) as well as SMEs (demand side). The study team examined detailed survey items and methods, including the employment of a local consultancy service for the implementation of the study.

**(6) Preparation and Mailing of Inception Report**

The Inception Report containing the study results for the preceding (1)-(4) was prepared. This report was mailed to the Chinese side in advance via the Japan International Cooperation Agency (JICA) China Office.

**(7) Holding of Advisory Committee for the Study**

For the purpose of effective implementation of this study, the Advisory Committee, established by JICA, was held. In the committee, the study team explained the basic policy and the work items of the study to the committee members, based on the inception report.



## <Second Year>

In the second-year of the study, the study team conducted the following work items.

### **First Fieldwork in China**

#### **(1) Ex-ante coordination for the study**

Since the launch of the second-year study was forced to be delayed due to Severe Acute Respiratory Syndrome (SARS), the study items and procedure (including planning of utilizing local consultants) were freshly discussed between the study team and the Chinese counterpart.

### **First Home Office Work in Japan**

#### **(2) Preparation for Second Fieldwork in China**

In order to prepare for the starting of the full-scale study from the second fieldwork in China, the study team made necessary adjustments to the study content and the implementation system including preparation for the bidding work for employing local consultants.

### **Second Fieldwork in China**

#### **(3) Holding of Kick-off Seminar**

A kickoff seminar was held on October 31, 2003 with the main themes of explaining the inception report and the exchange of views on the basic policy, content and methods of the study between participants. The participants included the study team, the Research Department of the People's Bank of China and personnel from the branches of the PBC in the targeted areas of the study. Ms. Mariko Watanabe, M Phil., Researcher of the Institute of Developing Economies, Japan, was invited as a lecturer to the seminar, where she presented the theoretical stance on implementing the study and her views on the present conditions of the SME financing system in China.

#### **(4) Collection of Basic Information and Grasping of Current Conditions concerning the SME Financing System Reformation**

In order to grasp the current conditions and issues of the SME financing system as a part of the analysis of current conditions of SME financing in China, the study team organized and analyzed public statistics and other materials and information collected in the fieldwork.

#### **(5) Study on Current Conditions concerning Policies, Legal Systems and Measures concerning SME Financing and Implementation of Fact-Finding Study on SME Fund Procurement**

For the purpose of identifying current conditions concerning policies, legal systems

and measures concerning SME financing, the study team, in cooperation with the Chinese counterpart, conducted interviews with governmental organizations such as the Small and Medium Enterprise Department of the National Development and Reform Commission, state-owned banks including the Agricultural Bank of China and the Industrial and Commercial Bank of China and other financial and credit institutions. In addition, the study team interviewed SMEs, which stand on the demand side of SME financing.

The study team signed a contract with a local research institution on November 18, 2004, after negotiations with the institution followed by JICA's approval, on the implementation of questionnaire and interview survey for the fact-finding study on SME fund procurement.

#### **(6) Preparation and Submission of Progress Report 1**

The study team prepared and submitted Progress Report 1 in order to present the results from the study up until the second fieldwork and the current progress.

#### **Second Home Office Work in Japan**

##### **(7) Organization and analysis of the second fieldwork**

We organized and analyzed the results from the second local fieldwork, intending to make use of the results at the first workshop planned to be held during the third fieldwork.

#### **Third Fieldwork in China**

##### **(8) Execution of Additional Studies**

A study was conducted for obtaining additional information necessary to grasp the current conditions on the SME financing system in China, including interviews with the Beijing SME Service Center and small enterprises and financial institutions in the study areas.

##### **(9) Holding of First Workshop**

The first workshop, which was composed of a series of discussion type meetings in the study areas, was held for the purpose of explaining the study result up to that point and exchanging participants' views on the results. The "Japanese experience" in SME financing was also reported on this occasion. At the end of 2003, the workshop was held in Beijing on December 4-5, in Dongguan/Shenzhen on December 17-21, in Wenzhou/Taizhou on December 21-24, in Xi'an on December 24-26, and in Weihai on December 24-26. It was held separately for SMEs, banks, and credit guarantee institutions in each area.

### **(10) Evaluation of the Current SME Financing System in China and Examination of Emphasized Issues**

Based on the study result up to that time, the study team evaluated the current SME financing system in China and examined priority issues for the development of the system in the medium term.

#### **Third Home Office Work in Japan**

### **(11) Preparation of Interim Report**

The interim report was prepared based on the study results up until the third fieldwork.

#### **<Third Year>**

#### **Fourth Fieldwork in China**

### **(1) Explanation and Discussion of Interim Report**

The content of the submitted interim report was explained to and discussed with the Chinese side.

### **(2) Holding of First Seminar**

In cooperation with the Chinese counterpart, the study team held the seminar prepared during the third home office work in Japan, with the objective of improving the capacity of related Chinese parties to establish policies and plans for SME finance. The content of the interim report was presented and discussed.

### **(3) Studying of Desirable SME Financing System**

Taking into consideration the results of the first seminar, the study team examined the necessary policies, legal systems and measure implementation systems for achieving the medium and long-term objectives to resolve the emphasized issues identified in the process of this study.

### **(4) Preparation and Submission of Progress Report 2**

Progress Report 2 presenting the progress of the study was prepared and submitted.

#### **Fourth Home Office Work in Japan**

### **(5) Organization and Analysis of Fourth Fieldwork Results**

The study team organized and analyzed the fourth fieldwork results including comments on the results from the Chinese side. Based on this, the team started preparing improvement proposals that would be included in the final report of this study.

**(6) Preparation of Second Workshop**

The study team conducted the preparation and coordination work of the second workshop and prepared necessary materials.

**(7) Preparation for Counterpart Training in Japan**

The study team held discussions with JICA to finalize the curriculums and organization for the counterpart training, taking into consideration the needs of the counterpart. The team then made arrangements for the training.

**Fifth Fieldwork in China**

**(8) Studying of Specific Measures for Improving the SME Financing System in the Medium to Long-term**

Based on the work results to this point, the study team examined specific and practical measures for improving the SME finance system in China in the medium and long term.

**(9) Holding of Second Workshop**

The second workshop was held for the purpose of explaining the study result up to this point and exchanging participants' views on the results. The workshop also had the objective of improving the capacity of related Chinese parties to establish policies and plans for SME finance. The workshop was held in Wenzhou and Xi'an in September 15 and 21, 2004, respectively. As special lecturers other than experts in the study team, two Japanese experts were invited to the workshop in both cities.

**Fifth Home Office Work in Japan**

**(10) Holding of Advisory Committee for the Study**

Based on the results of the study, the study team prepared an initial draft of the final report and explained it to the advisory members on the advisory committee.

**(11) Preparation and Submission of Final Report Draft**

Based on the results of the advisory committee, the final report draft was prepared and submitted to the Chinese side.

**(12) Preparation of Result Sharing Seminar (Second Seminar)**

The study team prepared for the second seminar for sharing results and created materials for it.

**Sixth Fieldwork in China**

**(13) Explanation and Discussion of Final Report Draft**

The content was discussed after explaining the final report draft mailed to the Chinese side.

**(14) Holding of Result Sharing Seminar**

The study team held a seminar for explaining the content of the final report draft in Beijing to broadly inform related parties of the results of this study, gain effective penetration of the study results and promote its application.

**Sixth Home Office Work in Japan**

**(15) Preparation of Final Report**

Necessary revisions were added to the Final Report based on the comments from the Chinese side and the comments of related parties from the above seminar for sharing results, and the Final Report was prepared.

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### 1.3.3 Outline of Skill-Transfer Seminar and Workshop

This section shows the outline of the skill-transfer seminars and a series of workshops held as part of the study in fiscal 2004.

#### 1) Outline of First Skill-Transfer Seminar

- Seminar title:** Interim Report Meeting on JICA Study on Reforming SME Finance System in China
- Organizers:** JICA study team for the study on reforming SME finance system in China and People's Bank of China
- Collaborator:** Small and Medium Enterprise Department of the National Development and Reform Commission
- Date:** May 21, 2004
- Venue:** New Century Hotel, Beijing
- Participants:** 51 people on the Chinese side (from the People's Bank of China, Small and Medium Enterprise Department of the National Development and Reform Commission, China Banking Regulatory Commission, financial institutions, credit guarantee institutions, enterprises, International Finance Corporation, and news agents); 12 people on the Japanese side (from the JICA Beijing Office and the study team)

#### 2) Outline of Second Workshop

- Seminar title:** Interim Report Meeting on JICA Study on Reforming SME Finance System in China
- Organizers:** JICA study team for the study on reforming SME finance system in China and People's Bank of China
- Dates:** September 15, 2004 (Wenzhou); September 21, 2004 (Xi'an)
- Venues:** Wenzhou International Hotel; Xi'an International Conference Center
- Participants:** 53 people on the Chinese side (from the People's Bank of China, financial institutions, credit guarantee institutions, and enterprises); 10 people on the Japanese side (from the study team and a visiting lecturer) in the Wenzhou workshop.
- 48 people on the Chinese side (from the People's Bank of China, financial institutions, credit guarantee institutions, and enterprises); 10 people on the Japanese side (from the study team and a visiting lecturer) in the Xi'an workshop

**3) Outline of Second Skill-Transfer Seminar**

**Seminar title:** Final Report Meeting on JICA Study on Reforming SME Finance System in China

**Organizers:** JICA study team for the study on reforming SME finance system in China and People's Bank of China

**Date:** December 16, 2004

**Venue:** Huarong Hotel, Beijing

**Participants:** 72 people on the Chinese side (from the People's Bank of China, Small and Medium Enterprise Department of the National Development and Reform Commission, China Banking Regulatory Commission, financial institutions, credit guarantee institutions, enterprises, Asian Development Bank, and news agents); 24 people on the Japanese side (from the JICA Headquarters and Beijing Office, Embassy of Japan, Bank of Japan Representative Office in Beijing and the study team, etc.)

### 1.3.4 Outline of Counterpart Training in Japan

Counterpart training in Japan was provided to three officials at the People's Bank of China from October 11 to 23, 2004. The training was conducted in accordance with this study's aim of increasing the capacities of those involved in SME promotion by transferring knowledge and skills to policymakers in related organizations. The study team prepared the training program and provided logistical support to JICA for the implementation of the training. The list of trainees and the program are shown at the bottom of this section.

The trainees highly evaluated the overall training program upon its completion. One particular comment from them was that the program enabled them to deepen their understanding of the basic philosophy, roles, and real conditions of Credit Guarantee Corporations and government financial institutions such as the Japan Finance Corporation for Small and Medium Enterprise, through a series of discussions during the visits to these organizations.

#### <List of Trainees:>

- 1) Ms. Liu Ping, Division Chief, Research Department of the People's Bank of China
- 2) Ms. Liang Bing, Associate Researcher, Research Department of the People's Bank of China
- 3) Ms. Zhang Hong, the People's Bank of China, Xi'an Branch

#### <Training program: >

Month	Day		Organizations visited	Route	Stay
Oct.	11	Mon	[Public holiday]	Beijing Narita	Tokyo
Oct.	12	Tue	JICE [Common Orientation]	JICE [Specific Orientation]; JICA Economic Development Department	Tokyo
Oct.	13	Wed		Credit Guarantee Corporation of Tokyo, Shinjuku Branch	Tokyo
Oct.	14	Thu	Taiyo Toy	Daichu Denshi, Co., Ltd.	( Hanyu, Saitama ) Tokyo
Oct.	15	Fri	Bank of Japan	Japan Finance Corporation for Small and Medium Enterprise	Tokyo
Oct.	16	Sat	[Moving day]	Tokyo Sapporo	Sapporo
Oct.	17	Sun	[Holiday]		Sapporo
Oct.	18	Mon	North Pacific Bank		Sapporo
Oct.	19	Tue	Hokkaido Government; Sapporo Chamber of Commerce and Industry	Hokkaido Association of Small Business Entrepreneurs; Nikkokinzoku.Co.; Machimura Farm Ltd.	Sapporo
Oct.	20	Wed	[Moving day]	Sapporo Tokyo	Tokyo
Oct.	21	Thu	National Life Finance Corporation		Tokyo
Oct.	22	Fri	Evaluation Meeting; Completion Ceremony		Tokyo
Oct.	23	Sat		Narita Beijing	



### 1.3.5 Special Circumstances Arising During the Process of the Study

Due to a particular circumstance, this study was forced to fall way behind schedule from a very early stage, requiring the study team to make frequent revisions and adjustments of the work plans. The reason is that the launch of full-fledged study was impossible for several months since major cities and areas in China started to be put on the list of Severe Acute Respiratory Syndrome (SARS) hot spots from March 2003 forward.

The original plan of the study indicated that the full-fledged study in China (First Fieldwork) including discussion meetings on the Inception Report between the study team and the counterpart would be launched in May 2003. However, the World Health Organization (WHO) started to put major Chinese cities and areas including Beijing on the list of SARS hot spots from March 2003 forward, virtually halting the ordinary operation of administrative bodies including the counterpart organization, the People's Bank of China. In response to the WHO's designation of SARS-affected cities and areas in China, the Japan Ministry of Foreign Affairs issued recommendation against traveling to these areas and cities. Consequently, the preparation work for the contract on the second-year study between JICA and the study team was not initiated until the letter of work instruction was issued by JICA on July 17, 2003. Thus, the second-year study started in August 2003, after a delay of three months.

Since the study team effectively had no contact with the counterpart during the waiting period until the official start of the second-year study, the team was not able to confirm the counterpart's opinions on the study plan indicated in the Inception Report, which had been prepared by the team based on the results of the first-year study and sent to the counterpart. This made it indispensable that preliminary discussions between the Japanese and Chinese parties would be held again on the overall design of the study, such as revising the schedule, reconfirming the implementing system of the Chinese side and adjusting the scope of the survey that would be conducted by a local consultant. For this reason, prior to the initiation of full-fledged studies, an additional field mission to China for coordination, composed of members from JICA and the study team, was dispatched in August 2003.

In the course of the discussions held between JICA and the PBC during the additional mission, both parties reconfirmed to determine the implementing body of a fact-finding survey on SME financing, based on the technical proposals to be submitted by willing research and consulting bodies. The survey has been an important component of this study. It has consisted of questionnaire and interview surveys to SMEs, banks, and credit guarantee institutions. A method was adopted to be based on technical proposals for determining the survey implementing body, because this survey must be conducted by a local research or consulting body with highly specialized knowledge and capability in finance, a great deal of familiarity with lending practices, a good access to financial institutions and enterprises, the cooperative relationship with the appropriate divisions responsible for financing affairs in the central and provincial governments, and the capability to analyze the credibility of financial institutions and enterprises. In view of the fact that a technical proposal-based method had been adopted only rarely in selecting local consultants as part of JICA's development studies, the entire bidding process required sufficient time

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for the study team to carefully design, prepare, and implement the work, as well as for JICA to approve the terms of reference of the survey and to approve the result of the bidding. With the approval by JICA, the study team signed the contract on the survey with Financial Research Institute, an independent research institute for PBC on November 18, 2003.

It can be noted that the samples for the questionnaire survey are not considered to completely represent the whole population of China from the viewpoint of selecting reference districts and sampling. The reasons are as follows:

First, the districts for the survey had been selected and agreed jointly by JICA and the PBC and later given to the study team without allowing sufficient opportunities for it to verify detailed process of and logical reasons for the selection.

Second, time constraints did not allow a preliminary or test study to be conducted during the process of carrying out the questionnaire survey, since the second-year study including the questionnaire survey came under pressure to produce the study results based on an effectively five-month period of study from November 2003 to March 2004.

Against this background, the full-fledged study in China was started in late November 2003, about 6 months behind the original schedule. Considering the situation, the study team placed great emphasis on effective and efficient implementation of the study. For that purpose, the team made appropriate adjustments, as necessary, for the setting of the areas/issues of particular focus and the directions of the recommendation in the study, by reflecting the needs and requests suggested from the Chinese side during the course of the study as much as possible.