Leverhulme Centre for Research on Globalisation and Economic Policy

The University of Nottingham

Research briefing

Chinese firms forced to wine and dine to survive

Does Social Capital Affect the Financing Decisions of Chinese SMEs?

By Jun Du, Alessandra Guariglia and Alex Newman

Continuing discrimination by banks has made splashing out on entertainment expenses vital to the short-term survival of many Chinese companies.

According to new research, fledgling small and medium-sized firms have little choice but to wine and dine key contacts if they hope to endure.

On average they spend almost 7% of their total assets on building up "social capital" – the web of relationships that helps them thrive.

Such an approach is crucial to their chances of gaining leverage in a system that still heavily favours state-owned enterprises, says a GEP study.

The findings highlight the continued importance of "guanxi" – informal networking – in Chinese business.

But they also reveal the problems still faced by the nation's privately-owned small and medium-sized enterprises (SMEs).

Despite constitutional changes dating back to 1998, the lending practices of China's banks still heavily favour state-owned enterprises.

In light of this, the study found, for many SMEs social capital effectively acts as a substitute for fixed assets as security for short-term lending.

By contrast, firms that are able to access long-term financing generally have less need to spend on meals, gifts and other expenses.

Economists say such obvious and widespread reliance on guanxi may not benefit Chinese SMEs or the country itself in the long run.

Key findings

- Banking practices that continue to favour state-owned enterprises mean fledgling privately-owned small and medium-sized firms in China have to rely on "social capital" to survive.
- For many of these companies social capital acts as a substitute for fixed assets as security for short-term lending.
- On average Chinese small and medium-sized enterprises (SMEs) spend 6.7% of their total assets on entertaining key figures – e.g. bank and political officials – who can help them thrive.

Managers and policymakers alike therefore need a greater appreciation of the importance of the widespread availability of effective formal financing.

Research basis

The study examined data from annual accounting reports filed with the National Bureau of Statistics by 65,551 firms from 2000 to 2006.

Researchers focused on privately-owned firms with sales of less than 30m RMB and fewer than 300 employees.

Among the observations discounted were those involving negative sales; negative total assets minus total fixed assets; and total assets minus liquid assets.

In all more than 110,000 observations made up the study. The lowest number for a year was 4,380 in 2000; the highest was 43,138 in 2006.

Entertainment expenditure was used as a proxy for social capital and was found to account for an average of 6.7% of firms' total assets.

Comments and implications

Study co-author Alex Newman, a Lecturer in International Business at Nottingham University Business School, Ningbo, China, said: "Chinese companies are clearly influenced by the social and business relationships they have.

"These relationships might be with executives at other firms, bank officials or government officials.

"They allow companies to gain preferential access to a whole host of scarce information and resources, including financial capital.

"This is especially important when China's state-owned banks still discriminate against the private sector in their lending practices.

"Until 1998, when the constitution was changed, state-owned commercial banks were instructed to lend only to state-owned enterprises.

"Yet even now banks still consider private enterprises riskier than their public-owned counterparts – and the problem is even bigger for SMEs.

"This is why an SME's entertainment expenditure represents such a crucial investment in building business and social relationships."

Newman warned over-reliance on guanxi would not necessarily help China's long-term development of world-class SMEs.

He said: "It's right to say senior managers need to recognise the importance of building relationships to enhance firm performance.

About GEP

Based at the University of Nottingham and substantially funded by grants from the Leverhulme Trust, GEP is the major centre in Europe studying the impacts of globalisation and economic policy.

In January 2008 it opened GEP in Malaysia at the University of Nottingham's purpose-built Semenyih campus, 30km from Kuala Lumpur. In November 2008 it launched GEP in China at the University of Nottingham, Ningbo, China.

GEP is keen to promote its research work and is committed to communicating its expertise. Its academics have advised the Treasury, the OECD, the World Bank and the WTO.

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"Without adequate social capital, SMEs may face huge difficulties in obtaining the short-term financing so vital for them to survive their early years.

"But managers should also recognise the consequences of becoming over-reliant on these relationships, as well as what they might entail.

"Guanxi confirms numerous benefits on firms, regardless of their capabilities, but is reinforced by implicit rules of reciprocity and obligation.

"In addition, policymakers also need to acknowledge the importance of developing effective formal financing mechanisms for all businesses.

"This is especially crucial in times of economic crisis, such as we're experiencing now, when informal credit to SMEs has dried up.

"Wining and dining might have supported the growth of Chinese SMEs until the present day but may not necessarily take it much further."

Alex Newman

Alex Newman is a Lecturer in International Business at Nottingham University Business School, Ningbo, China. His research interests include social capital and small business financing, the impact of culture on employee and consumer behaviour and training and retention in multinational companies. Before entering academia he worked in international business in Japan. His co-authors for this research were Alessandra Guarigilia, a Professor of Financial Economics at Durham Business School, and Jun Du, a Lecturer with Aston Business School's Economics and Strategy Group.

June 2010

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