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Financial Reform & SMEs Development in China:

Unleash Growth Potential through Innovation and Entrepreneurship

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Abstract

Various analyses forecast that China will become a middle-class country by the end of this decade (using standard of having more than 50% of the population living in that social segment). Some others consider such a goal to be just an intermediate stage in China´s transformation into a High Income Economy by 2030. To achieve either goal, the Chinese economy will have to continue its ambitious and permanent reform process, broadening its scope, and multiplying engines for job creation and income distribution.

The main purpose of this paper is to identify instruments, tools, vehicles and regulatory reforms to strengthen the link between financial markets and small and medium enterprises in China as well as to support entrepreneurship development. This paper discusses the relevance of maintaining the focus on acquiring technological leadership as well as the importance of further promoting a vibrant business community ready to unleash growth potential, multiplying its presence in capital markets.

In that context, it will recommend the strengthening of the ongoing financial reform process with regard to entrepreneurship and SME development, proposing it as a way to further improve the correlation between technological progresses, value added, job creation and income levels. By means of this, we can build a "sound society" with inclusive finance.

About the Author

With more than 25 years of intensive professional experience in trade and industry, environment, energy and international relations, Carlos Magariños is currently the Chairman of Global Alliance of SMEs (GASME). He has worked in leading positions at the private sector, at the national government of Argentina and at the multilateral system in the United Nations. He is the founder and manager of the Global Business Development Network, a private equity group with offices in Washington, Buenos Aires, Lima, Vienna and Mumbai.

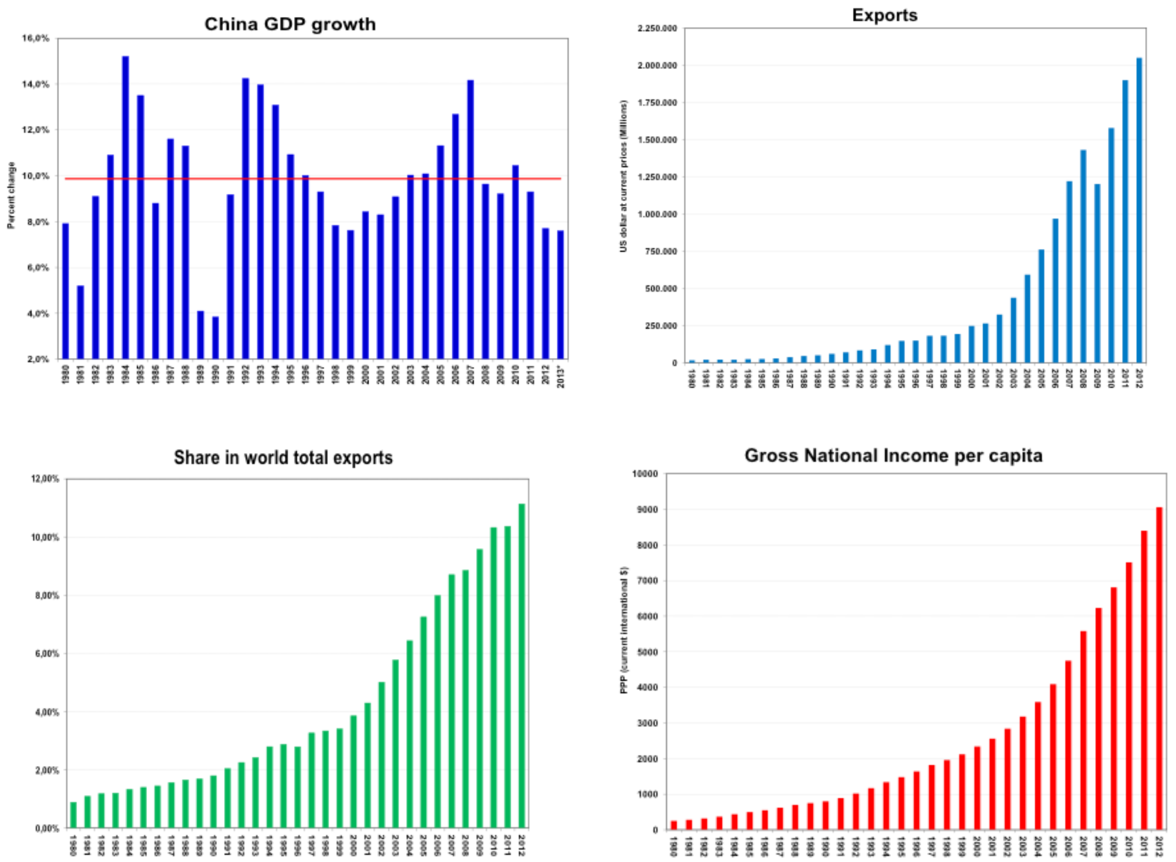
In 1993, at the age of 30, he was appointed as State Secretary of Industry and Mining of Argentina. In 1996, he was appointed as Economic and Trade Representative to Washington DC. A year later he was elected as Director General of the United Nations Industrial Development Organization (UNIDO). In 2006, he was elected as Senior Associated Member of Saint Antony's College, at Oxford University.

His interest in understanding the challenges of developing and emerging economies and societies in a global economy led him to design and manage various research works. The results obtained were presented in several articles and writings, as well as his numerous conferences and presentations around the world. His outstanding performance in international affairs made him won more than 25 international awards in Europe, Asia and America.

I The Future of the Global Economy Lies with Emerging Market

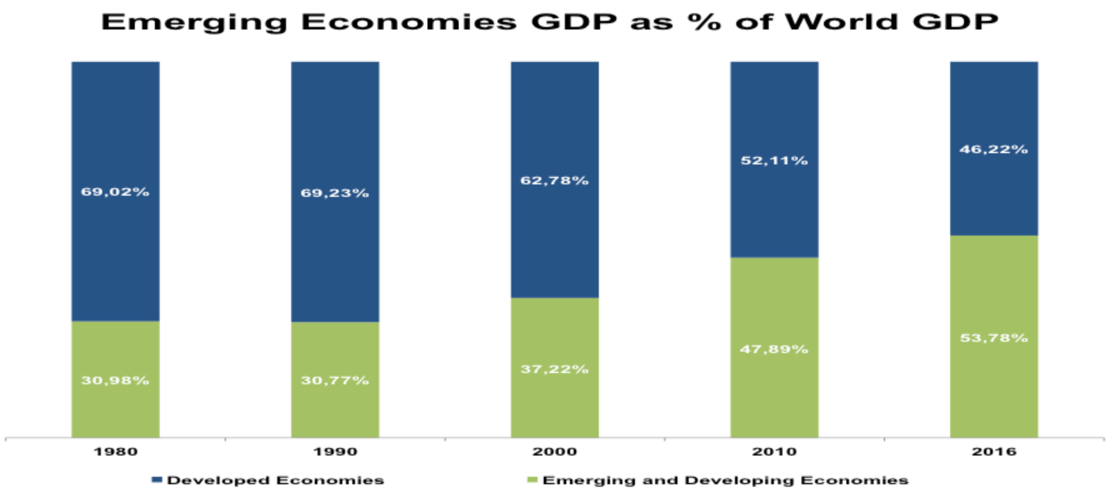
Pervasive technological dynamism and structural social change are transforming the world economy, with a remarkable new position for emerging countries as engines of global output and the emergence of a new global middle class. Successful economic and social reforms in China played an important role in this process, improving living conditions for its people and creating opportunities in countries overseas.

Chart 1: GDP growth, Exports, % of World Total Exports, and Income per capita in China between 1980 and 2013



As we can see in the Chart 1, Chinese economic and social reforms have been very successful by all classical measures of wealth and progress, and represent a considerable improvement in the living conditions of hundreds of millions of people in this country, as well as a formidable impulse for renewed opportunities and prosperity to people and countries overseas. The peaceful rise of China is changing the global economic landscape, giving rise to many structural changes in the world economy and society. For the first time, emerging economies are reaching an equal share of global GDP in PPP terms, as shown in chart 2.

Chart 2: Share of World GDP by Emerging Economies (Purchase Parity Terms between 1980-2016)



Asian growth in general, and China´s economic growth in particular, helps to explain a considerable portion of the performance of emerging economies, although this is happening after an exceptional decade of growth that was widely spread across the whole range of emerging economies. Analysts, experts, academics, and scholars have begun to ask themselves whether the global economy is at the dawn of a new era, or at least at the beginning of a structural shift of its basic working conditions.

The financial crisis brought to an end a period that many analysts labeled the "Great Moderation", which refers to the moderate but constant income growth in advanced economies coupled with low unemployment and relatively low volatility in financial markets over the last decades. Each time developed countries faced the effects of the economic cycles and/or the bursting process of asset bubbles, they were able to resort to new levels of debt to mitigate any potential negative effects on the level of economic activity. For developed countries, the future is no longer what it used to be. The debt super-cycle has come to an end, confronting them with hard choices if they are to avoid prospects of lower growth, higher volatility, and less employment.

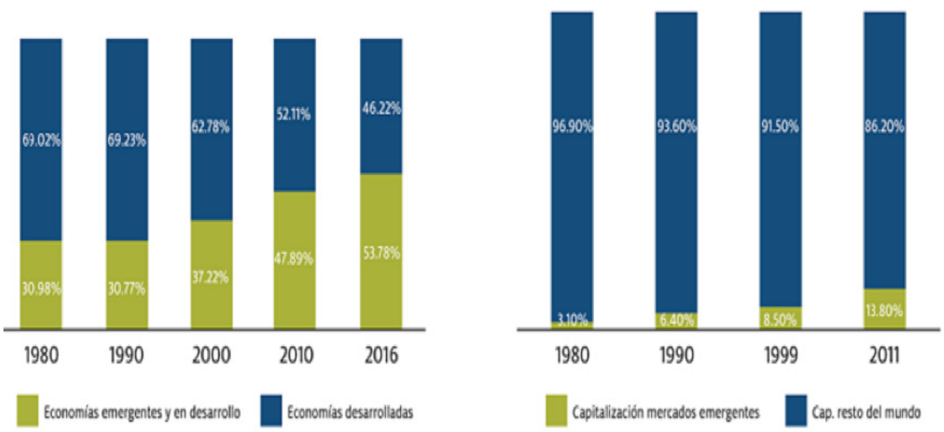
For developing countries, however, there is no reason to assume that the exceptional levels of growth experienced over the past decade will be sustained automatically by the performance of the global economy without much effort in the years to come. As soon as 2020, the group labeled as the BRICS (whose top four members are Brazil, Russia, India and China) could overtake the G7, replacing four of the present members of this selected group of the most industrialized nations of the world. Many developing countries and emerging economies will also improve their performance and share of world trade and participation in the world economy.

Still another very significant reason to assume we are at the dawn of a new era, a phenomenon that China very much contributed to unleashing, is the emergence of a new Global Middle class. Last time the world saw such a revelation was around a century and a half ago at dawn of the second industrial revolution. If the global middle class is defined as the group of people spending between 10 and 100 dollars per day, in 2009 we find slightly over 1,8 billion people living in such a social segment. By 2020, the number of people living as middle class will grow to almost 3.3 billion. At that time China will be a middle class country by the standard of supporting one half of its population at that level of income. Asia will be the host of 54% of the Global Middle Class, the proportion hosted until recently (2009) by Europe and the US combined.

Most impressive would be to forecast what changes will happen in the structure of Global Middle Class spending. By 2009, Europe plus the US represented 64% of the more than 21 billion dollars spent by this segment. At that time Asia represented just 23% (Chart 8). Projections show that Europe and the US will contribute a little more than 46% of the more than 35 billion dollars to be spent by the Global Middle Class in 2020. Around the same time, 42% Global Middle Class spending will originate in Asia, nearly matching the percentage of Europe and the US. This means that the spending of the Global Middle Class in Asia will triple in just one decade, from 5 to 15 billion dollars.

On the whole, these processes represent an important opportunity for the companies operating in emerging Asia and the rest of the developing world. Emerging markets' multinationals and other companies are operating in the most dynamic area of the new global economy, although they still represent only a minor share of the global market capitalization value. The speed and range of value creation will be certainly influenced by the way these new breeds of companies get to the public, and how the countries where they are born and operate decide to fill in the regulatory gaps in areas like environment, bio-tech, food safety and labor, converging towards global standards. Companies themselves will have a lot to do to upgrade their participation in Global Value Chains and Global Production Networks by devising the right strategies as well as investing in research and technology.

Chart 3: Emerging Countries Participation in World GDP (PPP) and Emerging Markets Companies Participation in Total Market Capitalization



Charts3 shows that there is a lot of value to be created and reaped by emerging market companies in the stock markets.

In mid-and-long term, China enjoys sound prospect economically, meaning that it is sure to meet its goal of completing the building of a moderately prosperous society in all respects by 2020. Still, China now faces significant challenges as the old growth model featuring high investment and high energy consumption has been proven to be unsustainable. The Chinese government is leading its people to develop a more efficient and sustainable growth model. Such a shift actually indicates a rebalance in China's economy to promote its productivity and technological intensity, where priorities are given to domestic rather than external demands, to consumption-led rather than investment-led growth, and to public private partnership (PPP) rather than government dominance in certain industries.

Premier Li Keqiang proposed "twin engines", namely upgrading of the traditional engine while fostering a new engine, to ensure stable and healthy economic development. To foster a new engine, Premier Li Keqiang advocates "mass entrepreneurship and innovation". Obviously, the characteristics and advantages of SMEs have qualified them as the main force of this endeavor. However, like all SMEs across the world, China's SMEs, among other challenges, find it difficult and costly to obtain financing. This paper attempts to recommend various methods and tools to rebalance real economy and capital market as well as social demands and financial services. In this way, China's financial system can be upgraded as part of the efforts to fuel the growth of SMEs .

II China Set to Embark on " the Fast Track " to Become a High-income Country

The end of the debt Super-Cycle and the new role of Emerging Markets at the global level, as well as the emergence of a new Global Middle Class, will create a new political and economic scenario for the international community, one that has plenty of opportunities for the years to come, presenting at the same time many uncertainties and challenges. As mentioned, China´s own progress has played a very important role to bring about these new realities. With its new status it has new responsibilities to its people, and, whether it likes it or not, also to the world as well.

The peaceful rise of China has indeed showed the clear commitment of the Chinese leadership to play a constructive role as a responsible global neighbor, while giving due priority to meet the many pendant social demands of its people. This is the context for China's continuous reform effort, including the "re-balancing" of the Chinese economy, driving it toward a so called "new normal", represented by a growth rate evolving to around 7,5% and an inflation rate near 2,5%.

It can be expected that in this new scenario, private companies – especially SMEs – and job creation will face heightened pressures. The financial system, and more broadly the financial reform process, could and should play a greater role to ease these pressures to the extent possible. On the other hand, a general demand for additional productivity across the Chinese industrial complex will increase the need for upgraded technologies, advanced management capabilities, and a consistent process of skills renewal throughout the workforce.

These and other problems will be addressed in a demanding context of a) rising social demands for social security, quality education, etc.; b) limited capacity to sustain the current levels of revenue due to constraints imposed by the need to facilitate Small and Medium Enterprises´ adjustment to a new level of competitive pressure and lower contributions from land use, as well as potentially reduced housing prices; c) less popular support for reform efforts, as is usually the case when a certain number of citizens improve living conditions; and d) weakening international environment.

Possibly, the best way to escape this potential labyrinth of difficulties is upwards. In particular up the technology ladder, meaning strengthening China´s emerging role as a science and technology power in order to enable the continuous incorporation of technology in its industrial complex, as well as to stimulate the capacity to innovate across the productive sectors. This is the way chosen by the Chinese leadership a long time ago, but it needs to be further promoted and deepened.

It has long been argued that there is a positive correlation between the complexity of one productive system and the long-term average income level of a given economy, both in terms of value added and the level of technology incorporated.This concept, intuitively, is widely accepted and has been also sustained by a considerable body of literature and academic research. However, the task of measuring progress in such fields relative to others and to gauge the correlation between technological progress, value added and income levels is not an easy one.

This section outlines the results of two research reports produced by the United Nations industrial Development Organization (UNIDO) intended to produce a proxy for the measure of the level of industrial depth and technological complexity of productive systems around the world (Competitive Industrial Performance Index – CPI), and the factors behind income level convergence and catching up processes by focusing in "Capabilities Building".

The Competitive Industrial Performance Index (CIP Index)

The variables included in the index compare the share of industry in GDP and in exports as well as the level of medium and high technology including in local production and export products (sorted using the International Standard Industrial Code - ISIC). It also considers those values in per capita terms.

Chart 4: Competitive Industrial Performance Index

Ranking of countries by the CIP Index, 1980, 1990, 2000 & 2005											
1980			1990			2000			2005		
Rank	Economy	Score	Rank	Economy	Score	Rank	Economy	Score	Rank	Economy	Score
1	Switzerland	0,758	1	Singapore	0,772	1	Singapore	0,833	1	Singapore	0,89
2	Singapore	0,683	2	Switzerland	0,748	2	Ireland	0,738	2	Ireland	0,689
3	Germany	0,658	3	Germany	0,683	3	Japan	0,694	3	Japan	0,678
4	Sweden	0,604	4	Japan	0,661	4	Switzerland	0,653	4	Switzerland	0,659
5	Japan	0,585	5	Sweden	0,611	5	Sweden	0,593	5	Sweden	0,603
6	Belgium-Luxembourg	0,569	6	Belgium-Luxembourg	0,601	6	Germany	0,586	6	Germany	0,602
7	Netherlands	0,536	7	Finland	0,561	7	Finland	0,583	7	Finland	0,594
8	Finland	0,519	8	Austria	0,547	8	Belgium-Luxembourg	0,563	8	Belgium	0,581
9	France	0,513	9	Ireland	0,53	9	United States	0,558	9	Republic of Korea	0,575
10	Italy	0,511	10	Netherlands	0,525	10	Taiwan	0,552	10	Taiwan	0,555
11	Austria	0,497	11	Italy	0,522	11	Hong Kong	0,532	11	United States	0,533
12	UK	0,496	12	France	0,509	12	Republic of Korea	0,528	12	Austria	0,528
13	United States	0,489	13	UK	0,505	13	Malaysia	0,509	13	Hong Kong	0,5
14	Denmark	0,48	14	United States	0,504	14	Austria	0,504	14	Slovenia	0,486
15	Norway	0,455	15	Taiwan (Prov. China)	0,497	15	Canada	0,500	15	United Kindom	0,474
16	Hong Kong SAR	0,443	16	Denmark	0,485	16	United Kindom	0,491	16	Malaysia	0,474
17	Canada	0,44	17	Canada	0,455	17	Malta	0,483	17	France	0,472
18	Taiwan (Prov. China)	0,428	18	Rep.Korea	0,44	18	Luxemburg	0,481	18	Netherlands	0,455
19	Ireland	0,426	19	Malta	0,438	19	France	0,477	19	Luxembourg	0,453
20	Israel	0,415	20	Spain	0,438	20	Italy	0,471	20	Canada	0,453
21	Spain	0,402	21	Hong Kong	0,431	21	Netherlands	0,466	21	Italy	0,447
22	Poland	0,362	22	Israel	0,43	22	Israel	0,457	22	Czech Republic	0,439
23	Rep.Korea	0,344	23	Norway	0,405	23	Denmark	0,456	23	Denmark	0,437
24	Brazil	0,31	24	Malaysia	0,368	24	Slovenia	0,448	24	Hungary	0,436

The index is comprised of a sample of 123 countries whose data was available for collection, and compared over a period ranging from the 1980s to 2005 (Chart 4 and 5).UNIDO started its publication in 2003, and continues its analysis and refinement on the basis of the original work of the late Professor Sanjaya Lall from Oxford University. As could have been expected, high income countries featured prominently at the highest level of the scale in each of the years for which the index was calculated.

It can be safely said that moving upwards in the index means climbing the technological ladder. In addition, the Competitive Industrial Performance Index serves as a bench-marking tool to evaluate the progress made by others. China has been doing that over the last few decades with good results and now faces the challenge of sustaining the efforts to continue its progress in the years to come.

Chart 5: Competitive Industrial Performance Index

Ranking of countries by the CIP Index, 1980, 1990, 2000 & 2005											
1980			1990			2000			2005		
Rank	Economy	Score	Rank	Economy	Score	Rank	Economy	Score	Rank	Economy	Score
25	Portugal	0,309	25	Romania	0,367	25	Hungary	0,415	25	Thailand	0,423
26	Turkey	0,306	26	Hungary	0,354	26	Thailand	0,408	26	China	0,418
27	Australia	0,303	27	Portugal	0,324	27	Spain	0,407	27	Malta	0,414
28	New Zealand	0,302	28	China	0,323	28	Mexico	0,404	28	Slovakia	0,402
29	New Caledonia	0,298	29	Brazil	0,321	29	Czech Republic	0,398	29	Spain	0,392
30	Barbados	0,296	30	Poland	0,317	30	Philippines	0,388	30	Philippines	0,391
31	Hungary	0,285	31	Mexico	0,297	31	China	0,387	31	Israel	0,386
32	Mexico	0,282	32	New Zeland	0,286	32	Slovakia	0,364	32	Mexico	0,379
33	Iceland	0,281	33	Australia	0,285	33	Costa Rica	0,345	33	Poland	0,332
34	Argentina	0,281	34	Thailand	0,281	34	Portugal	0,344	34	Norway	0,328
35	Greece	0,276	35	Iceland	0,276	35	Norway	0,326	35	Costa Rica	0,326
36	Zimbabwe	0,248	36	Argentina	0,272	36	Brazil	0,323	36	Portugal	0,32
37	South Africa	0.246	37	Turkey	0,268	37	Poland	0,31	37	Estonia	0,319
38	Cyprus	0,245	38	India	0,262	38	Indonesia	0,301	38	Brazil	0,308
39	India	0,243	39	Greece	0,262	39	Estonia	0,297	39	Romania	0,308
40	Malaysia	0,24	40	Jordan	0,253	40	Romania	0,286	40	Iceland	0,291
41	Peru	0,238	41	Barbados	0,251	41	New Zeland	0,281	41	Cyprus	0,284
42	Philippines	0,228	42	Uruguay	0,246	42	Australia	0,281	42	Indonesia	0,282
43	Kuwait	0,224	43	Mauritius	0,24	43	Turkey	0,268	43	Turkey	0,28
44	Mauritius	0,221	44	Zimbabwe	0,239	44	Jordan	0,267	44	New Zeland	0,277
45	Uruguay	0,219	45	Philippines	0,235	45	Argentina	0,266	45	El Salvador	0,27
46	Rep. Dominicana	0,215	46	South Africa	0,232	46	El Salvador	0,261	46	South Africa	0,269
47	Thailand	0,213	47	Morocco	0,225	47	Bahamas	0,261	47	Qatar	0,268
48	Trinidad and Tobago	0,209	48	Qatar	0,224	48	South Africa	0,26	48	Greece	0,266
49	China	0,206	49	Cyprus	0,222	49	Bulgaria	0,26	49	Tunisia	0,263
50	Bangladesh	0,201	50	Pakistan	0,219	50	Egypt	0,259	50	Bulgaria	0,262
51	Chile	0,196	51	El Salvador	0,218	51	India	0,256	51	Jordan	0,257
52	Reunion	0,194	52	Tunisia	0,213	52	Tunisia	0,254	52	Argentina	0,256

III Innovation and Entrepreneurship as the Powerhouse of China's Growth

The Chinese economy´s performance in the index features pretty well – in spite of the enormous weight of its population. From position 49 in the 1980s, the Chinese economy was able to reach to the position 28 a decade later, the biggest jump in the index by far. The following decade it struggled to maintain the same level, ending in position 31 in 2000. In 2005 the country resumed its way upwards reaching position 26.It should be noted, however, that we are screening a very competitive field.

Since then China´s economy further improved its position based on the progress made by its science and technology systems over the last few years, and the investment dynamic in research and development that has provided the opportunity for China to achieve technological leadership in certain fields.

Chart 6: Chinese World Leadership in Key Technology Sectors.

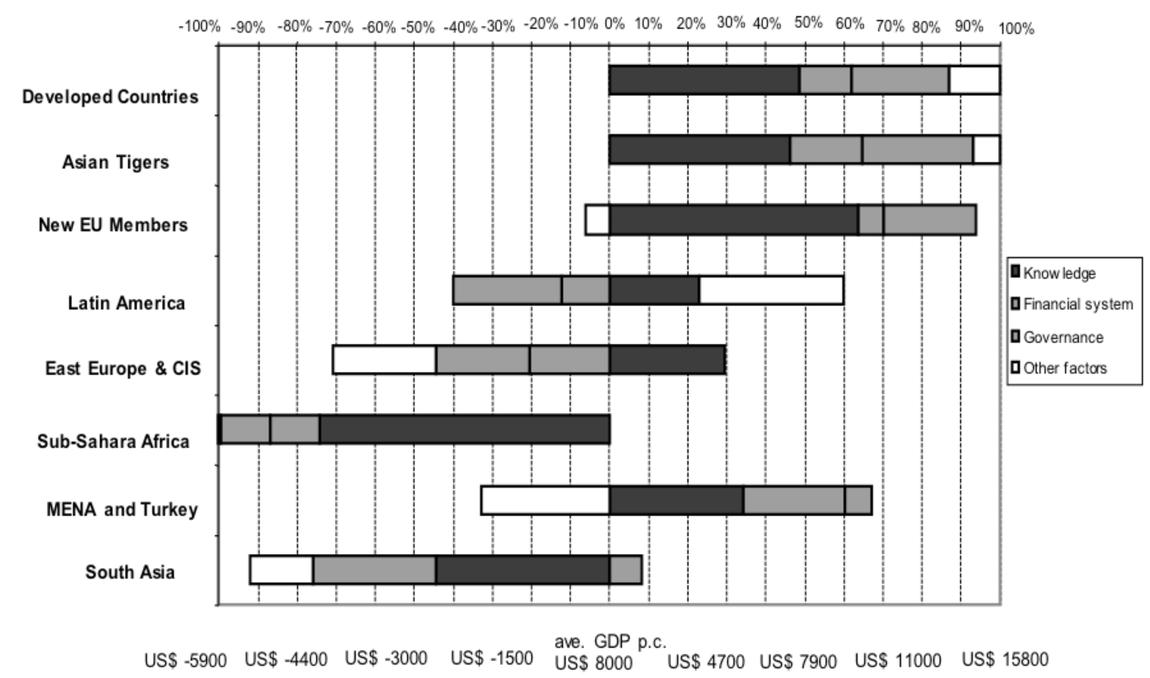
High Voltage Transmission	High-Speed Rail	Advanced Coal Technologies	Nuclear Power	Alternative Energy Vehicles	Renewable Energy	Supercomputing
China has deployed the world's first Ultra High Voltage AC and DC lines – including one capable of delivering 6.4 gigawatts to Shanghai from a hydroelectric plant nearly 1300 miles away in southwestern China. These lines are more efficient and carry much more power over longer distances than those in the United States.	In the span of six years, China has gone from importing this technology to exporting it, with the world's fastest train and the world's largest high-speed rail network, which will become larger than the rest of the world combined by the end of the decade. Some short distance plane routes have already been cancelled, and train travel from Beijing to Shanghai (roughly equivalent to New York to Chicago) has been cut from 11 hours to 4 hours.	China is rapidly deploying supercritical and ultra-supercritical coal combustion plants, which have fewer emissions and are more efficient than conventional coal plants because they burn coal at much higher temperatures and pressures. Last month, Secretary Chu toured an ultra-supercritical plant in Shanghai which claims to be 45 to 48 percent efficient. The most efficient U.S. plants are about 40 percent efficient. China is also moving quickly to design and deploy technologies for Integrated Gasification Combined Cycle (IGCC) plants as well as Carbon Capture and Storage (CCS).	China has more than 30 nuclear power plants under construction, more than any other country in the world, and is actively researching fourth generation nuclear power technologies.	China has developed a draft plan to invest $17 billion in central government funds in fuel economy, hybrids, plug-in hybrids, electric and fuel cell vehicles, with the goal of producing 5 million new energy vehicles and 15 million fuel-efficient conventional vehicles by 2020.	China is installing wind power at a faster rate than any nation in the world, and manufactures 40 percent of the world's solar photovoltaic (PV) systems. It is home to three of the world's top ten wind turbine manufacturers and five of the top ten silicon-based PV manufacturers in the world.	Last month, the Tianhe-1A, developed by China's National University of Defense Technology, became the world's fastest supercomputer. While the United States – and the Department of Energy in particular – still has unrivalled expertise in the useful application of high performance computers to advance scientific research and develop technology, America must continue to improve the speed and capacity of our advanced supercomputers.

As can be seen in Chart 6, there is a group of technologies where China has gradually taken the lead at the world level, surpassing even the US. Such progress has been critical to build new capabilities across the productive system and the society, creating new opportunities for people and companies.

Capabilities Building for Catching-Up

“Capability Building for Catching-Up” is precisely the issue addressed by the second index presented in this section, which intends to provide a tool to analyze the role played by these and other factors to explain the evolution of income levels and the extent to which it could influence the convergence or catching up process.In a report published in 2005 on “Capability Building for Catching-Up”, UNIDO seeks to deepen the analysis on the CIP Index, further exploring its linkages with income levels.An index comprising 29 variables exploring social capabilities in 135 countries is presented here. Using factorial analysis those variables were reduced to 4 key factors explaining 76.7% of the income difference across the sample of countries.

Chart 7: Deviation from average GDP per capita explained by factors (in % value and US$, 2000-2002)



Source: UNIDO IDR 2005

The first factor correlates highly with the creation, use and transmission of knowledge, specifically R&D and innovation, scientific publications, ICT infrastructure, ISO certifications and education.

The second factor is called inward openness and shows the correlation between imports and inward FDI.

Third factor is labeled financial system, and relates largely to the overall aspects of market capitalization, country risk, and access to credit.

Finally the last factor is represented by the government and the political system in general.

With all its shortcomings the index presented above could be considered a sort of proxy for the analysis of the factors explaining average per-capita income differences across a sample of countries.

Section I showed that China features well in some dimensions of "Governance" (Chart 1), and that important efforts have been devoted by the Chinese leadership towards improving the rule of law, reducing corruption, and to improving the administration of justice.This section shows the initial returns on efforts dedicated to improve the creation and dissemination of knowledge (for example see Chart 6).Clearly, the accession of China to the WTO and its measurable results, as shown in Chart 1 regarding exports and total share of world exports, would allow us to say that the factor labeled "Inward Openness" is, at least, being taken care of.

The observations derived from these analyses confirmed the centrality of a strong and dynamic financial system to sustain efforts aimed at diversifying the economy and raising living standards. This is also an area where a lot has been done in China. It is currently being addressed further by sustained efforts towards financial reform.

It is important to understand, as the Chinese leadership does, that technological leadership requires significant public investment. The calibration of technological leadership - once acquired - with value added, and increased job creation and related income levels throughout the productive system, however, entails to some extent the promotion of innovation by the private sector, and rests in the quality of entrepreneurship and SME development.

Chart 8: Job Creation by Type of Firm in the United States.

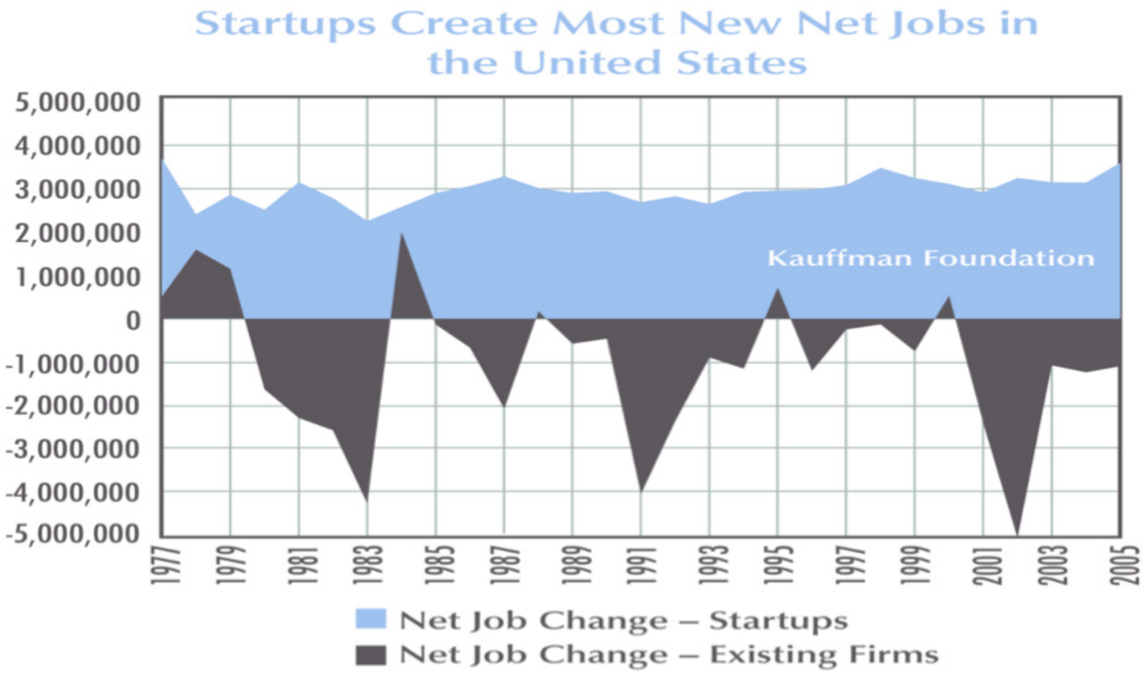
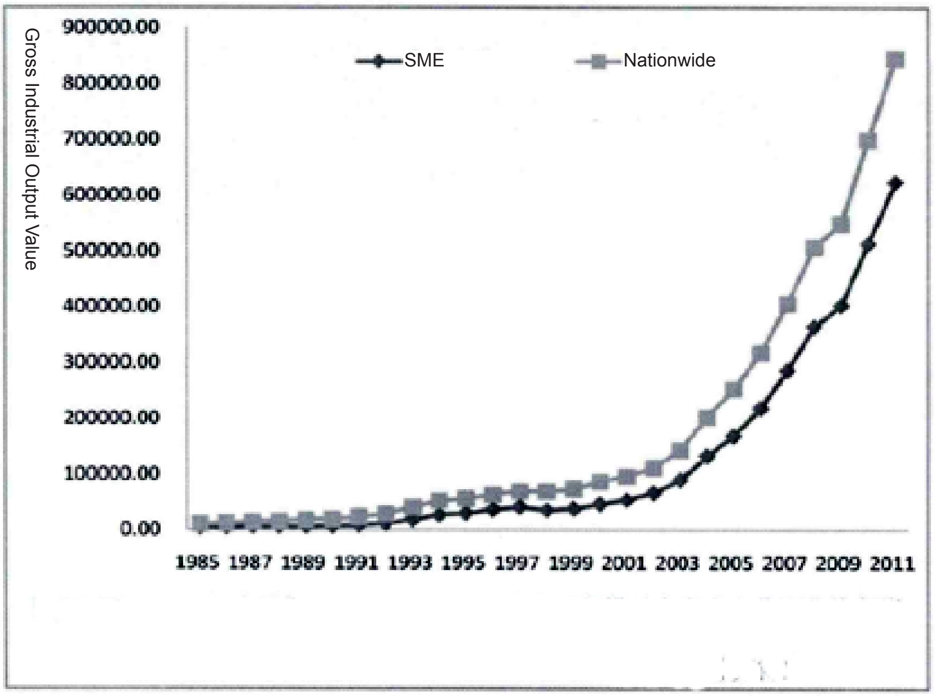


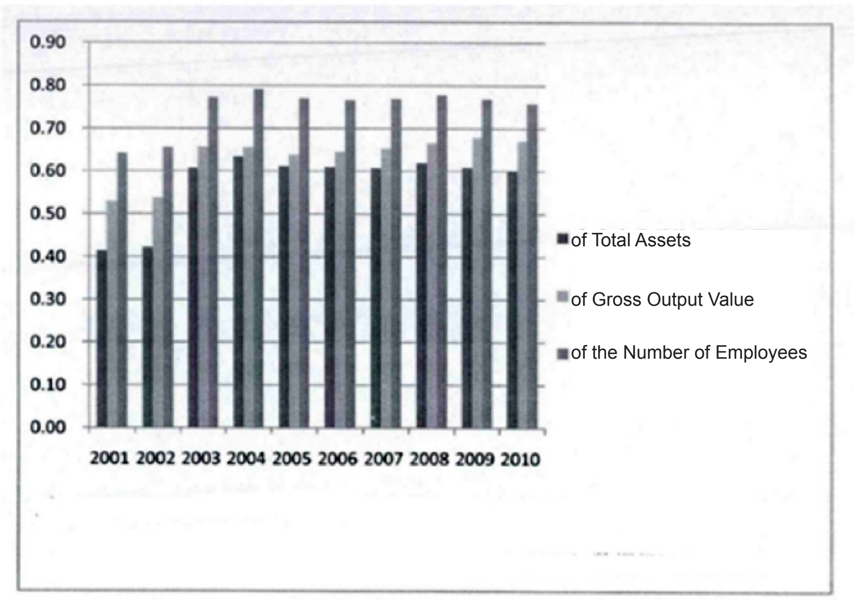
Chart 8 tells us that start-ups, mainly SMEs, are the largest contributor to new jobs in the United States. The story is similar in China as SMEs are ever more important in the country's economic growth. Statistics shows that over 99% of Chinese enterprises are SMEs, contributing 60% of the total growth, 80% of jobs in urban area and about 50% of national tax revenue. SMEs also lead in technological innovation as they are home to 65% of Chinese innovation patents and over 75% of company technological innovations.

Chart 9: Gross Industrial Output value of Industrial Enterprises above Designated Size and of SMEs above Designated Size (China, 1985-2011)



Source: China Statistical Yearbook （1986-2012）

Chart 10: The proportion of SMEs to Industrial Enterprises above Designated Size in terms of Total assets, Gross Output Value and the Number of Employees (China, 2001-2010)



Source: Yearbook of China Small and Medium Enterprises

Without a doubt, this way of thinking is behind the strong policy momentum shown by the central government in Beijing that is moving to boost the role of the SMEs in the Chinese economy.Last August, Premier Li Keqiang attended an SMEs Symposium gathered in Jinan, Shandong province to congratulate the audience for the 1,7 million new businesses that registered nationwide in the first six months of 2014, an increase of near 60% as compared with the same period of the previous year. By the end of September, that number had increased to 2,6 million new businesses, with 2,5 million of these registered as private businesses, the rate of growth of new businesses registered in the service sector reached almost 79%. Employment in the private sector increased by over 20 million jobs from the end of 2013 to end of September 2014.

The Premier's address, however, embodied a stronger message: although this is a great start much more needs to be done. Chinese leadership seems to understand very well that SMEs are a powerful engine in any dynamic economy. Conscious of the critical role of the financial sector, Premier Li also criticized banks for excessively focusing on loans to big business, paying insufficient attention to SMEs.

It is interesting to analyze the data collected by the Global Entrepreneurship Monitor (GEM). Probably the largest on-going study of entrepreneurial dynamics in the world, GEM is an annual assessment of the entrepreneurial activity, aspirations and attitudes of individuals across a wide range of countries. It was initiated (1999) as a partnership between the London Business School and Babson College. Its 2013 edition has covered 75% of the world population and 89% of the Global GDP (National Chinese team was based at at Tsinghua University).

Reportedly, Chinese entrepreneurs see themselves as above regional average when responding to statements such as "entrepreneurship as a good career choice", "high status is given successful entrepreneurs" and "media attention should be successful entrepreneurs". However, they feel close to the average when "perceived opportunities" are evaluated, and below the average for the region with regard to "perceived capabilities", "fear of failure" and "entrepreneurial intentions".

No doubt these perceptions will have to improve to unleash China´s full SME potential, and there is no reason for this not to happen. Foreign multinationals and Chinese SOEs account for around 55% and 15% of total exports, while SMEs are already over 30% of the total.Many industrializing economies have confronted similar challenges, particularly those where the public sector has played a significant role such as France (dirigisme) where they moved towards the privatization of SOEs, Germany (planning) including "Mittelstand" companies, or Japan (development) where structural reforms have been proposed.

It is certainly against this background of domestic and international challenges, opportunities, and responsibilities that we have to look at the financial sector and the contributions needed from it.

IV Financial Reform in China: how to fuel entrepreneurship and innovation?

The Chinese financial sector has been transformed into a diversified, multilevel system with a central bank at the helm. Policy lending at the State Banks was modernized and policy banks were created, while the adoption of a banking law provided the foundations for commercially-oriented banking. Interbank lending, securities, equities, and foreign exchange markets have been established and progress has been made in the use of the indirect instruments of monetary policy. In the short term, the financial system could probably benefit from carefully addressing the problems posed by the non-performing loans and distressed debt. A solution to prevent the further build-up of these phenomena would free the resources currently locked-up there, allowing more funding for new investments and consumption opportunities. A stronger credit culture and improved corporate governance will be essential in this context, and so will be continuing the reform process in SOEs.

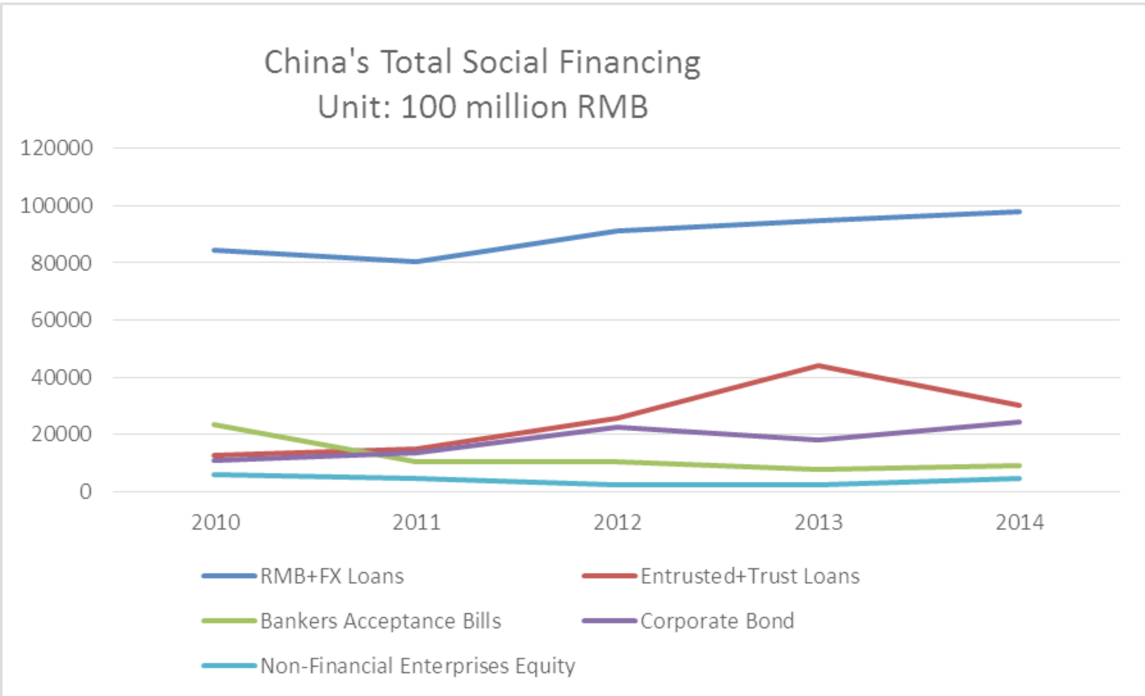
In the longer term, the country will need deeper capital markets to diversify the sources of investment financing. Equity financing could attract strategic investors and improve market discipline. Financial institutions will have to improve their capacities at pricing credit risks and managing market risks. Deeper capital markets could also provide risk diversification opportunities for local investors whose savings are hungry for new financial products. It goes without saying that a proper balance needs to be struck between stability and reform in the financial sector. Clearly, there is no single "right" place on this continuum.

At the end of the day, success in this process hinges on the ability to balance economic, financial, and social costs in the short term with potential gains in the long term through the cooperation and coordination of the many actors involved.The key point, however, would be to focus financial reform efforts on unleashing entrepreneurship and SME potential to better calibrate the interactions between technological progress, value added, increases in job creation and income levels during China's transformation process to become a middle class country and, later on, a high income economy.A bigger and more resilient SME sector and renewed entrepreneurial dynamism, no doubt, would help to spur the gains of technological progresses by stimulating innovation along the industrial complex, developing new skills through the workforce, creating new jobs, and improving income levels and its distribution.

While a stronger credit culture and improved corporate governance would be essential in the short term to prevent further build-up of non-performing loans and distressed debt in order to free resources for new investment and consumption opportunities. In the longer term, the country will need deeper capital markets to diversify the sources of investment financing by attracting strategic investors, equity financing and improving market discipline. The rest of this chapter is devoted to provide insights into Chinese financial markets, including how Chinese SMEs obtain financing from various institutions.

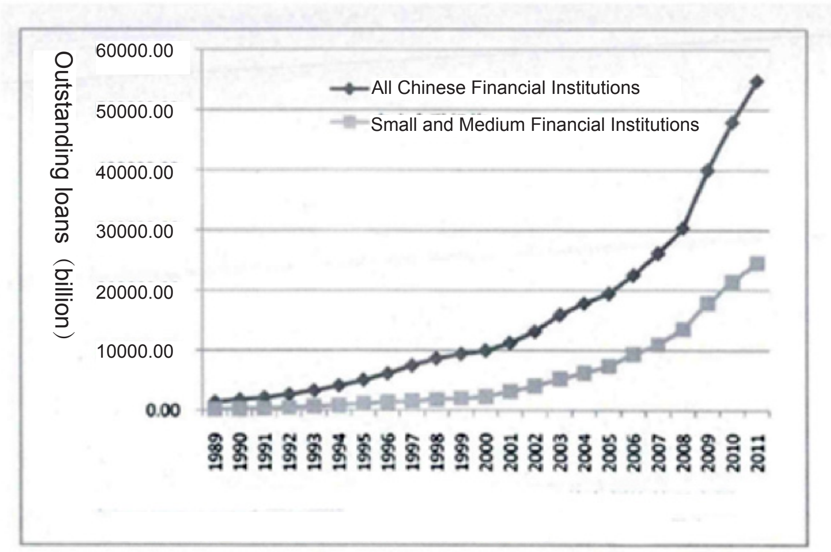
First, we will introduce total social financing in China. Total social financing is a money added concept. It refers to the total funds raised by the real economy from the financial system over a period of time. It is an incremental index used as a liquidity measurement tool invented in 2011, and has come to prominence as an indicator of monetary policy that is better than traditional measures of money supply. Although it has been a goal to increase direct-financing through bonds and stocks for several years in China, bank and "shadow bank" lending still account for the majority of financing available.

Chart 11: Total Social Financing during the 2010-2014



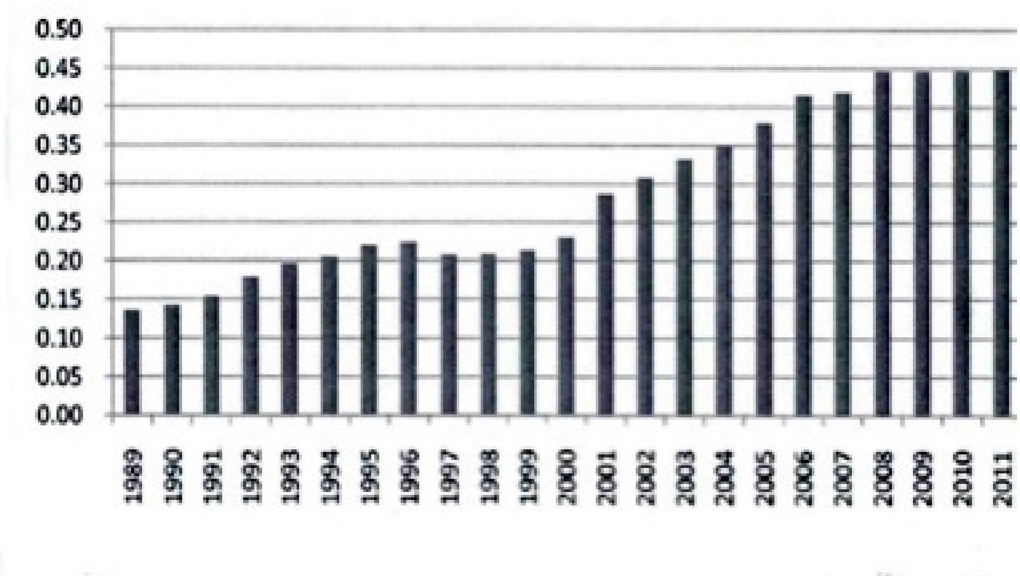
In terms of lending, small and medium financial institutions is the mainstay of China's financial institutions. Since 1989, loans made by Chinese financial institutions have continued to climb, so have the total and the share of loans offered by small and medium financial institutions. As a matter of fact, their share has increased from less than 15% in1989 to 45 % in 2011.

Chart 12: Outstanding Loans of All Chinese Financial Institutions and of Chinese Small and Medium Financial Institutions (1989-2011)



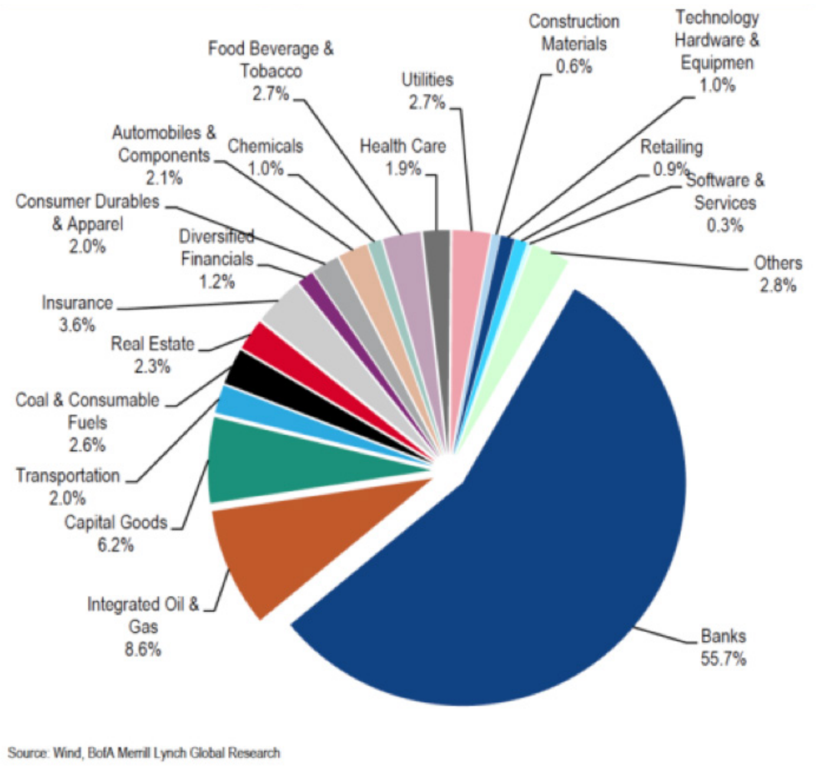
Source: Almanac of China's Finance and Banking

Chart 13:The Proportion of Small and Medium Financial Institutions to Chinese Financial Institutions in terms of Outstanding Loans(1989-2011)



Source: Almanac of China's Finance and Banking

Chart 14: A-share 1H13 earnings split



The Third Plenary Session of the Eighteenth Central Committee of the Communist Party of China has proposed an ambitious financial reform agenda. Since 2012, financial reform for SME also has made important progress. In order to play a more important role for the SME in China's economy, the central government rolled out a range of policies to facilitate the development of SME.

Chart 15: Breakdown of China Stock Market by Board

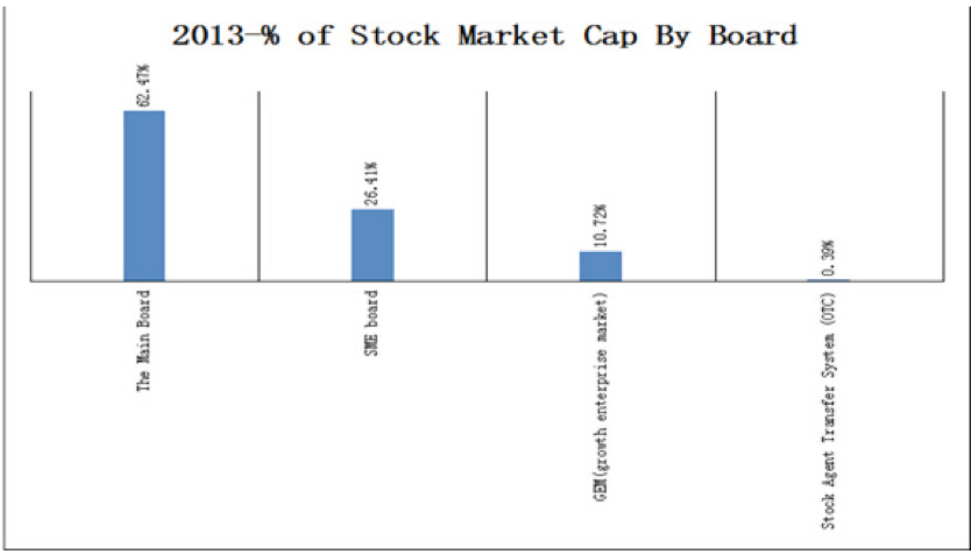
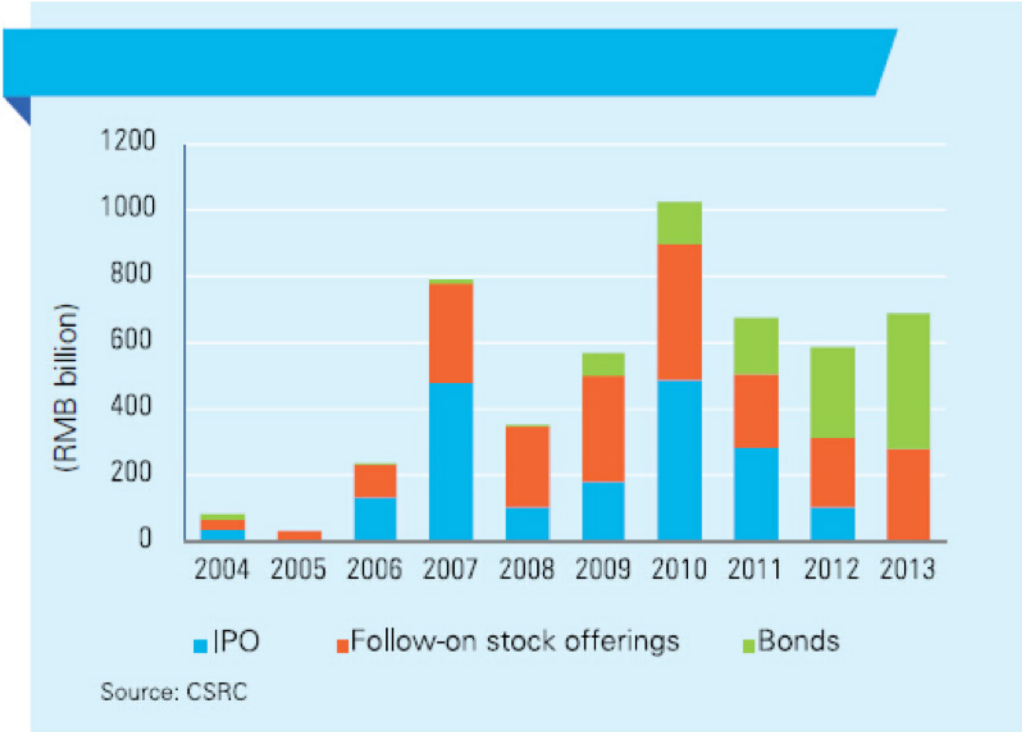


Chart 16: Funs Raised on Mainland Bourses



In 2015 China will enter into the last year of the 12th five year plan. Through the end of the 12th five year plan China will complete the "establishment of a system of multi-level financial markets", and by the end of 2015 will have laid a strong framework for the continuing of reform. The initiation of the Shanghai-Hong Kong stock connect may be extended and made more convenient. The Shanghai free-trade zone is set to shorten its negative list for foreign investments, and more negative list schemes should be created in new free trade zones that are currently being planned. Many are predicting a new registration-based IPO approval regime to be implemented in the beginning of 2016 after the National People's Congress amends securities regulations in mid-2015. The new registration-based system will make IPOs more market oriented.

V SMEs Financing: Financial Innovation and Market Forefronts

According to different estimates, credit demand from SMEs, both formal and informal, operating in all sectors in emerging economies already reached nearly USD 2,5 trillion in 2010.

It is therefore very likely that, in spite the effect of the deleveraging process in advanced economies, and considering the contributions to world GDP growth made by developing countries over the last four years, the credit gap for SMEs in emerging economies in 2014 could be close to USD 2,8Trillion.Governments, multilateral organizations, and multilateral financial institutions have devised a number of different initiatives, tools, and instruments to improve credit access and its terms for SMEs in order to address this gap and to support private sector efforts to improve skills, technology, access to new markets, and to encourage industrial re-equipping. Many of these initiatives have been already adopted in China.

The purpose of this section is to revise those that can be improved and expanded upon in the context of the Chinese financial reform process in order to strengthen the policy toolkit that can be used to support SME and entrepreneurship development. Their primary aim has to be a focus on building strategies for companies´ access to credit. Ultimately, the different terms and rates governing an industry´s access to credit in the medium to long term are expected to flow to a “new normal” through the evolution of savings and interest rates. In the meantime, a series of interventions could stimulate more competitive offers from the financial market and to a large part of the country´s productive complex, integrated by SMEs and a new breed of entrepreneurs.

Here 9 common financing tools used by SMEs are listed, which can help Chinese SMEs in financing.

1. Mutual Guarantee Societies

Also called Reciprocal Guarantee Companies (RGC), the Mutual Guarantee Societies (MGS) are commercial companies aiming at facilitating SME access to credit through the provision of guarantees for the fulfillment of its obligations. This instrument aims at forging a partnership strategy between large companies and SMEs to reduce the latter credit risk levels. Large companies could become, this way, a formidable tool, enabling SMEs to guarantee any commitments or obligations subject to monetary appreciation.

They have emerged in response to the problems faced by SMEs in their business relations with bigger companies, or companies operating in sectors whose typical scale of operations are larger than SMEs. Almost all European Union countries have adopted one or another type of reciprocal/ mutual guarantee schemes. The same is valid for Latin America. Countries like Russia and Turkey have also developed this instrument.

Mutual Guarantee Societies are typically organized around two types of partners: Participant Members and Patron Members. Participant Members are only small and medium enterprises, whether natural or legal persons, who meet a number of conditions, determined by the enforcement authority and subscribed shares. For the purposes of its constitution, all mutual guarantee companies must have a minimum of participating members to be determined by the enforcement authority to be eligible, depending on the region where it is filed or the economic sector on which they operate.

Normally the enforcement authority stipulates the maximum assets share allowed for a Participant Member, for example, maximum 5% each. Protector or Patron members are all natural or legal persons, public or private, national or foreign, who make contributions to social capital and the risk fund.

For Participant Members, MGS may provide many advantages by: potentially increasing their guarantees to credit institutions; zooming in on borrowing capacity; improving financing periods; reducing financial cost; channelizing soft credit lines through rate subsidies from the state and the private sector; advising and informing SMEs.

In China, Mutual Guarantee Society, co-funded by local governments and SMEs and participated spontaneously by SMEs, is crucial to the SMEs credit guarantee system. Cluster guarantee is a significant feature for mutual guarantee among Chinese SMEs. As enterprises involved are geographically close and operate in same industry, cluster guarantees have more symmetric information and less transaction cost, which enabled low risks and high returns. There is one serious flaw, however, as all the enterprises involved in the cluster are in the same industry. When that particular industry falls into trouble, all enterprises will be financially challenged, paralyzing the cluster's ability to perform bailout. (See appendix for roles and functions of MGSs.)

2. Specialized Rating Agencies for SMEs

Typically designed to reduce information asymmetry in financial markets – as is the case with the standard rating companies – these specialized agencies provide also critical services and advice for SMEs to gain productivity, increase efficiency, and adjust its overall performance by stimulating them to improve their rankings obtained in order to access better credit conditions. Specialized Rating Agencies for SMEs has been established in different countries, including India and Bangladesh.

As they normally do in the case of big firms, Specialized Rating Agencies for SMEs (SSMEs RA) assess a firm's financial viability and its capability to comply in time and quality with its commercial and industrial contractual obligations. The rating agency will produce information and insight on company sales, as well as operational and financial structures to evaluate risk-related issues, highlighting the general health of a given company and providing the basic elements to benchmark performance. Ratings are valid for a certain period of time, for example one or two years depending on industrial sectors and firm's specific characteristics, and are based on a numbered scale, where better rankings receive a lower number

Most rating agencies for SMEs were created by the Development Banks and other public sector institutions, but many are also established by the private sector. In general, their staff includes bankers, academics, former regulators and specialized professionals. The rating services are provided on a private basis, with Specialized Rating Agencies for SMEs charging a fee related to the size of the company under evaluation, generally associated to its total sales.

Although SMEs could fear rating procedures, shying away from the possibility of getting ranked at low levels, the whole exercise should be presented in a positive light in order to assess the sustainability of a given company and to organize proper advice for the firm to improve its performance. The rating system could be made a critical point to provide SMES with access to the benefits and mechanisms listed in this section, form subsidized credit loans to SME Bonds and technical assistance .For example, in line with the issues discussed in section 2 of this paper, a specialized Chinese SMEs Rating Agency could assess the following indicators for these types of companies:

- Technological content of the product
- Innovation capacity
- Corporate solvency, credit records and cash flow
- Company´s management quality
- Investment records

In concrete terms, China can build on the experience gained by its credit rating system, and the good reputation of entities like Dagong Global Credit Rating Co. Ltd, to organize a more country specific rating system for SMEs. Currently, China's rating agencies can rate SMEs, but their processes are not tailored to SMEs. First, the credit rating system of these institutions generally designed for big companies rather than SMEs. Second, the lack of unified credit rating indicators can lead to uneven results for a same company, undermining the credibility of SMEs credit rating. Therefore there is an immediate demand for a single SMEs credit rating system, which shall be regulated by a special institution.

3. SMEs Exchanges

Over the last two decades, policy makers, regulators, experts and academicians realized the need to outline and implement a special set of rules to enable SMEs access to capital markets, making them available to a wide range of investors. Such understanding unleashed a wave of customized regulatory frameworks in the form of multilateral trading facilities, dedicated stock markets, specialized stock exchange sections and the like. As of today, nearly forty countries in the world have some form of listing regulations for SMEs. The highest number of examples in this field is found in Europe, the US, and to some extent also in Asia. This section is presenting a number of specific cases.

AIM

Formally called the Alternative Investment Market, AIM is the London Stock Exchange's international market for smaller growing companies. A wide range of businesses regularly join AIM seeking access to capital. Since its launch in 1995, allegedly, more than 3,000 companies from the world over have resorted to this market to unleash the power of their companies. AIM is meant to help smaller and growing companies raise the capital they need for expansion. Probably, this is one of the most successful experiences in this field.

Alternext

Alternext defines itself as a multilateral trading facility – rather than a regulated market within the meaning of EU directives – operating under its name by the relevant market operator in Brussels, Lisbon, and Paris since 2005, and offering market access with fewer regulatory requirements for SMEs.It has developed an Alternext All-Share Index with the purpose to promote trading by improving investor's ability to benchmark Alternext-listed companies. Less stringent listing requirements and innovative operating rules are combined with guarantee protections and enhanced financial transparency. It is based on the Euronext main cash market, enhancing liquidity.

Listing and trading on Alternext can take place in multiple formats; a) the traditional IPO (retail investors); b) private placement (institutional and qualified investors); and c) direct listing. To be listed in this market, companies need to choose a listing sponsor, usually an investment bank, but it can also be a corporate finance boutique or an accountant.

The well-established pan-European Alternext market offers an alternative route for small- and mid-sized companies (SMEs) that may lack the necessary resources to satisfy the requirements of a regulated market to join a reliable and profitable equities market. Alternext is the home of 184 listed companies with a market capitalization of 8,325 million Euro (DEC 2013).

MAB

MAB is a special market dedicated to companies of reduced capitalization that seeks expansion, operating within the framework of the Spanish Bourses and Markets system (Bolsas y Mercados Españoles). MAB started operations in 2009 by adapting existing procedures to allow SMEs to be listed, trying to maintain at the same time the highest levels of transparency. To that end it has introduced the role of the Registered Advisor, whose mission it is to help companies to comply with information requirements.In addition, companies listed in this market will have a "liquidity supplier", or intermediary dedicated to help them find the right counterpart and secure the proper quotation for its shares.

EnterNext

EnterNext is designed to enable SMEs to access financial markets and to generate the funding needed for them to grow and expand its business. Its main purpose is to gather all stakeholders of companies, intermediaries, financial analysts, investors and advisors in a single marketplace facilitating SME growth and development. Enternext was established in 2013 and is governed by a fifteen member board, including seven qualified external directors. It has dedicated teams in Belgium, Portugal, the Netherlands and France, with regional offices in Bodeaux, Lyon, Marseille and Nantes. Its mission includes a) positioning the stock exchange as a source for alternative funding; b) managing relationships with issuers and listing candidates; c) promoting SMEs to investors; d) developing marketing strategy; and e) designing financing options like bonds.

The Case of India

India has a special SMEs section of the National Stock Exchange (NSE), called Emerge, and another on the Bombay Stock Exchange (BSE). Both started operations in March 2012 and are similar to the other cases discussed above in this section.As of today BSE has 69 listed companies with around 50 of them joining over the eighteen months, comprised of firms from a broad range of sectors; from digital advertisers or travel operators to non-banking finance companies and department stores. Emerge seems to be less developed than its neighbor in Bombay.

ChiNext.

Starting in 1999 with a proposal to establish a stock exchange for high-tech companies,A decade later, ChiNext was inaugurated in October 2009 in Shenzhen. As of today, this market has 392 companies listed, 111 of which joined in the last 34 months. It should be taken into account that the issuance of IPO was closed in 2013. The CSRC decided to reopen the market in 2014. Already in January 2014 there were 24 new listings and last May the CSRC announced new rules to eased profitability requirements for firms looking for listing on ChiNext.

4. SME Bonds

To facilitate SMEs access to financial markets, authorization could be given for them to be incorporated as joint stock company cooperatives and partnerships to secure loans by issuing negotiable bonds. Issues would be allowed to range from the equivalent of USD 10.000 to USD5 million. A special type of risk assessment could be introduced, and even no risk assessment required to authorize smaller issuance.

Securitization of these types of negotiable bonds could be allowed under special regulations approved by the CSRC.

Banks, official financial agencies, state partnerships, state owned companies and public corporations, to which the issuer could also be supplier, could also be authorized to securitize bonds issued by Limited Partnerships, joint stock companies, Cooperatives, mutual associations, social work institutions, non-profit organizations, foundations and even Trade and Labor Unions.

Securitization for SMEs and negotiable bonds could also be provided by stockbroking institutions, mutual investment funds and individuals, for example people with a net worth over USD 250.000 equivalent – or USD 500.000 equivalent for partnerships, either local or foreign residents.

In recent years, the Chinese government adopted various policies and measures to cut business operation cost, including encouraging SMEs to issue bonds as a way to finance directly. As China's bond market has been boosted, there are problems. For example, it suffers from premature credit rating system, chaotic rating standards and processes. All of these problems have led to significant differences in rating results ,thus compromising the credibility of such ratings and increasing investors' risks.

5. Multi-annual Financing Plan

A Multi-annual Financing Plan is essentially a system aimed at equalizing interest rates for investments and technological upgrading, building on associated working capital, acquisition of capital goods, and financing exports. The program consists of a series of public auctions to select private banking offers of designed loans lines to fit the objectives of the program. Selected offers would receive an interest rate subsidy, defined in terms of interest rate percentage points to be paid by the SMEs, an amount that would be collateral for treasury funds. The length of the plan can be designed to match, in a set number of years, a convergence with open transactions in private financial markets, after the interest rate liberalization process gets finally settled. Each auction is organized around an amount of credit to be awarded for an interest rate subsidy to the participating institutions, provided the loans they offer have the proper characteristics in terms of length, and grace periods that are necessary to satisfy the purpose of the program. Typically, government officials would receive competing proposals to cover the amount defined for the auction and would proceed to select credit lines offered by different institutions by interest rate (with lower interest rates given preference) and loan size. Other criteria could also be included.

Such a mechanism ensures that banks compete to offer the lowest possible rate to get a better portion of the approved amount to be subsidized by government. This way SMEs benefit twice: by private banking competition, and by government subsidy. To promote partnerships between SMEs, the plan also finances the establishment company groups. This helps SMEs wishing to carry our joint activities to acquire and use technology, promote foreign trade, improve terms of access to credit, negotiate purchase or sale terms, improve quality, increase their specialization, and/or undertake any other activity designed to increase their sector competitiveness.

Special consideration or programs could also be devised to cover the needs of Microenterprises, facilitating access to credit to very small companies, enabling them to raise their productivity and contribution to employment, by gaining size gradually and consistently.Microenterprises typically need to gain access to training and specialized technical assistance through creating networks of public and private support agencies. The program chapter for microenterprises could help coordination and improvement assisting intermediate financing agencies by assessing and refining the criteria, systems and procedures for extending loans to this particular industrial sector. An example can be provided by referring to programs targeting micro and small business in all economic sectors for companies with up to 20 employees (owner included), and a sales turnover of less than the equivalent to USD200.000 a year with a USD10.000 (equivalent) ceiling for operation and USD20.000 (equivalent) per borrower. Obviously, ceilings can be adjusted at need, according to regional criteria, sector specific targets, and etc. Similar programs were adopted in most Latin American countries.

In China, biding is not a common practice in SMEs financing. Some Chinese researchers have recommended biding as way for technological intensive SMEs to get financing, as it can improve information symmetry, thus securing low-cost capital for SMEs and higher returns for banks without compromising risk control.

6. Invoices as a Financing Source

Regulations can be issued to equate commercial invoices with a sort of promissory note, creating a new financial source for SMEs, suppliers of major companies, and retail corporations. In such a way, companies could consolidate commercial operations with their clients, thus reducing administrative costs and allowing human resources to be assigned mainly to productive activities rather that to recruit administrative staff to secure sales revenues.The system basically entails that the obligation taken by the issuer of the invoice must pay it off in the terms and dates specified in the document with no changes or deferments. Mandatory confirmation is of the essence. It has been observed that in the absence of an obligation for major companies to confirm the commitment to the invoice payment date, markets did not respond positively.

The basic reason for this is that this instrument entails a mechanism for transferring the credit risk taken by the creditor (the financial institution who takes the invoice as collateral of a credit line) from the beneficiary SMEs – who has the right to get the invoice paid – to that of the (normally) big company that issues it.In such way the credit risk confronted by the SMEs is lower and the creditor can (and should) offer lower interests rates. The system has been in place in Latin American countries with good results. In some cases, like Brazil´s “Dupilcata”, the system proved to be a reliable source for SMEs funding.

In China, a similar practice is accounts receivable financing. As over 60% assets of Chinese SMEs are in receivables and inventory, meaning limited fixed assets, this practice has suits China well. By compensating inadequate SMEs credits with higher credits of the payer of receivables, it can make financing more accessible to SMEs. Still, the lack of credit awareness, opaqueness in financial information and questionable financial statements all stand in the way of account receivable financing. Chinese SMEs should enhance their credit -building so as to get more financing.

7. Deferred-payment Checks

Designed as an additional credit instrument for companies in general and SMEs in particular, the system consists in allowing legal omission of post-dated checks, endorsing them multiple times. This mechanism enables deferred payment checks to be registered and qualified by the financial institutions issuing and paying them, thus eliminating legal instability and arrears collection delays.

Normally, such a system provides for a legal framework to issue post-dated checks for a maximum of six months, "de facto" creating a significant secondary source of money supply, improving SME's access to credit.

Unlike the case outlined above (Section 3 - Invoices as a Financing Source) the SMEs credit risks level remain at the issuing company. The practice on schemes of the nature outlined here had considerable success when implemented

8.Financial Education Programs for SMEs

Standard analysis on SMEs funding for growth and development tends to concentrate on regulatory aspects so as to ease and facilitate general conditions and market access for this special type of companies. Experience at the national and multilateral level, however, shows that it is equally (or even more) important to address the capacities of SME owners and management to handle the financial mechanisms, instruments, and options to unleash the potential of their companies and businesses in the medium to long term. Financial Education, also referred to as Financial Literacy, is an issue that has been gaining importance progressively over the few last decades, to the extent that many major banking associations decided to dedicate resources and special programs to address the topic in a modern fashion.

Typically, SME financial education content requirements that provides for financial literacy could be generally described as the correct handling of information related to; a) Funding alternatives, types and sources available in the market (including equity finance) and credit products; b) requirements from financial intermediaries to access products and services; c) appropriate handling of other relevant financial products, like money market for business and transactional products (credit cards), CFC accounts for international trade, leasing and commercial property; d) risk management, including insuring stock and business premises and assuring the life of the SME owner/manager; and e) choosing business structure and its impact on financing options

Recent research published in the Journal of Economics and Finance (of the World Academic Journal of Business and Applied Sciences), for example, shows that basic financial literacy skills acquired through specific programs significantly contributed to enhance SMEs performance who participated of the programs. Those companies manage to improve revenue levels, make informed decisions on their growth strategies and facilitate access to credit, minimizing potential liabilities and interest's expenses. This way, companies and entrepreneurs get empowered and better equipped to make relevant contributions to national growth strategies by means of employment generation, new market access, and development of new products.

Financial education for Chinese SMEs is also highly relevant as it helps SMEs to learn about available financing channels, and to identify the most feasible financing vehicle in light of their own realities. It is also a way to detect flaws embedded in SMEs financing practice, as part of the efforts to promote financial reform in regulation. However, it shall be highlighted that the content of such education shall be tailored to China's realities, including the lack of credit awareness and questionable financial information. It is advisable to add in how credibility and financial information can contribute to the sound growth of SMEs.

9. Small and Medium Financial Institutions

The majority of SME financing comes indirectly from small and medium financial institutions, which is the last but not least financial tools introduced in this paper. Small and medium financial institutions here refer to all the financial agencies other than the major four state-owned banks, securities and insurance agencies. The group includes joint-stock commercial banks, city commercial banks, urban credit cooperatives, rural credit cooperatives, rural commercial banks, small loan companies as well as local financial institutions.

Small and medium financial institutions have edges in financing: As they are always in the same area as their borrowers, they are familiar with the operation status of their borrowers, which effectively reduces the negative impact of information asymmetry and lowers the cost of financing; Small financial institutions are flexible, responsive lenders who know their borrowers so much that they can accept guarantees that are not acceptable for large financial institutions, such as invisible guarantee based on social network.

Therefore, despite the efforts made by China to increase the share of direct financing for SMEs, it is likely that indirect financing through small financial institutions will remain the mainstay for Chinese SMEs.

VI Building “ Sound Society ” with Inclusive Finance

Over the last three decades the international community witnessed attentively the implementation of an ambitious program of economic and social reforms in China that – by all classical measures of wealth and progress – has been successful, improving living conditions for hundreds of millions of Chinese citizens and opening new opportunities for progress to peoples and countries all over the world.The international Financial Crisis (2007/2008) marked the end of the debt Super-Cycle for the advanced economies and triggered the emergence of a new Global Middle Class with a new role for Emerging Markets at global level. These new realities are drawing up a new political and economic scenario for the international community, one that has plenty of opportunities for the years to come, but at the same time presents many new challenges and uncertainties.

After 30 years high-speed growth, China has entered into “new normal”, which features medium and high speed growth, upgrading of economic structure, higher residential income, more broadly shared development results, and innovation-driven development instead of factors-driven or investment-driven growth. That means a movement away from external to domestic demand, and from investment-driven to consumer-led growth. It will also entail a move from dominant government investment in certain areas to an increasing partnership with private capital, and also a higher degree of productivity and technology throughout its productive system.

Statistics has shown huge leaps in China’s science, technology and industrial competence over its economic boom. In the future, to maintain a medium and high speed of growth while rebalancing its economy, China will have to facilitate scientific and technological innovations. This is in line with Premier Li’s idea of “mass entrepreneurship and innovation” strategy. And data have proven to us that SMEs are the main force of technological innovation as they are home to 65% of Chinese innovation patents and over 75% of company technological innovations. According to the IMF, SMEs in Asia contribute almost 60% of GDP in Korea and Indonesia, and more than 75% and 95% of the employment respectively in those countries, and almost 50% of GDP in China and Japan, where their contributions to employment are more than 70% and 80% respectively.

The same research reveals that between 50% and 60% of SMEs in Asia are under-served by the financial sector. This indicates that all SMEs across the world, including China's SMEs, face the same challenge, difficult and costly to obtain financing.

That is why this paper outlines a number support programs for SMEs and entrepreneurship and measures to be analyzed in the context of the on-going financial reform efforts; including the following: Mutual Guarantee Societies; Specialized Rating Agencies for SMEs; SME Exchanges; SME Bonds; Multi-annual Financial Plans; Invoices as Financing Sources; Deferred-Payment Checks; Financial Education Programs for SMEs; Small and Medium Financial Institutions.

All these programs have been widely analyzed and implemented the world over. Mutual Guarantee Schemes are common in Europe, Latin America, North America, and Asia. In China, while MGSs are crucial for SMEs, they suffer from ills that need to be addressed by government through multi-layer regulation.Special Rating Agencies for SMEs are also broadly spread and very much appreciated to bring transparency and accuracy with regard to SMEs records and management. China is in dire need of a unified credit rating system for SMEs that is specially regulated so as to keep SMEs credit ratings credible.

SMEs Exchanges have been under analysis and implementation over the last two decades with important developments in Europe and Asia (they are slightly different than ChiNext that probably resembles more the initial steps taken by NASDAQ). Similar comments could be applicable for SMEs Bonds issuance. As direct financing significantly cuts the cost of production, the Chinese government and regulation departments shall optimize terms regarding SMEs IPOs and bonds issuing so as to include more SMEs in direct financing.

Multiannual Financial Plans, Invoices as Financing Sources and deferred-payment checks have been utilized in many emerging economies with important results in terms of improving financial market access for SMEs by sharing risk with suppliers and/or clients. SMEs, watchdogs and governments may tailor the tools mentioned in this paper to China's realities so as to expand channels for SMEs financing with lower cost. It should be noticed that all these tools are based on heightened credit awareness, accurate financial information and SMEs-oriented credit rating agencies.

Financial Education or Financial Literacy has been increasingly regarded as a key element to improve both long term growth prospects of new businesses and short term SME revenues and job creation capacity. Enhance financial education for SMEs can also help them to understand financing tools they need to cut financing cost. Also, such education can help SMEs to raise credit awareness and develop compliant financial management, as part of the efforts to improve transparency in SMEs operation. This is of great importance in making financing less costly and more accessible for SMEs.

Small and medium financial institutions in China, enjoying the competitive edge of local knowledge, will continue to be the mainstay source for SMEs financing, despite probable increase in the share of direct financing for SMEs in the future. The Chinese government, on one hand, should encourage establishing private banks to enlarge the supply pool with social capitals. On the other, it should favor small and medium financial institutions in policy and finance so that they can better serve SMEs.

For all its shortcomings they could be considered worthy of further research and exploration in order to become effective tools to connect the Chinese financial system with the needs of the real economy and to support SME and entrepreneurship development. Ultimately these instruments and tools should play an important role. And we shall work to realize the aspiration of Chinese people: creating a “sound society” with inclusive finance.

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Appendix: Function, Structure and Benefits of MGSs

Function

MGSs are designed to help SMEs in following ways:

• Structural difficulties to generate credibility regarding contract compliance on issues related to quantity, quality, durability, safety and sanitation

• Lack of information on the region or sector to which they belong

• Evaluation based on equity and no project feasibility

• Limitations to finance working capital

• Long term financing almost nonexistent

• Mortgage guarantees requirements with high coverage range, sometimes two or three times the amount of credit made available

The mission of the Mutual Guarantee Societies is to act as a financial intermediary to help SMEs to strengthen their bargaining capacity to:

• Negotiate on behalf of a group of SMEs to improve credit conditions in terms of cost and deadlines

• Get closer to the employer and have greater certainty about the chances of project success

• Assist in the formulation and presentation of projects as well as benefits

Structure

Mutual Guarantee Societies are typically organized around two types of partners: Participant Members and Patron Members. The company may not enter into a reciprocal guarantee with the Protector/Patron members. The status of Protecting or Patron Member is not compatible with that of Participant Partner, they must be separate legal persons. The Protecting or Patron Member Participants participation level typically does not surpass 50% of total MGS assets.

The Mutual Guarantee Society(MGS) has to create to a Risk Fund that will integrate its assets. Such Risk Fund shall consist of:

• Assignments results approved by the General Assembly society

• Donations, grants or other contributions shall receive

• The recovery of monies paid to the company in the contract performance guarantee taken on behalf of their partners

• The value of the shares not redeemed by the excluded members

• Financial performance coming from the investment fund itself in placements which were formed

• The contribution of patron members

The Risk Fund may take the legal form of a Trust Fund, regardless of the corporate assets of the Mutual Guarantee Society (MGS). The MGS will be allowed to get contributions from Protector or Patron Members – who are not financial institutions – specifically earmarked to the guarantees determined by them. For that purpose the Protector or Patron Members will have to enter into separate Trust Funds, different from the Risk Fund. Enforcement Authority regulations typically determine the criteria to be met by such contributions, and the coefficient of expansion it may have on the provision of guarantees. Those regulations normally establish and also grant a percentage of tax deductions on income tax for these contributions.

Benefits

Mutual Guarantee Schemes and institutions are normally practiced all over the world. There is an important body of literature available on its performance and benefits.

Briefly, it can be said that, for Participant Members, MGS may provide many advantages by:

• Potentially increasing their guarantees to credit institutions

• Zooming in on borrowing capacity

• Improving financing periods

• Reducing financial cost

• Channelizing soft credit lines through rate subsidies from the state and the private sector

• Advising and informing SMEs

For the Protector or Patron Partner represents an opportunity by providing:

• Tax exemptions: capital contributions and contributions to the risk fund are deductible from taxable income entirely for determining the income tax in their respective activities in the fiscal year in which they are cashed

• The assets constituting the Risk Fund can be invested and earn income for their owners (patron members)

• Suppliers and Customer´s Development: The SGR is a powerful tool for professionalizing both the risk of exposure to SME customers and to enhance opportunities for supporting suppliers in the expansion policy of large companies

For Creditors the MGS provides a number of services by:

• Improving the quality assurance of their debtors

• Providing self-liquidating collateral

• Allowing them to potentially expand its market share

• Developing the commercial management of their credit lines

• Replacing banks in evaluating and compensating risk rating information asymmetries

• Reducing the risk of losses and uncertainty in the long term

• Reducing collections costs related to the credit lines allocated

For the State, this mechanism provides for:

• Reduction of the informal economy

• Support employment generation

• Potential Tax revenue increases over and above the fiscal sacrifices represented by the exemption granted to the patron members

• Increased transparency in the allocation of resources by the State

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