

Private Sector Financial Conditions in China

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Abstract

Historically it has been challenging to assess financial conditions for private firms in China. This article assembles a range of indicators that shows private firms find it more difficult and expensive to access financing than state-owned firms. Based on these indicators, the private sector had experienced a tightening in financial conditions over the past few years, although more recently conditions have generally eased as a result of new measures that direct more credit to private firms.

Background

The private sector plays a significant role in China following several decades of reforms to reduce the role of the state in resource allocation. In 2018, private enterprises accounted for more than 60 per cent of GDP and over 80 per cent of employment (Xinhua 2018b). As a result, financial conditions for the private sector are important for China's economic growth and financial stability, and have implications for countries with close economic ties to China, such as Australia.

Despite their large role in the economy, private enterprises struggle to compete for funding with

state-owned enterprises (SOEs) (Lardy 2018). As such, improving the allocation of credit has been a longstanding objective of the authorities. A key reason that private firms have relative difficulty accessing funding is they are generally regarded as riskier than SOEs, partly reflecting the widespread perception of credit guarantees in the Chinese financial system, which tend to be stronger for SOEs (Lam, Rodlauer and Schipke 2017).^[1] This is because the government is the ultimate owner of SOEs and so the perceived likelihood of SOEs defaulting is low. Investors also believe the authorities would not allow many SOEs to fail since they are often involved in achieving the authorities' policy

objectives. Indeed, SOEs tend to be more prevalent than private firms in strategically important industries.

Key characteristics of private firms may also mean that they pose a greater risk to lenders than state firms. In particular, private firms are usually smaller than SOEs and are more reliant on exports, so are more exposed to downturns in global trade (Bowman 2019). A range of other factors may also contribute to differences in access to financing. SOEs and private firms tend to operate in different industries; for example, manufacturing is dominated by private firms while SOEs comprise the majority of the energy and utility sectors, which tend to have steadier income streams (Lardy 2018).

This article outlines how efforts to improve the allocation of credit to the private sector have evolved over recent years. A range of indicators are compiled to examine private sector financial conditions, including the cost and availability of funding for private firms in bank lending, bond and equity markets and, where possible, shadow financing.^[2] In the past it has been difficult to assess financial conditions for the private sector and the effectiveness of policy support because data coverage of private firms is limited and the distinction between state and private firms is ambiguous.

Credit allocation policy

Improving the allocation of credit has been a longstanding objective of the government. To this end, the authorities have used a wide range of policy tools to support private firms' access to funding. The issue was brought more into focus over the past few years as the profitability of private firms was worn down by tighter financial regulation and as China's economic growth began to moderate (Bowman 2019; RBA 2018). There are two distinct phases in private firms' access to funding in recent history: first, a tightening in financial conditions through 2017 and 2018; followed by some easing since 2019 after concerted policy support for private firms. Some of the targeted measures introduced since early 2019 to ease policy include:

- providing liquidity to banks conditional on lending to private firms^[3]
- instructing banks to increase lending to private firms (window guidance)
- using fiscal measures, like providing banks with tax exemptions on interest income earned from loans to micro and small enterprises (MSEs). Measures to support private firms often overlap with support for MSEs
- reducing credit risk via a state-owned credit guarantee fund to provide a backstop on the debt of some private firms (Xinhua 2018a).

Earlier this year, the outbreak of COVID-19 put private firms under renewed pressure. Widespread shutdowns significantly disrupted cash flows. It was possible that some private firms could be cut off from funding in the event of a sharp tightening in financial conditions, given they are generally perceived as riskier borrowers. Subsequently, the authorities implemented a number of new measures to support financial conditions for private firms. Key policies have included:

- liquidity injections via existing bank funding facilities, and the creation of new facilities, to ease pressure on banks' capital and liquidity positions. This has allowed banks to extend more loans to smaller and private firms^[4]
- instructing large commercial banks that at least 40 per cent of new corporate lending should be directed to private firms (Li 2020)
- extending loan repayments for medium, small and micro enterprises to 2021
- a package of measures aimed at accelerating bond sales and easing the rollover of existing debts (National Development and Reform Commission 2020). This included allowing firms to issue bonds to refinance previous bond issues, a practice that was previously discouraged.

While the authorities have taken steps to direct more funding to private firms, there are still many reforms needed to improve the allocation of credit in China, some of which may be difficult to implement (International Monetary Fund 2019). For example, the authorities are allowing more SOEs to

default to unwind the perception of an implicit guarantee. In addition, some of the measures used to support private firms, like window guidance, are at odds with the pursuit of more market-based credit allocation.

It is unclear whether the outbreak of COVID-19 has dampened the appetite of policymakers to pursue these reforms in the near future. The government has continued to discuss efforts to move towards a more market-based allocation of resources in recent policy announcements. However, it may be challenging for the authorities to balance the implementation of these reforms with their objective of supporting employment in the wake of COVID-19 (Li 2020).

Financial conditions

This section provides a range of indicators that measure financial conditions for private sector firms. These indicators cover a range of asset markets that help illustrate the structural disadvantage that private sector firms often have to SOEs in terms of their access to financing. Private sector firms have higher funding costs and are more likely to face constraints in tapping certain markets for funds or to need to access alternative (or shadow financing) sources.

Bank lending

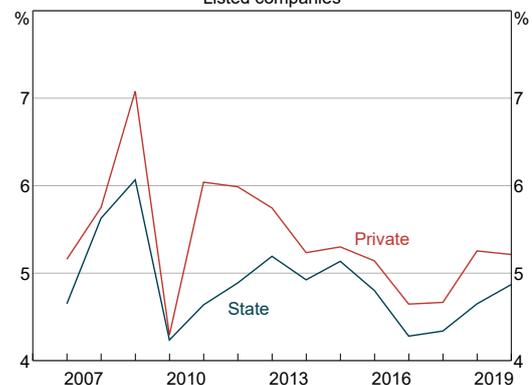
Bank lending is the main external source of business funding in China, accounting for around 59 per cent of total funding.^[5] It is particularly important for private firms because they tend to have less access to capital markets than SOEs. There are no up-to-date official data on bank lending to the private sector, but proxies can be used to make broad-based assessments of the cost and availability of bank credit. This article takes firm ownership as classified by WIND Information, where SOEs include only wholly state-funded firms.^[6]

The cost of bank funding is generally thought to be higher for private than state firms. This appears to be confirmed by implied interest rates constructed from the financial statements of listed companies (see Bowman (2019) and Bowman (forthcoming)).^[7] The rates facing both state and privately listed firms increased over 2017 and 2018; this is consistent

with the tightening phase of financial conditions for private firms, but also suggests that access to bank financing had become more expensive for all borrowers (Graph 1). Implied rates for private firms remain higher than those for state firms, which is consistent with the commonly cited view that state firms receive loans on better terms (Yi and Liang 2016). During 2017–18, tighter regulatory scrutiny left banks less willing, and less able, to lend to firms with higher credit risk. This widened the spread between the implied interest rates for listed private and state firms. In 2019, the implied interest rates for private firms declined slightly and the spread narrowed, reflecting the phase of easing financial conditions after a range of policies were put in place to support the private sector.

Proxies for loan growth indicate that it became more difficult for private firms to obtain bank funding in 2018. MSE data are often used as a proxy for the private sector, including by the authorities, since MSEs tend to be privately owned.^[8] In 2016, lending to MSEs accounted for around half of outstanding loans to private firms. Business loan growth declined in 2018, with a particularly pronounced fall in lending to MSEs as per the tightening phase in financial conditions for private firms (Graph 2). A survey on loan demand published by the People's Bank of China suggests that MSEs' demand for bank credit actually increased over this period, implying the fall in lending was primarily driven by supply factors, consistent with the regulatory tightening. State-owned banks may face

Graph 1
Implied Interest Rates*
Listed companies



* Ratio of annual interest expense to average debt in the current and previous year

Sources: RBA; WIND Information

incentives to lend to state firms which could impede the ability of private firms to access bank funding. In addition, interest rates in China’s banking system are not fully liberalised. This makes it difficult to apply risk-weighted pricing to loans, which may disincentivise banks from lending to riskier borrowers like private firms. Since 2019, loan growth to MSEs has increased, particularly following the outbreak of COVID-19.

Bond market

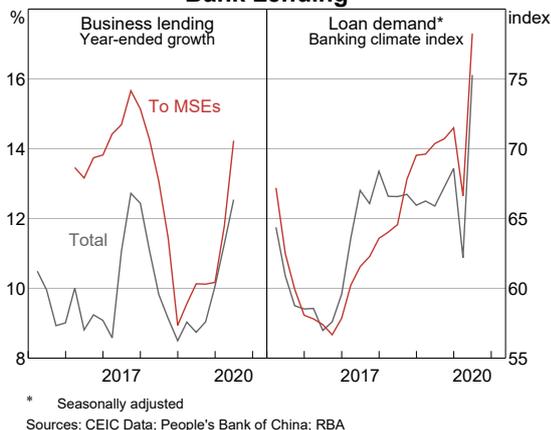
The corporate bond market accounts for a notable share of credit to the economy, at around 16 per cent of business financing. It is useful to examine bond market data because they are available on a more timely and granular basis than bank lending data. Similar to bank lending, it is more difficult and expensive for private firms to access bond funding than for SOEs.

Private firms pay higher interest rates on bonds than SOEs with the same credit rating. For example, over the past few years, there has been around a 150 basis point spread on yields between three-year bonds issued by private firms and SOEs (Graph 3).^[9] This spread could be partially driven by the perception of implicit guarantees, although this is difficult to disentangle from a range of other factors like firm size and industry composition. The spread on bonds with the highest credit rating (AAA) tends to be wider than the spread on lower-rated (AA+) bonds (based on ratings by Chinese credit rating agencies, which employ different standards than those used in other major markets). This is

consistent with implicit guarantees varying in strength across SOEs, partly reflecting their proximity to the government and its objectives. An increase in this spread may suggest that investors are demanding greater compensation to lend to private firms, although the volatility of these data make it challenging to draw robust conclusions from short-term fluctuations. In 2020, the signal from the change in the spread has been mixed – the spread for AAA rated bonds increased but the spread on AA+ rated bonds has narrowed.

Private firms appear to have relatively restricted access to bond financing and remain a small share of the market. There have been signs that private firms have had increasing difficulty issuing bonds onshore, although this trend appears to have reversed this year (Graph 4). Net issuance by private firms began declining from 2016, and turned negative in 2019, even while issuance from SOEs remained steady. Since 2016, private firms increasingly turned to offshore markets to issue bonds. The decline in private sector issuance was broad based although particularly driven by the real estate and industrial sectors, following regulatory changes in 2016 that tightened access to the bond market for firms in these industries (Graph 5).^[10] It became even more difficult for the private sector to issue bonds after a pick-up in defaults from private firms in 2018 contributed to some reluctance among investors to buy private bonds (Gatley 2018). This followed measures to curtail shadow financing, which led to liquidity shortages for some

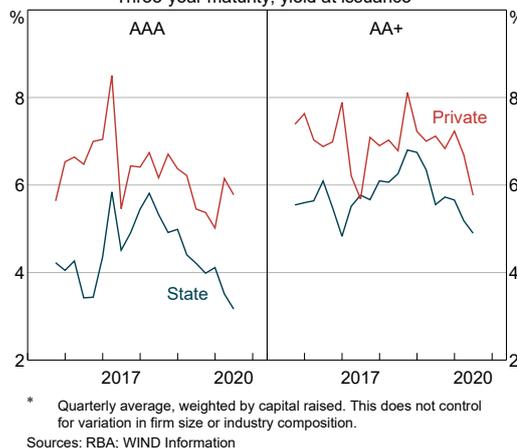
Graph 2
Bank Lending



Graph 3

Corporate Bond Yields

Three-year maturity, yield at issuance*



private firms (see ‘Shadow financing’ discussion below). Earlier this year, net onshore bond issuance by private firms increased sharply, alongside a broader increase in onshore corporate bond issuance, after a number of measures were implemented to support the bond market following the outbreak of COVID-19.

Equity market

The equity market accounts for a small, although growing, share of economy-wide funding, with equity to nonfinancial corporates currently representing 5 per cent of business financing. The market capitalisation of shares of listed private firms has increased eight-fold in the past 10 years, and now accounts for around one-third of Chinese companies listed onshore (Graph 6). This follows a

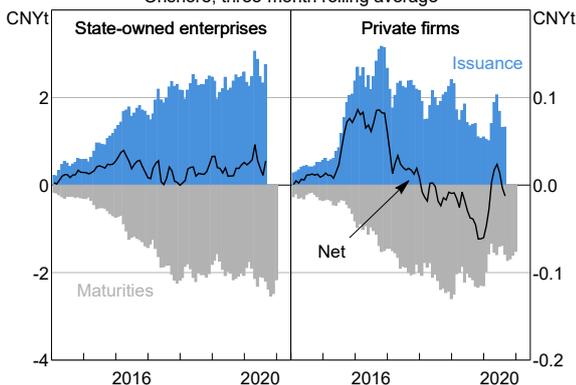
significant pick-up in listings from private firms, alongside a series of market-oriented reforms, including changes to the initial public offering (IPO) process (Li, Wang and Tsai 2017). It is useful to examine the equity market because, similar to bond markets, it presents more timely and disaggregated data than bank lending. However, the Chinese equity market has a history of periods of high volatility that do not necessarily reflect broader trends in financial conditions. This is because the market has a large proportion of retail investors, which can drive speculative investment, and there is a widespread perception of state support in the market. Notably, the government has appeared to direct state-owned financial institutions to purchase stocks to stabilise prices in previous episodes of volatility.

The equity prices of private firms track the broader market, although in some periods they have experienced larger swings, consistent with the higher risk of private firms (Graph 7). In the absence of an official equity price index for private firms, one can be constructed using weekly data from around 2,500 companies listed on the Shanghai and Shenzhen stock exchanges, weighted by market capitalisation. The steep increase and decline in equity prices in 2015, which coincided with rapid growth in debt-financed retail investment, saw much larger fluctuations in the equity prices of private firms than state firms (RBA 2015). In 2018, the private index fell by around 40 per cent, while the state index declined by only 30 per cent. This is

Graph 4

Bond Issuance*

Onshore, three-month rolling average

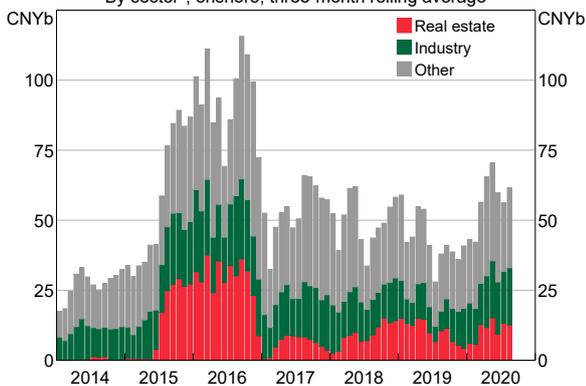


* Financial bonds, enterprise bonds, corporate bonds, medium term notes, commercial paper and certificates of deposit.
Sources: RBA; WIND Information

Graph 5

Gross Bond Issuance by Private Firms

By sector*, onshore, three-month rolling average

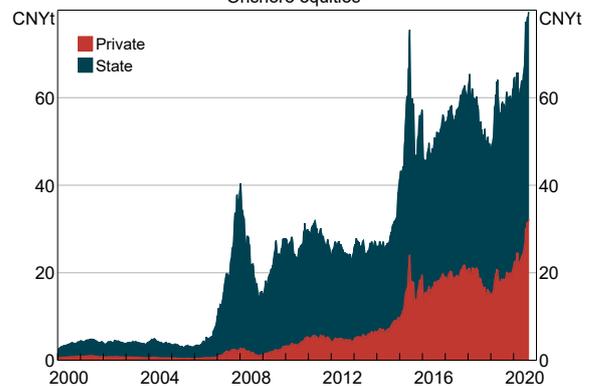


* Excludes financials
Sources: RBA; WIND Information

Graph 6

Market Capitalisation

Onshore equities*



* Excluding foreign and collectively-owned companies
Sources: RBA; WIND Information

consistent with the tightening phase in financial conditions, and is further evidence that the tightening in this period was more severe for private firms than SOEs. There are broadly similar trends in private firms' equity prices relative to SOEs' when disaggregated by industry. This suggests factors other than industry composition are contributing to the variation in the performance of the state and private indices, including perhaps implicit guarantees. This year, private firms have generally performed in line with the state index including the sharp increase in prices in July supported by low numbers of COVID-19 cases and subsequent better-than-expected economic data.

Private firms accounted for a relatively large share of IPOs over recent years, possibly reflecting the private sector's restricted access to other markets (Graph 8). The trends in the value of IPOs from private firms are broadly consistent with trends in bank lending and bond issuance data. There was a slowdown in IPOs over 2017 and 2018 reflecting the general tightening in financial conditions. IPOs picked up in late 2019, reflecting policy support, in particular for private firms, and reforms to reduce listing requirements for some companies.^[11]

Shadow financing

Given that private firms have had more constrained access to conventional funding via banks or capital markets, they have tended to make significant use of alternative financing channels. Financing from non-bank financial institutions, or shadow financing,

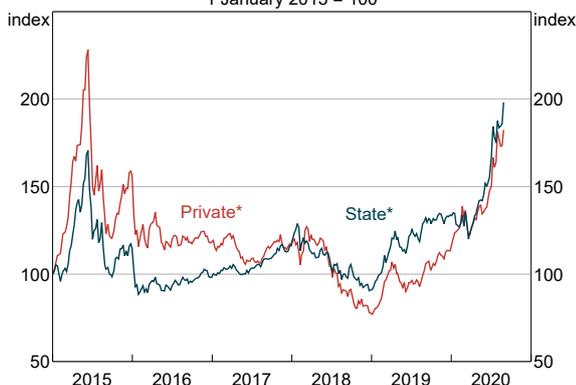
is a sizeable source of funding in China, accounting for around 12 per cent of business financing.^[12] Shadow financing captures a range of instruments that tend to be opaque and illiquid. As such, there is less visibility over this funding channel than other Chinese markets and there are no data on the split of shadow financing by firm ownership. However, it is reasonable to assume private firms make up a sizeable share of shadow funding given they have restricted access to other funding markets. In addition, there is an incentive for SOEs to prioritise funding from conventional channels because shadow financing tends to be more expensive. For these reasons, the growth rate of several major off-balance sheet instruments can provide a timely indication of the rate at which shadow credit is flowing to private firms.

Shadow banking activities can pose financial stability risks by facilitating an excessive build-up of leverage, eroding capital and liquidity buffers, and adding opacity to the financial system (Bowman, Hack and Waring 2018). The authorities have been taking steps to address these risks, and shadow financing has contracted since 2018, reflecting another channel through which private firms experienced a tightening in financial conditions (Graph 9). Chinese policymakers face a difficult balance between reducing financial risks and avoiding a slowing in credit which constrains economic growth, particularly for MSEs and private firms. Indeed, there is evidence that the tightening in shadow financing exacerbated the structural

Graph 7

Equity Prices

1 January 2015 = 100



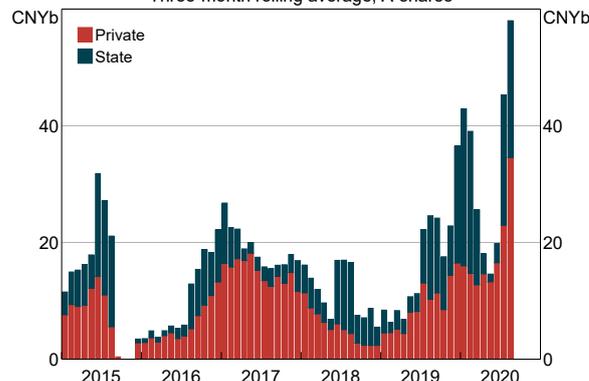
* Includes A-shares only. Calculated from firm-level data, weighted by market capitalisation.

Sources: RBA; WIND Information

Graph 8

Initial Public Offerings

Three-month rolling average, A-shares



* Excludes foreign and collectively-owned companies.

Source: RBA; WIND Information

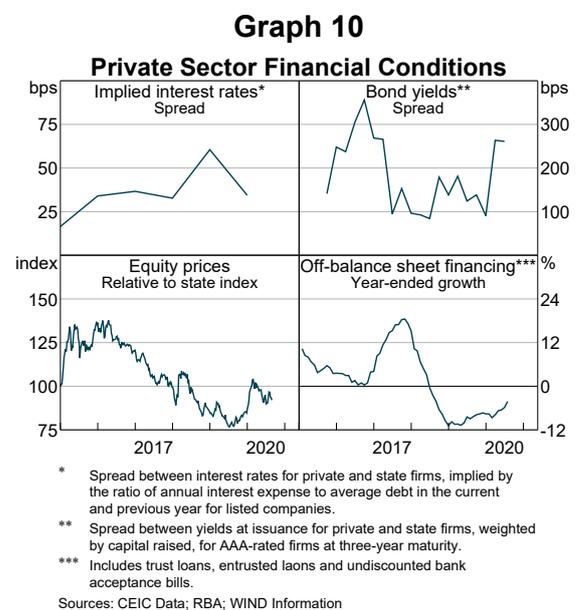
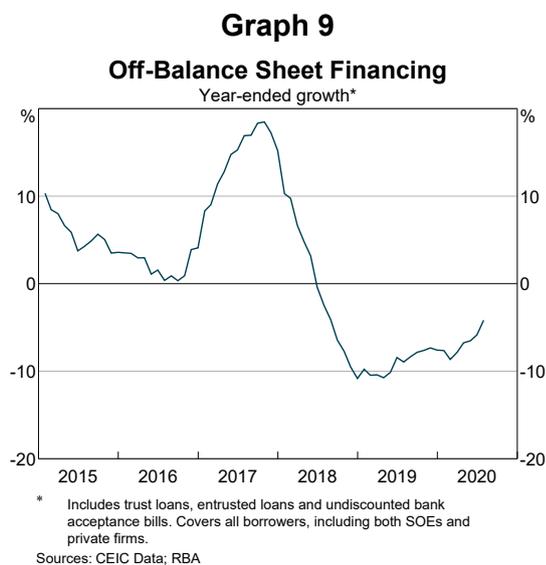
disadvantages for private firms in funding markets, leading to liquidity shortages and pushing some private firms to default on their debt obligations. The contraction in off-balance sheet financing has slowed over the last couple of years, including since the outbreak of COVID-19, marginally easing pressure on the private sector's access to funding. At the same time, the authorities have continued to tighten regulation for some types of off-balance sheet financing, like trust loans.

Assessment

It is more expensive and difficult for private firms to access funding in bank lending, bond and equity markets than state firms. This likely partly reflects pervasive perceptions of implicit guarantees for state firms in China. Private firms experienced a phase of tightening in financial conditions in 2017 and 2018, in absolute terms and relative to those for state firms. This was consistent with heightened risk aversion as financial regulations tightened and economic growth slowed (Graph 10). Implied interest rates on bank loans increased more rapidly for private firms than state firms and the spread between yields on bonds issued by private

and state firms widened. Similarly, private firms' equity prices fell further than the equity prices of state firms. There is also evidence that lending to private firms fell sharply during this period and it became more difficult for private firms to raise funds in bond and equity markets. This occurred alongside a broad-based contraction in shadow financing.

Over the past year or so, there has been a phase of general easing across all of these markets, with the exception of the increase in private sector yields in some segments of the bond market. This suggests that the authorities have had some success in directing credit to private firms, particularly since the outbreak of COVID-19. However, the continued focus on this objective implies that the authorities believe there is more to be done. The government also continues to face a difficult trade-off between their objectives of addressing risks in the financial system and improving the allocation of credit. Over the longer term, a range of reforms are needed to direct Chinese financial markets towards more market-driven credit allocation, some of which may be challenging to implement. ✖



Footnotes

- [*] Matthew Bunny is from International Department.
[1] Zhu (2016), Elliott, Kroeber and Qiao (2015) and Cong, Gao, Ponticelli and Yang (2019) are other notable studies in the large literature exploring the prevalence of implicit guarantees in China.

- [2] This analysis does not account for possible differences in the funding composition of SOEs and private enterprises given limited visibility over these data.

- [3] Some of these tools include the targeted reserve requirement ratio, targeted medium-term lending facility and relending and rediscount facilities.
- [4] The People's Bank of China (PBC) increased relending and rediscounting quotas and cut the targeted reserve requirement ratio. The PBC also created two new funding facilities: one to support banks in extending the repayment deadlines for MSE loans and the second to fund local banks' MSE lending (PBC 2020). The PBC expects the program to support up to CNY 1 trillion of unsecured MSE loans.
- [5] This analysis focuses on private sector firm's access to external funding sources. Historically, retained earnings have also been an important funding source for private firms. For a more detailed discussion of this issue, see Lardy (2016).
- [6] China has a complex firm classification system which varies across official data sources. The National Bureau of Statistics' *China Statistical Yearbook* defines eight types of ownership, with varying degrees of state funding and supervision (NBS 2019). However, financial market data are generally not published with the same granularity. In this analysis, SOEs cover public enterprises, central SOEs and local SOEs, as defined by WIND Information. Private firms includes only private enterprises. Foreign companies and firms where the extent of government involvement is less clear, like collectively-owned enterprises, are excluded.
- [7] The implied interest rates are calculated based on total debt and so do not differentiate between the interest rates paid on bank loans and bonds. Listed companies are also generally much larger than the average firm and are likely to benefit from better access to bank funding. Nonetheless, these data provide an unusually detailed insight into the conditions facing Chinese firms in bank lending markets.
- [8] Official data on bank lending to private enterprises has not been published since 2016.
- [9] Yields at the three-year tenor are used because this is the largest segment of the corporate bond market.
- [10] Regulators tightened access to the bond market for real estate developers and industrial firms in excess capacity sectors as the economy recovered from a slowdown in 2015 and concerns about financial stability risks in the housing market intensified (Zhang 2019).
- [11] The Shanghai Stock Exchange Science and Technology Innovation Board, or STAR Market, was launched in July 2019 to facilitate listings from technology firms. It accounts for a significant share of IPOs over the last year or so. The STAR Market has less stringent listing conditions than other boards in China, including waiving the requirement that companies are profitable.
- [12] The stock of shadow financing is estimated by the sum of trust loans, entrusted loans and undiscounted bank acceptance bills.

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