FINANCIAL CONSTRAINTS IN CHINA: FIRM-LEVEL EVIDENCE

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NON-TECHNICAL SUMMARY

This paper uses a unique micro-level data-set on Chinese firms to test for the existence of a "political-pecking order" in the allocation of credit and to investigate conditions that may mitigate the credit constraints faced by Chinese private firms.

Several macro studies have emphasized the detrimental effect of local government interference in capital allocation in China so that China appears as a counterexample to the positive relationship generally found between finance and growth in the literature. Indeed, in spite of a malfunctioning financial system, China has one of the fastest growing economies.

Our analysis is carried out on Chinese firm-level data originating from the data set ORIANA covering more than 20,000 Chinese firms over the period 1998-2005. From a methodological point of view we follow Harrison et al. (2004). We introduce external financing costs in the investment Euler equation to evaluate the magnitude of financial constraints in China. Sensitivity of investment to cash flow is associated with financial constraints. In perfect capital markets and in the absence of credit constraints, cash flow should not affect future investment. If results show otherwise this can be interpreted as an indication that capital markets are not perfect and that credit constraints exist.
In the first part of the paper, we test the “political pecking order” by analyzing whether different types of firm ownership face a different degree of financial constraints. In the second part, we investigate how the geographical and sectoral Foreign Direct Investment (FDI) and presence of state firms interact with the credit constraints that exist for Chinese private firms.

Our analysis extends the literature in several dimensions. First, it offers an explanation for the conundrum of firm growth in China despite evidence of credit constraints. Our results suggest that the stronger the presence of foreign capital in a sector or region, the lower the financial constraints faced by Chinese private firms operating in the same region and sector. The presence of foreign capital somehow allows Chinese private firms to bypass both the financial and legal obstacles that they face at home. It is coherent with the hypothesis put forward by Huang (2003) that FDI mitigates the credit constraints faced by Chinese private firms due to inefficiencies in the banking sector for which only macro-level evidence existed so far (Guariglia and Poncet, 2008). One possibility that we have in mind is that foreign firms may extend more trade credit to local Chinese firms which would explain why the presence of foreign firms in the region reduces credit constraints for local Chinese firms.

Second, we also assess the extent to which the effectiveness of financial constraints on private firms’ activity is contingent on state firms’ presence in the local economy.

Our findings confirm the “pecking order” hypothesis put forward by Huang (2003), where private firms face the highest degree of financial constraints, whereas State Owned Enterprises (SOE) and foreign firms do not experience any financial constraints. We find that the sensitivity of private firms’ investment to cash flow softens in a context of abundant foreign investment. By contrast, credit constraints are reinforced when the presence of state-owned firms is strong. These results obtained over the period 1998-2005 suggest that the ongoing restructuring of SOE may help to circumvent credit constraints and can boost the investment and growth of private firms.

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