Small and medium enterprises financing in China

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SUMMARY

November 2005

Introduction

After the start of an open-door policy in 1978 moving towards a more market-oriented economy, China has experienced a decline in state-owned enterprises and an important expansion for small businesses. The role of small and medium enterprises (SMEs) in economic development is well documented for advanced economies and have been crucial in China's process of economic reform. It has been pivotal in China's impressive economic growth during the last decades. Nevertheless, some bottlenecks and obstacles appear for further growth of SMEs, especially with respect to financing.

In this paper we describe the situation of SMEs in China and the main issues concerning the financing of SMEs. SMEs have been part of China's impressive economic growth of the last decades and the main actors in the privatization process. There is evidence, though, that further development is constrained by different factors, one of which is access to finance.

1 The development of SMEs in China

According to the World Bank Investment Climate Survey for China, SMEs in China face important credit constraints, and have limited access to private finance compared to other Asian countries included in the survey[1]. The survey also shows that the use of formal finance declines with firm

[1]According to the survey, SMEs in China obtain only 12 percent of their working capital from bank loans, while SMEs obtain 21 percent in Malaysia, 24 percent in Indonesia, 28 percent in the Philippines and 26

size. SMEs use less formal finance than large firms in all countries, since they are younger and subject to more growth uncertainty than large firms, but in China the difference is larger, even if we compare it with other Asian countries[2].

A very important issue is what finance is available to start-up firms. The Project Group of Research in Chinese Private Enterprises organized by China Industrial and Commercial Union and Research Commission of Chinese Private Business showed in a survey conducted in 2002 that self-accumulated money was the major source for starting up firms (approximately 55 percent), complemented by money borrowed privately (31.6 percent) and bank and Rural Credit Corporation loans (23.4 percent).

The main problems related to SME access to finance in China are the following:

Structure of the financial system China lacks an adequate credit system for SMEs, composed of the appropriate financial-service institutions. Large state-owned commercial banks have a very high market share of deposits and loans. The rating requirements for loans are quite high and are not met by SMEs, or the minimum amount that banks will lend vastly exceeds the demands for SMEs. City and rural credit cooperatives cannot fill this gap due to their own structural limitations.

A related issue is the insufficient development of the capital market in China. The capital markets started being developed by the sale of state-owned enterprises shares, but with a very cautious gradualist approach. This affected the initial development of stock markets. From the huge fund of household deposits only a small percentage (6-7 percent) are in the stock market (Kanamori and Zhao, 2004, p. 36). In short, there is not enough liquidity to absorb outstanding shares and there is a lack of institutional investors. Better perspectives can be found by the entrance of insurance companies and securities investment funds, which have been encouraged to invest in the stock market and are growing fast.

Existence of collateral to banks The most common mechanism to reduce informational problems in financing SMEs is the use of appropriate collateral. In general it is easier to assess the value of assets instead of the value of expected future cash-flows. In the United States, for instance, 92 percent of SME debt is secured by appropriate collateral and 52 percent of debt is guaranteed by the owners of the firms (Berger and Udell 1998). The most common form of collateral is accounts receivable or inventory.

But SMEs in developing countries in general, and specifically in China, lack of appropriate collateral to support their repayment ability in front of banks. The eligible collateral that can be used is determined by Article 34 of the Guarantee Law of the People Republic of China (1995), which usually are hard for SMEs to provide to banks[3].

percent in Korea and Thailand (Dollar et. al. 2003, page 31).

[2]Bank loans finance 27 percent of working capital of firms with 100 or more employees, but it drops to 13 percent for firms with 20 to 99 employees, ant to 2.3 for firms with less than 20 employees. For India, bank loan financing for the same firm sizes are 39, 38 and 29 percent (Dollar et. al 2003).

[3]Article 34 states the following: “The following property may be mortgaged: 1. Buildings and other objects fixed on land, which are owned by the mortgager; 2. Machines, means of transport and other property, which are owned by the mortgager; 3. Use-right of state -owned land, buildings and other objects fixed on land, which the mortgager has the right to dispose according to law; 4. State-owned machines,

Credit rating There is a lack of credit rating assessments for SMEs in China, together with low incentive of SMEs to build a credit reputation since it does not have a direct effect on future borrowing. This affects negatively the quality of loans and decreases further the credit rating of SMEs. A nationwide credit assessment system for SMEs was proposed in 2001. This credit assessment system was intended to improve the information processing and transmission of the credit situation of SMEs.

Accounting and auditing Financial structure of private firms is often opaque. There is a lack of transparent, audited financial records. There are restrictions in the registration under different forms of incorporation that gives incentives to firms to misrepresent financial flows, total employees, stocks of assets, and other aspects of the accounting and financial structure of firms. The tax system also can be circumvented partially by misreporting, usually underrecording. As in other countries where incentives for true reporting are weak, firms are said to keep different accounting books: one for the government, one for banks and the last one for themselves (International Financial Corporation 2003).

Economies of Scale There are important economies of scale in the activity related to borrowing by banks. These economies of scale cannot be exploited at the typical borrowing scale of SMEs, and consequently banks will prefer large loans which can only be demanded by larger enterprises.

Political risks According to Mu (2002), since most SMEs are non-state enterprises, the risks involved in performing bad loans is higher than for larger firms where there are still more state-owned enterprises.

Tax and investment policy treatment Private SMEs have disadvantages in accessing credit and receiving approval due to their weaker connection to local authorities (as compared to state-owned enterprises or privatized former state-owned enterprises, see for instance Kanamori and Zhao, 2004). This is also true for incentives in investment policy with respect to state-owned and foreign enterprises (Kanamori, 2004). Foreign firms, for instance, can enjoy special tax exemption programs, where they get exemptions for two years after the first year that they register profits. Private firms instead are subject to a 33% income tax plus a 20% individual adjustment tax.

2 Current SME financing policies in China

The Chinese government has become increasingly sensitive to the need of SME development. Policy has consisted of a mixture of interventions in financial markets to support access to finance and

means of transport and other property, which the mortgager has the right to dispose according to law; 5. The land-use-rights of barren mountains, barren valleys, waste hills and waste sands, which the mortgager has contracted according to law and the contract offering party agrees on the mortgage; 6. Other property, which may be mortgaged according to law. A mortgager may mortgage the properties listed in the preceding paragraph concurrently".

programs for local governments for SME development. In September 1999 a series of measures were enacted in order to restructure the SME sector. These included the promotion of firm groups and the exit of non-viable small firms, as well as the set up of business development services to assist SMEs in information consulting, marketing, funding, credit guarantee, technical support and services. In June 2002 the SME Promotion Law was enacted, emphasizing fair treatment and a "level playing field" for SMEs. This included greater access to finance and encouragement for venture capital investments in SMEs. To increase financial support the SME Technology Innovation Fund was established in 2000. The Law did not include any specific funding, program monitoring or enforcement. These measures were complemented with the Government Procurement Law of 2002 encouraging contracts to SMEs and mandates of the People's Bank of China so that banks relax loan approval procedures for SMEs with good credit records.

At the financial sector, an intended support measure for SMEs was the establishment of a ceiling on interest rates for loans to SMEs. This had a perverse effect as it decreased the incentives of banks to lend to SMEs (Wako 2004). In December 2000 the People's Bank of China raised the ceiling on interest rate for SME loans.

Credit guarantee schemes (CGSs) were first implemented in Shanghai and Chongqing in 1992. Initially they consisted of mutual guarantee funds (MGFs). The first commercial guarantee companies (CGCs) were established in 1994 in Sichuan and Guangdong, and after 1999, CGAs have been established at provincial and municipal levels under government sponsorship. Apart from these, there are also provincial credit re-guarantee agencies (PCGAs) and municipal guarantee agencies (MCGAs). CGAs account for about 90 % of the total credit guarantee business for SMEs, and obtain re-guarantee services from the other institutions. Prudential regulation and supervision of CGS is still preliminary and incomplete (Mu, 2002). It consists only of some simple ratios to control for exposure to single clients[4]. There are no requirements on minimum capital, liquidity risk and risk-sharing ratios.

3 SME financing policies: experiences from other countries

In the the 1960s and 1970s different developing countries enacted active policies towards SMEs, mainly based on directed credit programs as a tool for economic development and growth. The main arguments in favor of direct support and subsidies for developing countries relied on mainly on three arguments. First, it was argued that SMEs enhance competition and entrepreneurship and therefore their development has a positive impact on innovation and productivity growth. Second, it was also argued that SMEs can be more productive than large firms, but their development is constrained by an insufficient development of the financial system that is not able to provide sufficient credit for them, which has to be provided by direct government support. Third, it was thought that SMEs are labor intensive and therefore their development helps in reducing unemployment and poverty.

After the 1980s though, direct support policies for SMEs started to be reconsidered, as practices in different countries showed that they mainly stimulated capital-intensive projects. On the other

[4] For instance it is stipulated that a single client should not have more than 10% of it paid-in capital.

hand preferential funds were sometimes allocated for non-priority purposes, such as the survival of declining industries, and reduced financial discipline conducting to repayment problems, which in turn had a negative impact on budget deficits. Finally, direct support programs for SMEs created their own strong political support and are very hard to remove once implemented.

3.1 Support policies for Small and Medium-Sized Enterprises in Japan and Korea

Despite the different historical development of SME support policies in Japan and Korea, some common features can be described in both cases. Support policies for SMEs can be divided in five categories. The first type of policies refer to the promotion of association and cooperation of firms, and are oriented towards the creation of networks and subcontracting relationships. Very often other types of support measures were subordinated to the creation of these cooperating networks. The second category refers to the assistance for start-ups, technology transfer, product development and innovation. The third group of policies is related to marketing assistance, both for the penetration of domestic as well as foreign markets. The fourth category is financial assistance, both public support as well as access to private financial services. In the fifth category we can find a set of additional generic measures.

Association and cooperation. Both Japan and Korea have promoted vertical and horizontal integration of their SMEs. Special credit and tax exemptions are provided for firms that belong to associations. Joint marketing and information exchange are also promoted with this type of policies. Japan has for instance promoted the creation of industrial and commercial agglomerates and “shopping districts”. Cooperation with universities and research centers has been also incentivated. Special training is also provided to facilitate this type of exchanges. With respect to subcontracting, special laws have been enacted to promote subcontracting relations and joint projects. This has allowed in Korea to start subcontracting relations, since there were historically less developed than in Japan.

Technical assistance. Technical assistance has been oriented mainly to the creation of public R& D research centers for the diffusion and adoption of new technologies. The facilities are available for SMEs both for in-house technical assistance or to provide infrastructure for testing and prototyping. Support centers for SMEs provide assistance for technology transfer, patents, foreign and domestic technology acquisition and adoption. These support centers have local and regional branches.

Marketing Assistance. Joint marketing projects for associations and cooperatives of SMEs are promoted. Measures include technical services for marketing and the diffusion of information on local and foreign markets. The objective of this type of measures is the promotion of the internationalization of SMEs. The main agencies are the Japanese Small Business Corporation (JSBC) and the Japan External Trade Organization (JETRO) in Japan, and the Korea Trade Promotion

Corporation (KOTRA) in Korea[5]. The main measures are the promotion of trade fairs, exploratory tours, identification of foreign services such as export insurance and the diffusion of market information. Special training for international trade and product promotion is also provided.

Financial assistance. The first type of financial support is related to loan assistance, which is usually channeled through cooperatives and associations. Public funds do not represent the main source of finance (they represent only 10% in Japan, for instance) and try to serve as a signal for the involvement of the private sector. In Korea banks are required to channel specific percentages of loans to SMEs. Special guarantee funds are also created to face the problem of collateral. The last type of financial support is associated with tax exemptions and depreciation allowances for investments in equipment, R&D, export promotion and training.

Other types of measures. Other measures refer to special support for human resources in SMEs, channeled through cooperatives and associations. Government procurement is also oriented in part to SMEs, and some measures are taken to increase the opportunities of SMEs to participate in this area.

3.2 Japan

The current financial support for SMEs in Japan is formed by three components: Finance (through the Japan Finance Corporation for Small and Medium Enterprise (JASME), the National Life Finance Corporation (NLFC), the Shoko Chukin Bank and others), credit supplementation (JASME and Credit Guarantee Corporations), and enhancement of capital (Small and Medium Business Investment & Consultation Co. Ltd.). The main idea behind this financial support system is to supplement the activities of private financial institutions.

Relationship banking has been particularly important in Japan, and has been founded on the development of the banking system through a post-war policy of economic growth with bank regulation (Ueda, 1994; Allen and Gale, 2000). The system implied close relationships between banks and borrowers, in general large firms but also associations and cooperatives of small firms, and cross shareholdings between banks of firms. This long-term relationship between banks and borrowers allowed the bank to have very detailed information about firms and the ability to monitor performance closely. In case of financial difficulties, banks were also better placed to offer refinancing or restructuring (Aoki et. al. , 1994; Sheard, 1994). This system was described as efficient as it implied more effective loans, with lower risk premia, while firms had better access to finance and lower liquidity constraints (Hoshi et. al., 1990 and 1991). More recently, the system may be evolving towards one increasingly based on internal funding, due to different reasons (Suzuki and Cobham, 2005). First, there is some evidence that firms monitored and tied to main banks may be no longer getting better financing (Hall and Weinstein, 2000), less liquidity constraints (Hayashi, 2000) or better profitability or performance (Weinstein and Yafeh, 1998). The traditional view on the importance of relationship banking has been also challenged by arguing that the main role in the growth of Japanese firms was base on international competition rather than the banking struc-

[5] The China External Trade Development Council has played this role in China.

ture (Hanazaki and Horiuchi, 2000) or even that the Japanese banking system was detrimental to the development of the equity market (Wood, 1992).

Nowadays, support for Japans SMEs comes through the interaction between the private and public sector. The support measures focus on technical, financial and marketing assistance. The main feature of the most dynamic sectors is the network of subcontracting agents that characterizes most Japanese industrial sectors, for instance auto parts and synthetic textiles, as other producers of intermediate goods, work mainly with subcontractors. Technical support for SMEs come mainly through the interaction between these private firms, including parent firms, equipment suppliers and other providers. It has been argued that small firms have helped large firms to function more effectively, through the establishment of strong networks of collaboration and mutual dependence (Friedman, 1988). SMEs had to compete for subcontracts and this was good for large corporations as it improved quality of components, implying quality improvements for the final products (Womack et. al, 1990). Public support was subordinated to these private relations, and was oriented mainly to the creation and development of private networks[6]. Private sources such as parent firms or trading companies also provide the main channels for marketing support.

Credit support for SMEs has been traditionally provided under competitive market conditions, except for about 20 per cent of the total credit volume which was provided by specialized publicly supported agencies, local government or loan guarantees. Even in this sector default rates were low (less than one per cent of outstanding loans).

It can be concluded that SME financing in Japan is successfully integrated into a well-functioning competitive and prudential financial system, where the public sector plays a subordinate role both in direct credit and in the establishment of partnerships between private firms and between the public and private sector (Itoh and Urata, 1994).

3.3 Korea

Support systems for SMEs in Korea have been traditionally based on three types of support: technical, marketing and financial.

The idea of technical support is based upon the fact that SMEs have greater difficulties in accessing information about new technologies and how to introduce them profitably into their production processes. This can be overcome by the set up of an external support system. Korea offers an extensive network of agencies providing collective external technical support. This support includes technical assistance, training programs, information services or joint research opportunities. These services are often complemented by financial incentives. An important part of this system is composed by the network of public research institutes, which try to assure that SMEs can benefit from technology transfer. Another component of the system is formed by non-profit private agencies. In a survey conducted in 1994, it was found that SMEs used often this technical support system, but complained that the assistance was not always effective because of the lack of experience that public agencies have in manufacturing (Kim and Nungent, 1994).

Marketing support pursues the objective of overcoming marketing costs in what refers espe-

[6] On the importance of the Japanese policy framework towards SMEs in encouraging inter-firm networks, see for instance Aoyama (1999).

cially the penetration of external markets for exports. SMEs lack the in-house resources of large firms, since market information is hard to get and transactions costs are high. The Korean government developed a variety of institutions to assist firms in marketing their products for export. The largest agency is the Korea Trade Promotion Corporation (KOTRA) which offers information about foreign market opportunities, market research, assistance with trade fairs and overseas marketing trips, and identification of other services such as export insurance. Within KOTRA, the Korea Trading Company (KTC) was specifically established to provide import/export services to SMEs. A key feature of the KTC is that it operates commercially. Not all the marketing support services are public, there is also the Korea Traders Association (KTA), a large association representing the interests of firms. This agency assures public relations and lobbying for firms, but also encourages information-sharing.

Government financial assistance for SMEs adopts many different forms. Originally the main source of financial support for SMEs came from unregulated non-bank financial institutions, mainly credit markets based on reputation and family relations with no tradable assets, informal commercial paper markets, mutual savings and loan funds, popular funds and private finance companies. The interest rates for SMEs in these markets were very high, perhaps two times higher than those in formal markets. The main collective source for SME finance support was the SME Restructure Fund, created in 1978. During the 1970s, state commercial banks had to allocate 30 percent of their new credit for SMEs, while for local banks it raised to 70 percent. In the 1980s, there was a shift towards a stronger SME support system. Many SME oriented credit funds were set up to encourage collective and cooperative activities among SMEs, to access new technologies and to help SMEs relocate some of their operations abroad. Both commercial and rural banks were required to allocate minimum specified percentages of loans to SMEs. Tax breaks were also used to incentivate specific restructuring programs (accelerated depreciation allowances, deductions from taxable income, tax moratoria and tax rate reductions, see Kim and Nugent 1999).

More recent trends in the development of SMEs, as stated above, have implied an increasing role of SMEs in the Korean economy with respect to large conglomerates. An important aspect of this more prominent role is the set of a subcontracting network between large and small firms (Nugent and Yee, 2001). Access to successful large firms and other firms can be an important means for SMEs to overcome some of the constraints on their development, under the right environment (for instance in terms of competition). The model to follow is for instance the Japanese automobile industry, where a multi-tiered subcontracting system is regarded as transaction-cost efficient. Some studies have compared Korea's subcontracting system with Japan (Kim 1991) or with Taiwan (Levy 1991), and in both cases they find these other systems of subcontracting to be deeper and more transaction-cost efficient. Nevertheless, subcontracting is acquiring a very important role for Korean SMEs.

3.4 Some common criteria

From the financing practices of Japan and Korea it is possible to draw some criteria that may be useful. These criteria were not applied consciously at all times, but ex-post they seem to show practices that may be helpful in all contexts.

1. Financing programs for SMEs have to be sector-specific, well focused and of limited dura-

tion. In general, both in Japan and Korea the programs were targeted to specific sectors and implemented locally.

2. Direct subsidies have to be in general avoided, as they introduce wrong investment incentives and distort the financial intermediation system. There is no empirical support on the effectiveness of direct subsidies. A well functioning business environment seems to be more important.

3. To prevent a negative impact on inflation and macroeconomic stability, the programs have to be in general financed by long-term funds.

4. Declining industries should be treated apart from the rest, and any support there should be have a very clear phase-out horizon.

5. Export orientation should be always promoted. In both Japan and Korea the most successful support for SMEs seem to have been the promotion of access to international markets.

6. Policies should be part of a credible and consistent long-term development strategy. The support for SMEs cannot be viewed as an isolated attempt to create employment and reduce poverty, but as part of the creation of an adequate and competitive business environment, where strong links are established between large firms and SMEs.

7. The credit programs should be channeled by well-capitalized and professionally managed institutions, which should function autonomously and should use market-based criteria for the assessment of the loans. Public funding should be used as a signal for the involvement of the private sector.

8. Monitoring criteria should be based on clear and objective information. In this sense clear business plans and transparent accounting information seems to be very important to improve the prospects of financing.

9. Repayment procedures should be established as to avoid losses.

4 Proposed measures to improve small and medium-sized enterprises financing in China

In this section we draw some recommendations from the previous discussion. Some of the proposed measures are not strictly financial, but can help in enhancing access of SMEs to finance.

Improving the financial sector

1. China's credit system should try to adapt for the financing of SMEs, in order to increase the amount of funds available to them. Right now state-owned banks do not have all the resources to correctly evaluate credits for SMEs, most banks should have specialized departments for this type of credits. There should be also a more flexible interest rate floating

regime for credit available to SMEs. Ceilings on interest rate may represent an important constraint on SME access to finance. A ceiling on interest rates reduces the attractiveness for banks to lend to SMEs.

2. Specialized financial institutions oriented towards SME credit should be gradually developed. To accomplish this goal, the current financial structure should be appropriately reformed. Currently there is an important amount of information asymmetry between urban and rural credit cooperatives and SMEs. The latter should develop into independent non-state small and medium sized banks that could cooperate with SMEs and are incentivated by competition among them. The structure of financial institutions oriented towards SMEs could include different types of specialized institutions: regional stock markets, regional banks initiated by non-state investors, small credit guarantee companies, small leasing companies ans small finance companies. All this structure should be complemented by the appropriate regulatory framework, in order to prevent financial risks.

3. It is very important that a social-credit environment and an SME credit-rating system is established. A well-functioning financial system demands the existence of mechanisms where efficient SMEs can build their credit reputation and secure the funds that they need for their growth. Since economic reforms in China are fairly recent, these type of mechanisms are still to be developed.

Direct Support for SMEs

4. Government funds directly used to support SMEs should be subject to a professional management based on commercial criteria. The current lack of transparency in the financial and accounting information of SMEs may be distorting resource allocation through incorrect government funding.

5. SMEs also need a favorable external environment, composed by support in all social areas and associated services. This should include an SME legal guarantee system, venture support, fiscal and taxation support, professional and technical training and information and consultation system.

Improving the financial information of SMEs

6. Financial information systems should improve for SMEs. This involves a proper financial accounting system for SMEs, which has to assure adequate disclosure of financial information at least in three basic components of the budgetary period: a) the operating statement, the balance sheet and the cash–flow statement. This information disclosure may allow banking institutions to be better informed on the governance of SMEs, in order to evaluate more adequately their credit risk. The support system for SMEs should involve support in accessing information storage, processing and retrieval systems. The diffusion of information and communication technologies has allowed to increase the availability and affordability of dedicated software on standard accounting programs customized for SMEs. The improvement of better communication with credit providers can be also achieved by providing support

to SMEs on business plan preparations, both for start-ups or for the development of existing firms. A well-prepared business plan can serve both as a roadmap for the improvement in the management of SMEs and as a means to assure better channels of communication between SMEs and funds providers. It is crucial then to build up the skill base of SMEs in financial analysis and business plan writing. This may allow to improve credit prospects for young small firms that lack real-asset collateral, equity or do not have a credit history.

Subcontracting and networking

7. From international experience, support for inter-firm cooperation involving SMEs can be considered a “best practice”. These should include support for marketing in local and especially international markets, associations to facilitate efficiency-enhancing information-sharing and help in the establishment of subcontracting networks between large and a small firms. Support should be provided for several SMEs and it should be avoided to create a large administrative system to implement theses policies, given their time-limited nature.

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