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The Effects of Interest Rate Liberalization on Small and Medium Enterprises

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Abstract: The financing difficulties faced by small and medium enterprises (SMEs) are major problems hindering the development of the Chinese economy. These challenges not only impede the growth potential of SMEs but also limit innovation and job creation, posing a significant hurdle to overall economic progress in China. This article first presents the financing difficulties of SMEs and examines the reasons causing these difficulties. Then, this article briefly introduces the interest rate liberalization reform in China. After that, this article discusses three effects of interest rate liberalization on SMEs. The first effect is the reduction of the financing cost; the second effect is the increase of accessibility of loans; and the last effect is the transfer of credit resources from large and state companies to SMEs. Then, suggestions on how to tackle the financing difficulties are provided from the perspective of SMEs, financial institutions, and authorities respectively. Lastly, this article concludes that interest rate liberalization reform is conducive in helping enterprises and economic recovery.

Keywords: interest rate liberalization, small and medium enterprises, financial institutions

1. Introduction

Since implementing the reform and opening policy, China has witnessed economic development in a fast pace. During the process, small and medium enterprises (SMEs) play an important role in supporting the economy, providing employment opportunities, and promoting social harmony that cannot be replaced by large companies. According to the National Bureau of Statistics, more than 90% of Chinese companies are SMEs, providing over 75% of the total employment positions and 50% of tax revenue [1]. However, as flourish as it may seem, the development of these enterprises has been hindered by a number of factors, in particular, the thorniest issue is the difficulty in financing. Although small and medium companies contribute more than 60% of the national gross domestic product, their annual loan only takes up less than 50% of the total loan [2]. In addition, the time during which SMEs apply for loans from commercial banks and receive the fund is longer than usual, which takes from ten days to three or four months [3].

This phenomenon can be caused by various reasons. From the perspective of external factors, the first problem is the lack of supporting regulations and policies. Although the Small- and Medium-sized businesses Promotion Law has been implemented in China, it fails to interpret the detailed rules, therefore proved ineffective in practice [1]. Besides, other legal and regulatory systems regarding other activities like fund management and venture investment are still absent [1]. Secondly, the credit guarantee system in China is incomplete. The government guarantee agency cannot satisfy the diverse demand of small and medium-sized companies, and they prefer large and state enterprises that have a more reliable reputation [4]. Due to the lack of effective risk diversification mechanisms, guarantee agencies are reluctant to support SMEs because they are afraid to undertake too much risk they cannot afford. They tend to choose small companies with extreme caution and raise the guarantee fee to reduce their risk, which also increases the financing cost of SMEs [1]. Thirdly, many financial institutions like commercial banks are short of support backing SMEs. Given that the supply of the fund is always greater than the demand in the credit market, commercial banks, as the main source of the fund supplier, have bargaining power over companies. And because banks tend to concern about the security of their credit fund, they prioritize their lending to large and state enterprises [1]. Additionally, the information between companies and banks is asymmetrical. In order to be eligible to apply for a loan, some small companies tend to temper their financial statement in covering their mismanagement, making commercial banks have difficulties assessing the operating risk of SMEs. The moral hazard due to asymmetric information has also made banks reluctant to lend loans to SMEs [1].

From the internal point of view, firstly, SMEs are constantly losing their credibility. The fact that some small companies do not repay their debt on schedule has reduced the incentive of banks to lend loans to SMEs. In addition, small companies committing breach of contract is making sales on credit between companies more difficult, most SMEs are required to pay with cash, which increased their cost of financing [1]. Secondly, SMEs have higher operating risks. The management systems in most SMEs are imperfect, lacking a standardized and systematic management process, especially in credit and financial management [2]. In addition, many SMEs overlook long-term development, focusing on short-term profitability, which increases the risk of bankruptcy. The average lasting time of SMEs is 2.5 years [1].

In dealing with this situation along with other problems in the Chinese financial market, the government has implemented a series of policies, including the interest rate liberalization reform that has been going on for years. The idea of marketization of interest rates starts in 1993, when the 14th Central Committee of the Communist Party of China make the "Decision on Several Issues Concerning the Perfection of the Socialist Market Economic System" [5]. In 1996, the People's Bank of China (PBC) established an interbank market, making the interbank borrowing rate marketized [6]. Liberalization of the lending rate and deposit rate was achieved in 2013 and 2014 respectively [6]. In 2013, PBC introduced the loan prime rate (LPR) to the market and conducted an LPR reform in 2019, making LPR the benchmark interest rate [7]. This article examines the effect of this marketization process on SMEs and then makes some suggestions on how to tackle the financing difficulties faced by SMEs.

2. Impacts of Interest Rate Liberalization

2.1. Reducing the Financing Cost

When the PBC introduced LPR in 2013, their intention was to make it a new benchmark rate that reflect the market rate. However, even though commercial banks took it as a reference rate, they are more concerned with the base interest rate of the short-term loan when setting credit rate, leading to an LPR that cannot respond to the market but is closely related to the base short-term loan interest rate [8]. Under this circumstance, the monetary policy cannot guide the interest rate by the interest transmission mechanism. Instead, PBC had to increase credit supply to commercial banks in order to reduce the financial cost of SMEs. However, this method was not effective. Because of asymmetric information, commercial banks are reluctant to provide loans to SMEs. As a result, SMEs had a higher interest rate premium, thus their financing cost became higher than before [9]. Besides, because of the fierce competition among commercial banks, the profit margin between loans and deposits was

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shrinking. In order to maintain the margin, SMEs that did not have high-quality collateral may face an increased financing restraint, thus a higher financing cost [9].

However, as the marketization process proceeds, the formation mechanism of interest rates has improved. After the reform in 2019, LPR is pegged to the interest rate of the medium-term lending facility, which is the monetary policy tool PBC uses to provide the monetary base. The interest rate transmission path starts from MLF to LPR and then reaches the lending rate eventually. Commercial banks adjust lending rates based on LPR, thus PBC could reduce the financing cost of companies by decreasing the interest rate of MLF. Compared with large and state companies with relatively strong bargaining power, SMEs have limited financing channels and are more dependent on commercial banks, therefore this new transmission mechanism is more conducive to SMEs in terms of reducing financing costs [9]. Conducting a quasi-natural experiment based on the difference in difference (DID) method, Wang and Zhu use data from 300 small companies in the SME stock market and 300 listed companies in the main board market to conclude that the LPR reform in 2019 has reduced financing cost of SME compared with large companies [9]. Gao also studies the impact of interest rate liberalization by using the OLS regression model on SMEs in Henan province, she suggests that the deregulation of interest rate intensify the competition among banks, in order to expand the scale of loans, interest rates of loans to SME has decreased [7]. In addition, the marketization process that improved the social credit system, which reduces the risk of asymmetric information, has also motivated banks to provide loans to SMEs [7]. Based on the data of PBC, since the LPR reform, the lending rate to SMEs was decreased from 5.23% in July 2019 to 4.61% in December 2021, and interest rate marketization contributed almost 20% to the reduction [7].

2.2. Increasing the Accessibility of Loans to SMEs

The credit rational theory of Stiglitz and Weiss (S-W) asserts that there exists an optimal interest rate in the loan supply curve where banks could maximize their benefit and amount of loans [10]. Initially, when the interest rate is lower than the optimal interest rate, the amount of the loan increases as the interest rate increases, however, when the interest rate goes above the optimal interest rate, the benefit gained from interest is lower than the potential default loss, thus the loan supply starts to decrease [10]. This theory could explain the reason why, when faced with excess demand, commercial banks are reluctant to lend money to SMEs even if they could offer a higher interest rate. One of the innovations of this theory is that it considers the adverse selection effect caused by asymmetric information: as the interest rate increases, enterprises with good reputation would exit the loan market and choose direct financing as their substitute, therefore the default risk increases rapidly [10]. However, Stiglitz and Weiss conclude this theory based on the financial markets in America. In China, this effect is weakened.

Chinese enterprises are so dependent on loans from commercial banks that direct financing is not a strong substitute. A study shows that loans from banks take up 92% of the external finance in Chinese private companies [11]. Based on this situation, the marginal default risk increases at a relatively slow rate as the interest rate rises because there are fewer “good” companies that would exit the loan market. As a result, the optimal interest rate in the Chinese loan market should be higher than that of the American market [11]. Before the marketization process, the interest rate is set to be lower than the optimal interest rate. However, in 2013, after the floating control of loan interest rates for financial institutions based on the official benchmark interest rate was completely canceled, commercial banks were able to provide more loans such that the optimal interest rate would be reached [11]. Even though this meant that the interest rate would be higher than before, a survey conducted in 2012 suggest that up to 84% of 3231 small companies from 36 cities in China are willing to accept a financing cost that is 4 times the benchmark loan interest rate [11]. Therefore, the liberalization of interest rates increases the accessibility of loans to SMEs.

2.3. Credit Resources Transfer from Large or State Enterprises to SME

Considering the high-risk feature, the criteria for entering banking are relatively strict, which uses a franchising system [12]. As a result, the banking market exhibits some characteristics resembling a monopoly market or an oligopoly market. The limited market grants commercial banks excess return, which is the value of franchising [12]. In order to have a lower financing cost, companies tend to stress the security of loans they are going to get from banks, however, facing the uncertainty of loan recovery, commercial banks would ask for a higher risk compensation [12]. The franchising system also means that banks have much higher bargaining power than enterprises in the negotiation of loans. A study conducted by Liu shows that in quantitative analysis, commercial banks are 2.6 times more powerful than enterprises in negotiation [12]. Eventually, the interest rate of a loan is much higher than the “fair” interest rate, which is the interest rate under a frictionless and perfectly competitive market [12].

In addition, Li et al. state that due to the interest rate control policies in China, the lower limit of loan interest rates has been controlled, which increases the financing cost of low-risk companies and the excessive profit of banks [13]. This effect is particularly conspicuous in the negotiation of long-term loans [12]. However, with the gradual promotion of interest rate marketization, the competition among banks has intensified, which has weakened their bargaining power. Consequently, the difference between loan interest rates and the “fair” interest rate has shrunk [12]. Because SEM has lower bargaining power than large and state companies, commercial banks could gain more benefits from them. Therefore, SMEs could get more credit resources that should have been given to large and state enterprises before the interest rate marketization process [12].

3. Suggestions

3.1. In the Perspective of SMEs

The low quality of SME enterprises is the main reason for the difficulty in financing. Therefore, improving the quality of SMEs is of great significance in effectively alleviating the problem of financing difficulties [13]. The first suggestion is that SMEs should improve their financial system. SMEs do not attach importance to their financial accounting, most of them entrust financial companies to provide accounting services, but these financial companies do not have access to every business. The actual use of funds is reported by the cashier, who tends to record the enterprise's operating conditions unfairly [13]. Therefore, SMEs should regulate their financial systems in a rigorous and professional way and improve the professional quality of financial personnel [13]. They should also continuously improve the quality of their financial statements to enhance their financial analysis abilities and risk control and internal management capabilities [13]. SMEs providing accurate accounting information to financial institutions could also promote the loan application process [13]. Secondly, under the marketization reform of interest rates, financial organizations such as commercial banks tend to shorten their loan deadlines. Therefore, by adjusting the loan maturity structure, SMEs need to strengthen debt financing management to avoid holding multiple loans within the same repayment deadline as much as possible [6]. In addition, the marketization of interest rates will inevitably generate more direct financing tools and enrich the direct financing channels of enterprises. Therefore, the business management decision-makers of SMEs should choose financing tools and methods in a sustainable development point of view, and actively seek suitable direct financing methods to overcome the financing difficulties of the enterprise [6]. Lastly, SMEs should learn about relevant policies at the national, provincial, and city/county levels that have potential benefits to them and seek to obtain relevant financing support if they are suitable to the objectives and requirements of these preferential policies [4].

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3.2. In the Perspective of Financial Institutions

When conducting credit qualification examinations for SMEs, instead of learning about their development potential and prospect, banks, and other financial institutions pay more attention to their current situation such as financial data, profitability, and solvency, especially for some technology-based start-up companies [2]. In this regard, banks should pay more attention to the overall profitability and development potential of enterprises in the future, and moderately lower standards of loan application to increase financing support [2]. In addition, building a good bank-enterprise relationship is also helpful. By conducting research on SMEs based on their actual situations, banks could calculate their capital operation capabilities to reduce the risks of loans and provide credit support for financing SMEs from multiple perspectives [13]. By establishing this relationship, banks can fully be aware of the situation of the enterprise and no longer have to spend the cost to investigate and verify enterprise information, which could also reduce the cost of loans [13]. Lastly, Increasing the proportion of small and medium-sized banks is also beneficial for promoting interest rate marketization and reducing the financing costs of SMEs. The practice of developed countries has shown that small and medium-sized financial institutions can serve as the main force in providing financial support for SMEs, effectively alleviating the shortage of funds [1]. With the reform of internal fund transfer pricing methods by small and medium-sized banks including joint-stock banks, market interest rates have been incorporated into the capital cost accounting system [7]. In the meantime, in order to control the operational risks, it is necessary to supplement capital through multiple channels to small and medium-sized banks and guide them to improve their corporate governance so that their risk prevention ability is enhanced [7].

3.3. In the Perspective of the Authorities

To solve the problem of financing difficulties for SMEs, it is necessary to establish a sound and comprehensive legal system. Laws are regulatory guarantees for the financing of SMEs and an important part of solving financing difficulties. Compared to developed countries, there is still a lack of laws and regulations in China regarding the financing of SMEs [1]. The government ought to accelerate the improvement of relevant laws and regulations and put the framework and provisions into practice. Detailed legal provisions could be introduced to support SMEs in various aspects like financing guarantees, mortgages, venture capital, and credit system construction by refining the "Law on the Promotion of Small and Medium-sized Enterprises" to formulate relevant supporting laws and regulations [1]. Another measure the authorities should take is the establishment of a multi-layer capital market. As mentioned above, SMEs rely heavily on financing from commercial banks [11]. However, when the financing needs for normal operation cannot be effectively met in the bank credit market, SMEs mostly turn to the private lending market which usually offers a higher interest rate [7]. Based on this situation, the Chinese government should vigorously develop the equity market and high-yield bond market to encourage promising enterprises to obtain long-term equity funds through listing, and SMEs to obtain bond financing through the high-yield bond market [7].

4. Conclusion

This article first presents the financing difficulties of SMEs and examines the reasons causing these difficulties. And then this article discusses three effects of interest rate liberalization on SMEs. The first effect is the reduction of the financing cost, the second effect is the increase of accessibility of loans, and the last effect is the transfer of credit resources from large and state companies to SMEs. After that, this article puts forward some suggestions on to tackle the financing difficulties faced by SMEs. From the perspective of SMEs, it is advisable for them to improve their quality by refining their financial system and strengthening debt financing management, and seeking direct financing

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methods. They should also learn about the preferential policies that might help them with financing. From the perspective of financial institutions, the article advises that they should lower the criteria of loan applications to SMEs and put more effort into building bank-enterprise relationships. In addition, the importance of small and medium-sized banks should be stressed in catering to various needs of SMEs that cannot be met in state-owned banks. From the perspective of the authorities, the article suggests that a sound and comprehensive legal system and a multi-layer capital market should be built. In the post-COVID-19 era, China is still facing downward pressure in the development of the economy. It is evident that the marketization reform of interest rates should continue because it is conducive to helping the development of enterprises and also economic recovery. Currently, the liberalization reform is still facing many challenges, like the "dual interest rate system" that might allow people to take advantage of the arbitrage opportunity. However, there is no doubt that these difficulties will be tackled eventually and a liberal market will be formed eventually.

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