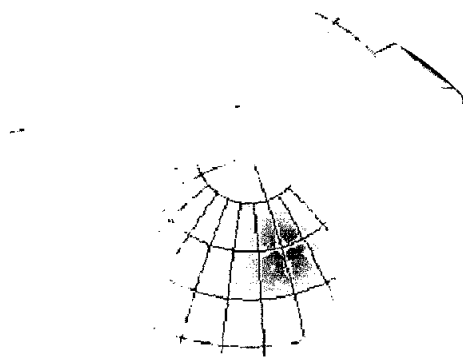


Role of Central Bank in Promoting Small and Medium Scale Enterprises in the SEACEN Countries

Dagva Boldbaatar



The South East Asian Central Banks (SEACEN)
Research and Training Centre

Kuala Lumpur, Malaysia

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PROMOTING SMALL AND MEDIUM
SCALE ENTERPRISES
IN THE SEACEN COUNTRIES**

Dagva Boldbaatar



The South East Asian Central Banks
Research and Training Centre
(The SEACEN Centre)
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FOREWORD

The pace of globalisation is increasing as economies become more integrated and borderless. Governments are, therefore, concerned about implementing policies for coherent economic development and emphasis has been placed on the development of micro, small and medium businesses. Although bigger firms are the major sources of R&D based innovations, smaller enterprises are necessary for an economy to be efficient and dynamic. One characteristic of a successful developing economy is a strong and vibrant SME sector. The best strategy for developing this sector is to create an environment conducive to the flourishing of small and medium scale enterprises (SMEs) backed by efficient institutional settings. However, it is well known that there various obstacles and challenges that face SMEs and their development and the one main reason is the limited access to funding from financial institutions.

In light of this, this collaborative project presents and compares the latest developments and policies concerning (SMEs) in SEACEN member economies. It specifically emphasises on financing for SMEs from central bankers' point of view and analyses the policy initiatives of the respective member central banks participating in the project. The paper is divided into two parts: the first part consists of the integrative report and regional analysis authored by Mr. Dagva Boldbaatar, Project Leader and Senior Economist at the SEACEN Centre who is seconded from The Bank of Mongolia. The second part consists of the country chapters authored by the country researchers from the participating member central banks.

The author is grateful to Professor Bishwa Keshar Maskay, Chairman, Centre for Development and Governance, Nepal, for his assistance in reviewing and commenting on the final draft paper. He would also like to express his deep gratitude to all the country researchers for preparing their respective country chapters and to the Directors of Research of the respective member banks/monetary authorities for their useful comments and suggestions on the final draft

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Dr. Subarjo Joyosumarto
Executive Director
The SEACEN Centre

July 2005

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Executive Summary

In most economies, the main constraint for Small and Medium-Scale Enterprises (SME) is getting access to external financing for their business expansion, restructuring and establishments. In light of this, the collaborative project aims to explore SME policies in the SEACEN member economies, especially on their financing, for cross country comparisons. The roles of the respective central banks in promoting SMEs as well as specific issues on the definition and financing of SMEs are discussed and compared in the integrative section of the paper.

While the definitions of SMEs vary among the countries, it was gleaned that on the average, SMEs constitute about 98 percent of total business establishments in SEACEN region. They employ almost 70 percent of the labour force and contribute to total value added by just under 50%. Therefore, SME financing remains an important policy agenda and crucially requires central banks' involvement and support. With multiple roles as monetary policy maker, regulator and supervisor of banks, as well as architect of financial infrastructure, central banks' actions may have implications on SMEs either directly or indirectly. In this respect, it would be worthwhile to highlight some important issues.

With respect to the existing or presumed financing gap, there is a general concern that the channeling of financial resources to SMEs are not optimal as banks, the core financiers tend to have higher charges for SMEs. Hence, changes in monetary policy to increase interest rate may hurt SMEs much more than the more established conglomerates. Secondly, the SME sector has proven to be dynamic and innovative and consequently, efficient and sustainable funding to the sector will contribute to the long-term dynamism of the whole economy. However, based on findings, banks are reluctant to provide funds to SMEs in the early stages of business establishment unless the enterprises can provide collateral and/or other forms of guarantee against default risks.

Thirdly, if SMEs are resilient to economic shocks as shown in Indonesia during the financial crisis in 1997, it will be of interest to banks and other financial intermediations to increase credit to them during recessions. However, due to existing or presumed lack of credit worthiness, of SMEs, banks often turn down their applications for loans during a recession. Thus, assistance by making available information such as credit worthiness of the individual borrowers may help to channel more loans to the SMEs.

The current trend towards consolidation of the financial sector impacts SMEs as well. Some argue that financial consolidation may result in higher cost for small borrowers, but others contend that the cost saving achieved through consolidation may lead to a fall in interest rate. One positive development is e-banking that may help to reduce the borrowing cost to SMEs. Another positive development is that the new capital accord (Basel II) will actually help banks to lend to SME. The question of whether innovative SMEs are more constrained from financial assistance than SMEs in general is still an open question without conclusive empirical evidence.

However, based on a British study, the size of SME enterprise does matter in getting external financing.

As for SME financing in the SEACEN economies, SMEs seem to prefer to have sustainable access to financing, rather than cheaper but harder to obtain financing, although better risk pricing could help bring down borrowing cost and make it more profitable for them. In general, SMEs lack collateral and business track records, which are normally required by banks. Country researchers noted that better information and support to understand financial products designed for them could enhance SME access to finance.

Most of the SEACEN central banks continue to provide support for SME policy loans, but now it is done mainly through banks and specialised financial institutions. The provision of subsidised funds directly to borrowers as in the earlier stage of SME development did not produce expected outcomes. These funds are small in proportion to total financing needs for the sector and often have other conditions, such as ethnicity, gender, priority industry or geographic location of final borrower. In addition, there are interest rate rules involving the provision of fund to selected conduit institutions at cheap interest rates with the aim that loans will be on-lent to SMEs at cheaper than market rates. However, such schemes could be a simple subsidy for SMEs, and has proven to be not very efficient because of market distorting externalities.

With respect to the heavy reliance on collateral by banks, we believe that there is a need for completing market mechanism or collateral surrogate that central banks may be able to play a role either directly or indirectly. In this respect, the set up of credit reference system, with direct involvement of central banks, and/or credit guarantee that central bank may indirectly initiate through banks, may be helpful. However, they are partial solution to the problem as they could not substitute collateral and do not provide information on borrowers' capital commitment to the projects. Setting up a credit reference system alone may also

not be enough as it may not be able to channel credit especially small loans swiftly, even though the early results of such a scheme in Malaysia are encouraging. Meanwhile, for credit guarantee scheme to be effective, additional assistance may be needed.

Central banks as compiler of financial statistics is also in a unique position to help banks obtain necessary information on SMEs. At present, SME statistics are scarce and their financial exposures and credit worthiness are not available. Currently, there have been efforts to close this information gap and we believe central banks could help in building such database. Besides statistics, central banks could also institute discretionary measures to increase loans to the SME sector, such as lowering capital requirement, lowering risk weighting for SME loans, and equity investment in venture capital funds.

In short, central banks in the SEACEN region use a wide range of tools to support SMEs and the support policies and measures are generally moving more toward market completing nature than market substituting. It is also observed that due to strong commitments by governments, and based on the past lessons, SME policies are better coordinated and integrated across government agencies and central banks.

Although promotion of SME is not the prime goal of central banks in SEACEN countries, involvement of central banks will continue so as to secure sustainable financing channel to the sector. In our opinion, there are three main areas where central bank can be involved in promotion of SMB. They are: i) market infrastructure development, ii) enhancing availability of credit information, and iii) swift, safe and secure banking for small borrowers.

CHAPTER 1

ROLE OF CENTRAL BANK IN PROMOTING SMEs IN THE SEACEN COUNTRIES

**by
Dagva Boldbaatar¹**

I. Introduction

1.1 Background and Objective of the Study

In most economies, the main constraint for Small and Medium-Scale Enterprises (SME) is getting access to external financing for their business expansion, restructuring and establishments. In light of this, this paper aims to look for ways of acquiring sustainable channels of funding for SMEs by comparing SEACEN country experiences. While it is recognised that the timing and availability of credit are more crucial to the needs of the SME, there has been concern that the sector is so burdened with excessively high interest rates that its development is impeded. Thus, government policies have long been focused on provision of funds to the SME at a subsidised cost. Unfortunately, experiences in many countries show that many of these schemes collapsed without achieving their objectives.

In general, the policy of promoting SMEs is emphasised because of their role in employment generation after economic slowdown in some countries. In Indonesia, it was revealed that credit to SMEs gave good returns in periods of financial crises. Developed countries' promotion of SMEs has brought about economic innovations and better adaptations. In a labour abundant country like India, attention was paid to its labour intensiveness, although subsidising SMEs on the ground of labour intensiveness has not been established empirically. The recent shift in policy emphasis to rely on domestic demand rather than exports as the main engine of growth has turned the attention of policy makers once again to develop SMEs in a coordinated way. Building on past experiences, however, policy makers have realised that the successful development of SMEs requires more than cheap credit. In the long run, it is the ability to channel funds

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to the sector in sustainable way, together with a host of other factors such as availability of inputs and marketing support that will help schemes to succeed.

From the SEACEN countries' experiences in SME promotion, policies have been mainly led by the Ministries. However, in spite of achievements in some countries, SMEs are lagging behind due to the difficulties in external finance. Central banks as the agency responsible for efficient functioning of financial intermediation should address the issue of SME financing and ensure that SME promotion policies are well co-ordinated. In this paper, central banks' core advantages on market promotion such as commitment to financial market stability, domestic financial market, informational advantage and research capacity are explored.

1.2 Scope and Structure of the Integrative Report

This report is the output of extensive reviews of literature on SME financing that focuses on issues related to the central banks' role in promotion of SME sector. The relevance of the study is limited to the SEACEN member economies². Despite the fact that SME promotion has been on the policy agenda of member countries for a while, statistical data on SME financing are fairly limited. In fact it was not possible to get quality data at the enterprise level from general sources. Thus, the study is descriptive in nature, giving a comparative review of participating central banks' policies on SME promotion. Policies and initiatives of authorities are conditional on the level of SME development and hence, it is not expected that there would be any similarities in pattern. Moreover, it will be overly ambitious to arrive at some general framework of policies for SME promotion because policies have been implemented by various different Government institutions.

The report is structured as follows: Section 2 begins with the definition of SMEs in SEACEN countries to give a reference on comparisons of SMEs in the countries. It is followed by the size and relative importance of that sector in SEACEN member economies. Section 3 analyses SMEs' role in job creation,

2. In this project, participants included ten SEACEN member central banks, namely, Reserve Bank of Fiji (RBF), the Bank Indonesia (BI), The Bank of Korea (BOK), Bank Negara Malaysia (BNM), The Bank of Mongolia (BOM), Nepal Rastra Bank (NRB), Bangko Sentral ng Pilipinas (BSP), Central Bank of Sri Lanka (CBSL), The Central Bank of China, Taipei (CBC) and Bank of Thailand (BOT).

Introduction

in terms of their contribution to value added, their role in innovation mechanism and competitiveness. The section also includes the view on SME resilience during crisis 1997 and how they were affected by the institutions. Section 4 is on SME financing and analyses the sources of financing, followed by the SME financing structure in SEACEN and by the member central banks' initiative currently taken by the participating banks. Section 5 gives the conclusion and recommendation for participating central banks.

2. Overviews on Definitions and Size of SME in SEACEN Member Countries

2.1 Definition

The definition of SMEs is country specific reflecting the need to identify them for various promotion programmes. The number of employees is used most commonly in defining SMEs. Other additional definitions include sales volume/turnover, capital formation, and balance-sheet size/asset volume. Definitions are usually separated for micro, small and medium scale enterprises and they are broken down further by the industrial sectors depending on industries' labour intensiveness. Nine out of ten countries specify explicit definition of SMEs and seven of those use the number of employee as criterion. The 200 employees mark was most often used as cut-off (3 times) and smallest number observed was 50 in Fiji and largest was 300 in Korea. In contrast to this common criterion, balance sheet items were used in seven countries and varied widely both in terms of value and specifications. A possible inconvenience of balance sheet item is indexation. Sri Lanka adopts explicit indexing rule for one of its definitions.

Not all SEACEN member countries officially define SME. Mongolia is about to propose an official definition of SME to be stated in the law. The Mongolian country paper gives the researcher's suggestions for an official definition. The differences in definitions are mainly from i) national policy settings, ii) economic endowments and iii) market structure. The first refers to the level of coordination and focus of promotion of the sector in national policy. For instance, Malaysia used several parallel definitions until recently, but which are still restricted to a few industries while in Sri Lanka, there are many working definitions by different institutions. The size of the economy determined by resource endowments and existing level of technological sophistication that led to consolidation of industrial developments are important source of differences. For example, a firm with 51 employees in Fiji will be large while 300 will be medium in Korea and 500 also

medium million in USA. Market structure as concentration of production or market power, specifics in input and output markets endowed by the resources, and existing policy stance including legislation and judiciary system are other bases for heterogeneity.

The following is on the definition of member countries on Micro, Small and Medium-Scale Enterprises.

2.1.1 Fiji

The Fijian definition of SMEs as stated in law in 2002³ involves: i) sales volume or total asset and ii) employment size as criteria for classifying micro, small and medium enterprises as follows:

Class	By turnover or asset volume	By employment
Micro enterprise	Less than \$30 thousand	No more than 5
Small enterprise	\$30 to 100 thousand	6 to 20
Medium enterprise	\$100 to 500 thousand	21 to 50

2.1.2 Indonesia

The SME definition of Indonesia in general separates micro, small and medium enterprises by their sales volume and balance-sheet size. The definition is relevant only to Indonesian owned SMEs. There are restrictions on the ownership so as to capture true SMEs, i.e., the small and medium scale companies not owned or affiliated with bigger companies.

3. Small and Micro Enterprise Development Act see Part II, Country Paper of Fiji.

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Class	Sales volume (mln Rp)	Asset (mln Rp)	Additional criteria
Micro Enterprise	<Rp100	NS	- Productive business - Owned by individual or family
Small Enterprise	<Rp1000	<Rp200 exclude: land, building	- Self reliant* - In the form of individual or entities (including cooperative)
Medium Enterprise	<Rp1000	Rp200 to Rp10,000 Exclude: land, building	- Self reliant* - In the form of individual or entities (including cooperative)

NS: not specified

* Not owned nor affiliated directly and indirectly to upper classified enterprise

2.1.3 Korea

The definition is set in the law and is specific to each industry. The list of industries is presented in the Korean country paper. The SME is classified as a company which employs less than 1000 person and total assets of which does not exceed 500 bn Korean won. Within this limit, the SME is defined by one of these two criteria specified in each industry groups.

Class	Industry	By employment	By paid-in-capital / sales volume
Small enterprise	Manufacturing, mining, construction Other	Less than 50 Less than 10	Not specified Not specified
Medium enterprise	Manufacturing Industry 2* Industry 3* Industry 4* Industry 5* Other	300 workers 300 workers 300 workers 200 workers 100 workers 50 workers	Paid-in-Capital: ₩8bln Paid-in-Capital: ₩3bln Sales: ₩30bln Sales: ₩20bln Sales: ₩10bln Sales: ₩5bln

* See Part II, country paper of Korea for exact list of industries

2.1.4 Malaysia

The new unified definition of SMEs was introduced by the National SME Development Council on December 2, 2004. The unification of several parallel definitions was a major advancement and has prioritised three key industries, namely manufacturing and manufacturing related service⁴ (MRS), primary agriculture, and other services including ICT. Shareholders' capital, which was used as criterion in one of the previous definitions, was excluded and the coverage extended beyond manufacturing.

Class	Industry	Full time employee	Annual turnover (mln of RM)
Micro enterprise	Manufacturing, MRS Primary agriculture Service including ICT	Less than 5 Less than 5 Less than 5	Less than RM0.25 Less than RM0.20 Less than RM0.20
Small enterprise	Manufacturing, MRS Primary agriculture Service including ICT	5 to 50 5 to 19 5 to 19	RM0.25 to 10 RM0.20 to 1 RM0.20 to 1
Medium enterprise	Manufacturing, MRS Primary agriculture Service including ICT	51 to 150 20 to 50 20 to 50	RM10 to 25 RM1 to 5 RM1 to 5

2.1.5 Mongolia

While Mongolia has yet to define SMEs, the Government announced that 2005 would be the year for promoting Small and Medium Scale Enterprises. The definition of SMEs will be specified within this framework. A special fund has been made available from The Bank of Mongolia through selected commercial banks for export oriented SMEs financed by the KfW, Germany and uses the

4. Activities classified under manufacturing related services are listed in the country paper of Malaysia.

Introduction

German definition of SME as a working definition. However, this definition is not binding and requires revision. There was an attempt to define small enterprises in the early 1990s but the usage and accuracy were not clear. Mongolia's country paper proposes possible definitions for SMEs and are based on the researcher's survey conducted specifically for this project. As the researcher suggests, employee number in combination with other balance sheet items can be used to classify SMEs in main industries. However, inherent labour market inefficiency and inaccuracy of SME's financial statements are likely to make it difficult for identifying SMEs for promotional policy purposes.

2.1.6 Nepal

Nepal defines small and medium industry instead of enterprise. This probably explains why only fixed asset is used for this definition. There is no clear distinction between the definition for SMI and SME. SMI maybe more relevant for enterprises operating in villages. While the country researcher uses SMI and SME interchangeably, the classification below defines small and medium scale industry:

Class	Fixed asset
Small industry	Up to Rs.30 mln
Medium industry	From Rs.30 to Rs.100 mln

2.1.7 Philippines

The Philippine definition of SME is by employee number and asset size.

Class	By employment	By asset (mln of P)
Micro enterprise	1 to 9	Less than P 3
Small enterprise	10 to 99	P 3 to P 15
Medium enterprise	100 to 199	P 15 to P 100*

* Medium enterprise Asset size increased from P 60 million up to P 100; SME Development Council Resolution No.1 of 16 January, 2003.

2.1.8 Sri Lanka

The institutions in Sri Lanka use different definitions for their policy emphasis. The include i) asset value not including building and land, ii) nominal value of fixed asset without land and building, iii) capital investment in plant and equipment, iv) employment, and v) export volume as criteria. A summary of these definitions presented in the following table:

Institution	Class	Asset	Fixed asset	CI in PE	Employment	Export volume
Industrial Development Board	Micro	NS	NS	NS	Less than 5	NS
	Small	NS	NS	<Rs4mln	6 to 49	NS
	Medium	NS	NS	NS	50 to 100	NS
Task Force for SME Dev. Prog.	Small	Rs.1 to 20mln	NS	NS	NS	NS
	Medium	Rs.20 to 50mln	NS	NS	NS	NS
National Devt. Bank & DFCC Bank	SME. A	NS	<Rs10mln	NS	NS	NS
	SME. B	NS	<Rs15mln	NS	NS	NS
	SME. C	NS	<Rs70mln	NS	NS	NS
Dept. of Small Industries	SME	NS	NS	<Rs5 mln	< 50	NS
Export Devt. Board	SME	NS	NS	<Rs20 mln	NS	<Rs40 mln

CI in PE: capital investment in plant and equipment / capital investment

NS: not specified

SME A, B, C: refers to different programmes of National Development Bank and DFCC Bank of Sri Lanka

Since there several balance-sheet items used for defining SME, they are subject to inflation and hence, the asset value is adjusted by inflation.

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2.1.9 Taiwan

The official definition of Taiwan's SME uses balance-sheet items as the primary criteria. Manufacturing, construction, mining and quarrying use paid in capital; other industries use preceding year's operating revenue. If a firm lacks information on the criteria, the number of employees is used as the sole criterion for qualifying SME. The micro enterprise, in contrast, uses the number of employee as the sole criterion.

Class	Industry	Primary criteria	By employee
Micro enterprise	A	Not specified	Less than 20
	B	Not specified	Less than 5
Small & Medium enterprise	A	Paid in capital less than NT\$80mln	Less than 200
	B	Preceding year's revenue less than NT\$100mln	Less than 50

Industry A: manufacturing, construction, mining, and quarrying

Industry B: other industries; agriculture, forestry, fishery, utility, commerce, infrastructure, finance, insurance, real estate and service

2.1.10 Thailand

Thailand uses the definition of the Ministry of Industry which defines SME by employment and fixed asset size excluding land.

Class	Industry	By employment	By fixed asset (mln of THB)
Small enterprise	Manufacturing, service	Less than 50	Less than THB50
	Wholesale	Less than 25	Less than THB50
	Retail	Less than 15	Less than THB30
Medium enterprise	Manufacturing, service	51 to 200	THB50 to 200
	Wholesale	26 to 50	THB50 to 100
	Retail	16 to 30	THB30 to 60

Given the differences mentioned above, it is difficult to suggest a common definition of SMEs among SEACEN economies. A country wide unified definition would be better to capture a broader range of economic activities allowing firms to participate in programmes on equal grounds. A widely used criterion is employees' number, the average of which is 200. The difference in the exact number is not important, since it is taken in isolation of the size of markets or the economy. An additional criterion is the asset value which has to be indexed in an inflationary environment and derived from frequent surveys. Otherwise, a double definition like that of Korea may work. Two ways of defining SMEs are observed - one is to define enterprises in a detailed manner as in Korea with broad coverage and another is a simple and uncomplicated way as in the Philippines.

The size classification cannot be unified unless there is further integration among SEACEN economies. However, there is a commonly applied definition used for all countries by international institutions for their programmes and cross country analysis. Ayyagari, Beck and Demirgüç-Kunt (2003) use the number of employees of 250 for their cross country analysis which differs from the World Bank's definition of 300⁵, which is similar to the OECD definition⁶. The World Bank's additional criteria is asset size and sales volumes of USD15 million for SME. In addition, the OECD definition explicitly restricts ownership structure to cover only non-subsidiaries of big establishments.

2.2 Size of SME Sector in SEACEN Member Countries

The size of the sector measured by i) share of SME in total business establishments, ii) share of their employment in total labour force and iii) contribution to total value added are analysed. As is common for emerging economies, SME constitutes a vast majority of total business establishments and employs a relatively large portion of the labour force as indicative of their labour intensiveness. Generally in industrialised countries, SMEs' contribution to GDP

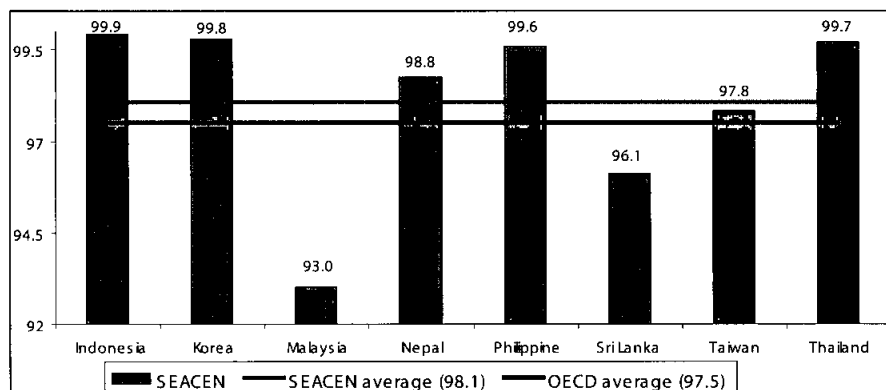
5. The SME Department of World Bank is currently working with the following definitions: "Micro-enterprise-up to 10 employees, total assets of up to \$100,000 and total annual sales of up to \$100,000; small enterprise-up to 50 employees, total assets of up to \$3 million and total sales of up to \$3 million; medium enterprise-up to 300 employees, total assets of up to \$15 million, and total annual sales of up to \$15 million." Available on web link: http://www2.ifc.org/sme/html/sme_definitions.htm

6. OECD (2002)

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is possibly smaller than big corporations. However, data from the country chapters reveal that SME contribution to GDP in SEACEN member economies is higher than the OECD average, indicating its relative importance. Graph 1.1 illustrates the size of the SME sector in SEACEN as a share of total number of establishments. Four countries' SMEs constitute almost 100 percent of total business establishments. Fiji and Mongolia were not included due to unavailability of data. The SEACEN average, excluding Fiji and Mongolia is slightly higher than the OECD average.

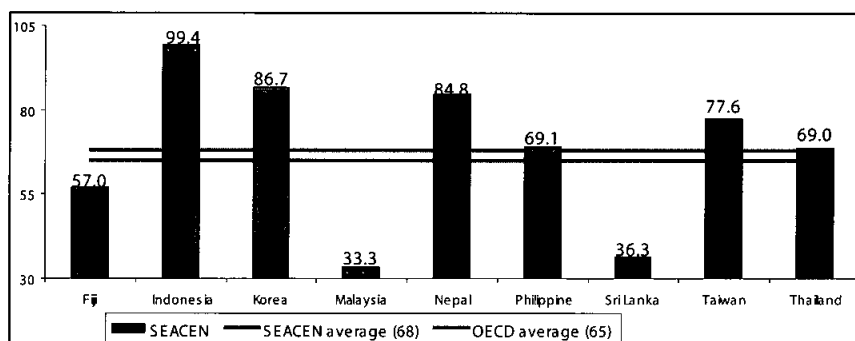
Graph 1.1: SME as Percentage of Total Business Establishments



Source: Country papers in Part II and OECD Small and Medium Enterprise Outlook (OECD (2002)).

SME employment is shown in Graph 1.2. In four countries, namely, Indonesia, Korea, Nepal and Taiwan, SMEs employ more than two thirds of the employed work force. In the case of Malaysia, the number is available only as share of manufacturing sector and is smaller than the economy-wide figure. There is no data available for Mongolia. The SEACEN average is again slightly higher than the OECD average, although the level of each country showed vast differences of 1/3 to 99 percent of work force.

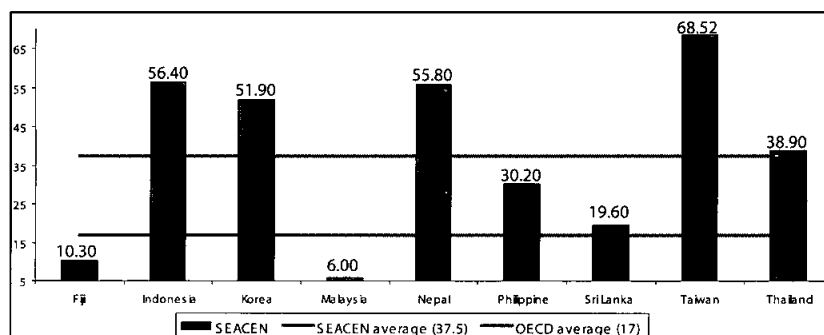
Graph 1.2: SME Sector Employment as Share of Work Force



Source: Country papers in Part II and OECD Small and Medium Enterprise Outlook (OECD (2002)).
Note: Data for Malaysia is based on Manufacturing Sector.

SME size as measured by their contribution to total value added is shown in Graph 1.3. Only four countries are captured having SME contribution to total value added exceeding 50%. Again, the Malaysian data covers only the manufacturing sector. The Fijian data is based on share of informal industries. It can be clearly seen that in Taiwan, SMEs form the backbone of economy and in case of Thailand and Indonesia, a few big companies make up a considerable portion of GDP. Despite the heterogeneity of data sources and big variations in levels in individual countries, it can be seen that the average value-added production of SMEs in SEACEN countries exceeds the OECD average.

Graph 1.3: Indication of Value-added Produced by SME Sector as % of GDP



Source: Country papers in Part II and OECD Small and Medium Enterprise Outlook (OECD (2002)).

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The definition of SMEs in the SEACEN countries is largely dependent on country-specific preferences reflecting policies on priority industries, level of institutionalisation of SME promotion policies, and countries endowments. In general, SMEs in SEACEN countries are small in nature and forms the majority of business establishments. They employ almost two thirds of the work force and produce more than a third of output, which is higher than the OECD average.

3. Role of SME in the Economy of SEACEN Member Countries

The role of SMEs is traditionally more valued in Asia than other parts of the world as the Asian culture of institutionalised social relationship contributed to the development of horizontal networking of manufacturing process (Hodgkinson (2000)). The success of the industrialisation process in Japan, Taiwan and Korea were largely due to the vast number of small firms operating flexibly and filling production processes of intermediate goods for big companies. Thus, SMEs are an integral part of most developed Asian economies. The philosophy of the survival of the fittest still predominates US policies regarding SMEs but the recent emergence of knowledge-based firms have attracted interest and focus on the SME sector. In contrast, European policy on SME had traditionally focused more on entrepreneurship, rather than direct policy interventions. In general, SMEs form an important part of the economy in almost every country. However, the changing global economic environment, advancement in Information and Communication Technology (ICT), and newly emerging economies have put greater pressure on SMEs to adapt to these changes and therefore also the policies for promotion. Therefore, governments and international institutions, including APEC, OECD, and the World Bank, are placing priority on its promotion.

3.1 SMEs in Employment Generation

There are arguments and debates about SMEs' ability to contribute to domestic demand expansion through job creation. Employment generation and further domestic demand strengthening reduces the relative reliance of the economy on export growth. At the same time, public wealth benefits from increases in employment. If SMEs are, indeed, effective job creators, then the promotion of SMEs can be effective to revive a sluggish economy in the aftermath of a slow-down. However, the effectiveness of SMEs in job creation has been questioned especially on the quality of the jobs created and SMEs' contribution

to job layoffs⁷. In developed countries, SMEs have been found not to perform very well in terms of job creation, the quality of jobs generated and durability of jobs (BDL (2003)⁸ contains review). In fact, BDL (2003) argues that the SME sector is not an effective job creator but that when the overall business environment improves, the improvement in business support will result in the SME sector expanding as well and thus employment. It also questioned the labour intensiveness of SMEs and concluded that a large SME sector results from a fast and successful growing economy and not vice-versa. It is clear that SMEs creates employment but because of inherent instability they also contribute to job layoffs almost as much as jobs created.

It is believed that the SME sector in emerging market economies is labour intensive. When SMEs are major employers and their production process is labour intensive, it follows that employment will be generated. This potential of job generation due to the labour intensive nature of SMEs has attracted the attention of policy-makers to promote the sector⁹. This is not a new idea as countries like Taiwan, which possess a large labour force has focused on SMEs since WWII. South Africa, for instance, sees SME development as a solution to its unemployment problem (Lloyd (2002)). However, there are insufficient empirical studies on the SEACEN countries to prove that SMEs are indeed labour intensive. In fact, establishing the labour intensiveness of SME would be a rather difficult task given the weaknesses of SME statistics.

However, it is clear that SMEs constitutes an important portion of the economy in the SEACEN countries and as such, they have to be nurtured to be competitive. In six of the nine countries where data is available, it is shown that SMEs employ more than 69% of total employed (Graph 1.2). In Indonesia, they employ more than 99% of total workforce. In Taiwan, 80 % of the increase for the year-to-year increase of total number of employed comes from SME employment from 1992 and 2003. The average annual growth rate of SME employment was 0.78% against 0.68 % of total employment growth rate¹⁰. In Korea, total

7. DHS (1993) presents data analysis on US data and argues that net job creation in US does not represent any systematic behaviour while job durability increases with firm size.

8. Beck, Demirgüç-Kunt and Levine (2003)

9. Tom Alweendo, 2004, Governor of the Bank of Namibia, "Keynote address" *6th African Development Finance Conference and SMME Awards*, Cape Town; Vepa Kamesam, 2003, Deputy Governor of the Reserve Bank of India, *Financing for Entrepreneurship and SMEs – an Indian Perspective*, Address at OECD "Workshop an Entrepreneurship in a Global Economy, Budapest; BNM (2003) and etc.

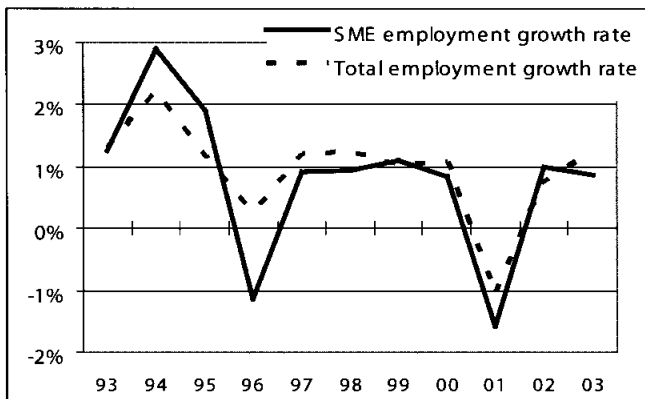
10. Calculated from data in White Paper on SMEs in Taiwan, Ministry of Economic Affairs (2001 – 2004).

Introduction

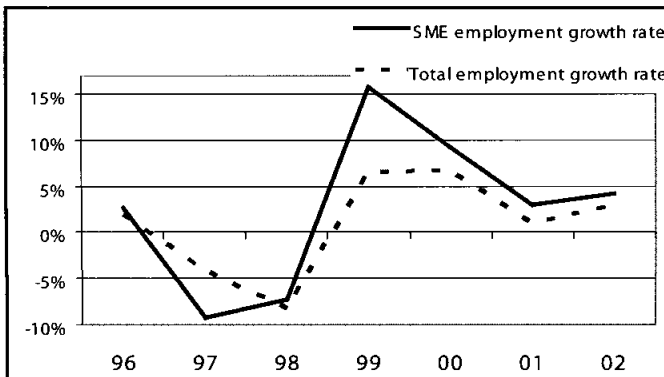
employment rose due to growth in SME employment. The year-to-year increment of SME employment data was on average higher by 59% over total increment excluding years of contraction (1996, 1997¹¹). The year-to-year growth rate of SME employment averaged 6.14% against 3.61% of employment total for same period.

Graph 1.4: Year-to-Year Growth Rates of Total and SME Employments

Taiwan



Korea



Source: White Paper on SME in Taiwan, Country Paper of Korea

11. In 1996, contraction of SME employment was higher than total contraction by about 70%, but in 1997 SME contracted less than the total.

Graph 1.4 also shows that SME employment is more volatile than total employment which is congruent with the inherent instability and the argument raised by Gertler and Gilchrist (1991) that SME reacts more quickly in times of contractions. However, they recover as quickly as they contract and the Thai country paper notes that with the recovery of larger firm, the employment share of SMEs falls.

Finally, SMEs' ability to contribute to employment is conditional on industrial development of the country and SMEs themselves. Thus, the theory that SMEs are effective job creators should be studied further. Since SMEs are the biggest employers, it indicates that a certain level of employment generation can be obtained with SME support programmes in the SEACEN countries. In addition, nurturing SMEs may contribute to durability of job according to DHS (1993).

3.2 Value Added of SMEs and their Distribution by Industries

SMEs contributions to value added vary among SEACEN economies. The country papers and other researchers have noted¹² that there is a lack of statistics in this area and available statistics are not reliable due to the largely informal nature of the sector. Many countries do not have consistent yearly series and some at best have data reported in industrial census or survey with frequency lags of 4 to 6 years. However, due to initiatives¹³ of the OECD Bologna Charter¹⁴ on SME statistics, countries like Korea have managed to publish detailed statistical information online¹⁵. The Indonesian Ministry of Cooperative and SME Website¹⁶, White Paper on SME in Taiwan published by the Ministry of Economic Affairs are very useful sources on SME data. Using data from these sources, it can be shown how SMEs in selected countries are contributing to value added in manufacturing.

12. Tambunan (2003) among others, noted statistical and policy definitions of SME may not be the same, hence statistics can deviate.

13. OECD (2003) web link: http://www.oecd.org/document/38/0,2340,en_2649_34233_2789222_1_1_1_1,00.html

14. Bologna Charter web link: http://www.oecd.org/document/17/0,2340,en_2649_34197_1809105_1_1_1_1,00.html

15. Small and Medium Business Administration web link: http://www.smba.go.kr/main/english/sub3/sub03_4_2_1.jsp

16. Ministry of Cooperative and Small Medium Enterprise, web link: <http://www.depkop.go.id>

Table 1.1: Value Added, Employment and
Value Added Over Employment Ratio of Selected SEACEN Countries (%)

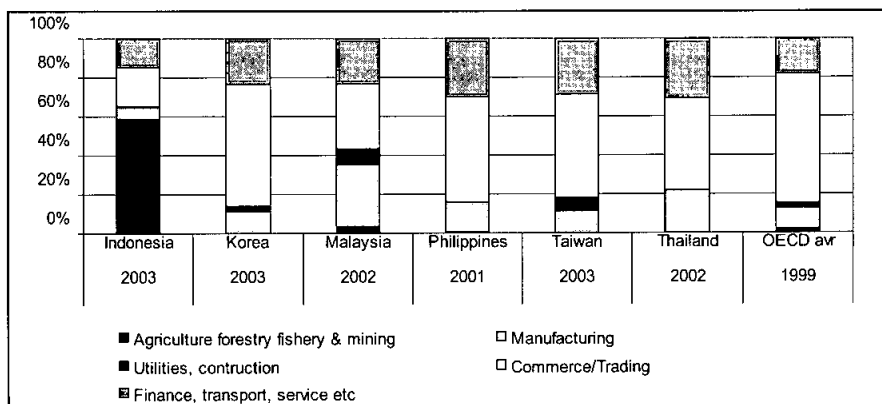
Country	Year	Value added	Employment	Ratio	Year	Value added	Employment	Ratio
Indonesia	1985	21	52	40	2003	35	98	36
Korea	1992	46	65	71	2002	52	77	68
Philippines	1983	21	43	48	2001	31* ♦	52	59
Taiwan	1992	39*	79	49	2002	27*	79	34

* Sales volume in Taiwan and Philippines, ♦ Data of 1998 Census, Philippines
Source: Tambunan (2003), country papers in Part II, Small Business Administration of Korea, Ministry on Cooperatives and SME of Indonesia, White Paper on SME in Taiwan

From the Table 1.1, it can be seen that manufacturing value added/output produced by SMEs grew from the 1980s. The growth rates range from 21% to 46% in late 1980s and early 1990s and presently from 27 to 56% for manufacturing production. SMEs' employment of labour during the same period grew considerably. However, value added per employee in SMEs as share of manufacturing as a whole decreased. It increased slightly in Philippines; decreased in Indonesia, Taiwan, and Korea, perhaps, indicating the success of large enterprises. Data obtained from different sources could be subject to discrepancies. However, if there is no significant improvement in value added over the employment ratio, it is difficult to confirm productivity improvement in SMEs and they therefore remain labour intensive.

Graph 1.5 displays SMEs' distribution by industrial sector. Apart from Indonesia, the majority of SMEs in the five countries operate in commerce and trade followed by service and manufacturing. In Indonesia, 59% of all SME are in the agricultural sector, which is very high in comparison to other countries and the OECD average, reflecting the sector's importance. In Korea, Philippines and Taiwan, 62%, 54% and 53% of SMEs are in commerce respectively. The smallest number of SMEs are operating in construction and utilities. For the comparison purpose, the OECD average was included. Malaysian and Thai SMEs in the manufacturing sector are higher than the OECD's (32%, 22% and 1% respectively), while only Korean SMEs in commerce/trade sector come close to the OECD level (62% and 67%).

Graph 1.5: SME Distribution by Main Industrial Sectors



Source: Country Papers, Ministry of Cooperatives and SME of Indonesia, OECD (2002)

The relative importance of SMEs in the industrial sector is compared in only two countries where data available, which is indicative of the market share of SMEs in these sectors or more precise, indicates the level of concentration in industries and market power of large companies. In Indonesia, the trading, hotel and restaurant industry is almost solely occupied by SMEs ($VA=96.8$, $E=99.8$ and $VA/E=96.9$), while in Taiwan, a few large firms employ a small number of people selling two thirds of output. In Taiwan, $E=94.5$ means that the majority of labour in this industry are employed by SMEs, but only about one third (33.6%) of sales are generated by them, meaning large firms employs only 5.5% of employees but sells two thirds of the output as indicated in the SV/E ratio of 35.6%.

Table 1.2: Relative Importance Expressed Value Added Per Employee (VA/E) in Indonesia, and Sales Per Employee (SV/E) in Taiwan

	Indonesia (2003)			Taiwan (2002)		
	VA	E	VA/E	SV	E	SV/E
Agriculture, fishery, forestry, and mining	65.4	99.8	65.5	52.8	98.7	53.5
Manufacturing	35.1	97.9	35.9	26.9	79.2	34.0
Construction and utilities	49.1	98.4	49.9	39.4	92.7	42.5
Trading, hotel and restaurant	96.8	99.8	96.9	33.6	94.5	35.6
Service	53.8	99.3	54.2	20.5	56.4	36.3

Source: Ministry of Cooperatives and SME of Indonesia, White Paper on SME in Taiwan

All the value added/sales over employment ratios are less than one which means that the ratios for large firms in all of these industrial groups are more than one, reflecting its efficiency, assuming that there are only two groups of producers, SMEs and large firms.

3.3 Innovative Nature of SME and their Competitiveness

Klapper et al (2002) called SMEs “agents of change”. In developed countries, the innovative nature of SMEs attracts policymakers’ attention more than any other characteristics. Promoting efficient innovation mechanism improves the overall dynamism and competitiveness of the economy. In that sense, resilience is matter of quick and efficient counter-response or adaptation to shocks or changed economic environment. Adaptability and flexibility are characteristics of SMEs and they tend to respond quicker to policy actions¹⁷. On innovation, it is generally argued that only larger companies have the ability to innovate through investments in R&D but there are cases where SMEs also contribute to innovations¹⁸. One way that SMEs introduce innovation is via specialisation as members of the subcontracting chain, as is the case in Asian economies. Another way is innovation based on SMEs’ niche strategy via adapting goods to customers’ needs and adding value to it.

The subcontracting scheme which was developed in Japan is an efficient innovation mechanism, from which both big companies and small subcontractors¹⁹ can mutually benefit from. In the system, SMEs provide flexible means to bigger companies specialising in intermediate goods and services, introducing differentiations and innovations in different stages of production process. In return, small firms enjoys access to in-house R&D developed by their large partners. Another way of contributing to the innovation mechanism is for SMEs to develop independently of the big corporations. In this case, the nature of innovativeness would be distinct from big corporations’ R&D based ones. There is a study which found that most newly established businesses adapted R&D developed in big corporations. For big corporations, it may be that it is cumbersome

17. See Gertler, Gilchrist (1991).

18. OECD (2000) noted that direct innovation by SME grew more than in large firms, patent requests higher with smaller firms signalling their inventions, direct measurement reveals SME contributes 2.3 time more than large firms in terms of innovation per employee, SME are less bureaucratic allowing innovative ideas, the scale of big firms stops them from being responsive to small inventions, and etc.

19. Hodgkinson (2000).

and expensive to do the detailed finishing and this leaves space for SMEs to be creative to fill in this niche. Newly established enterprises generally bring new products into the market either by differentiating existing ones or the introduction of a totally new commodity, whether it be intermediate or final products.

The third front of SME contribution to innovations comes from innovative start-ups. They are usually the most dynamically emerging businesses in a environment where intellectual property protection is well enforced, high-tech or knowledge intensive start-ups are an efficient part of the innovation system. As more knowledge intensive industries develop and their share in value creation grows, support for knowledge intensive start-up is becoming more important. As result of globalisation, competition in final and intermediate goods has intensified. The overall liberalisation and human rights protection have changed corporate culture in labour markets of the majority of economies. Thus, corporations are being changed, leaving more space for innovative small firms. According to Zingales (2000), new firms which are knowledge intensive, tend to be non-vertically integrated, human capital intensive entities operating in a globally competitive environment. In these firms, control over human capital, as suggested in the paper, can be maintained through specific nexus collections of individual human capital investments. The human capital investment decision is made as a reaction to the changing environment on the group of individuals that are connected via the nexus and more often when group interest conflicts with corporation's decisions; it creates space for individual business entities instead of vertically controlled institutions, thus initiating innovative start-ups.

The challenge of innovative start-ups is nurturing and financing them. OECD²⁰ and the Bank of England²¹ places prime importance on innovative SMEs rather than the whole population of SMEs. The process of introducing a new product, especially R&D intensive ones, goes through several difficult stages that is not easy for banks to enter into a financing agreement. The OECD (2004) provides a model of financing for this type of firm. To promote innovative SMEs, banks have to invest in developing strategies for financing knowledge based small firms. The model shows that even after successful start-ups, knowledge based small firms will face difficulties in obtaining financing from banks. Many of them lack the collateral for debt financing and their inherent instability makes venture

20. OECD Conference on Promoting Entrepreneurship and Innovative SMEs in a Global Economy, website: www.oecd-istanbul.sme2004.org

21. Bank of England (2001)

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capitalists wary. Attempts have been made to develop SME loan models that reduce transaction cost of products. However, these are based more on mass-serving approach than for individual project developing which need high-tech small firms²². This is another valid justification for government involvement in financing prospective and possibly innovative SMEs.

The changing business environment mentioned creates challenges and opportunities for existing SMEs as well. In line with these changes, SMEs pursue a policy of networking, clustering and developing partnership that allows them to compete better. The development of such contacts provides useful and flexible, adaptable opportunities for groups of small companies to link with each other via production and marketing nexus to compete with the big companies. The OECD (2000) summarises these strategies developed by SMEs in different parts of the world. Hodgkinson (2000) documents that Taiwanese SMEs are pursuing these strategies in the face of today's challenges and they are creating networks and vertical integrations that allow them to compete even with big corporations. Thus, global and local changes of the business environment including, i) restructuring and re-establishing corporate nature, as in Zingales (2000); ii) reduced transaction cost due to ICT intensiveness, better local and global networking opportunities; iii) financial deregulation and consolidation²³; iv) better policy focus, as displayed by the Malaysian Government in its policy re-orientation; and v) global business-to-business linkages that intensifies competition of both intermediate and final products, create more room for those which are competitive and innovative, but on the flip side of the coin, creates pressure on the others.

Less than 20% of SMEs are innovative in Europe, according the European Community Innovation Survey (OECD (2000)). They document that leading technology developers tend to be young small firms, credit to high-tech start-up financing, and with age, SME are more followers of technological change than developers. Therefore, many SMEs are not innovative and seldom invest retained profit in research and are subjected to pressure in a globally competitive business environment. For them, there is not much room for cutting down operating costs and the only option is expensive restructuring or shifting to other industries subject to constraints on managerial and entrepreneurial skills. In addition, many of

22. One example is credit scoring based approach. www2.ifc.org/sme/smeknowledge/html/credit_scoring.html

23. Hendrickson and Rauch (2004) argue that financial consolidation may cause a rise in interest rate for SMEs in case of smaller banks, while bigger banks may lower the rate in general.

them are purely domestic demand based and the competitiveness of these SMEs will be largely defined by efficient realisation of local opportunities. Thus networking, clustering and being aware of Government support programmes would be to their benefit²⁴. The evolution of SME development goes through stages as argued in Hodgkinson (2000), from petty producer to dependency stage, then from internalisation to the externalisation stage. After reaching localisation and globalisation stages, the SMEs are already operating in the international market, producing their own developed brand, deepening the global market through the created niche. Among the four SEACEN countries analysed, only Taiwanese SMEs have reached the localisation stage while in Korea and Malaysia, the SMEs are still at the stage of internalisation with matured technology but have yet to develop their niche. At the early stage, SMEs are more dependent on the domestic market and investing in better information and cheaper resources may worth while. Further levels of development like externalisation may require efforts in investing technology-transferring vehicles or in mechanisms that efficiently reduces transaction costs to stay competitive in the market.

3.4 Resilience of SMEs during the 1997 Financial Crisis

In the 2004 APEC SME Working Group Meeting in Santiago, Chile²⁵, it was revealed that in Indonesia the SME sector was resilient in the 1997 economic crisis. Hallberg (2001), for instance, gives reference to research that documents job destruction by SMEs tends to be smaller relative to big companies, while their loan applications are most likely to be denied during the crises periods²⁶. The former finding supports the Indonesian observation. In the country paper of Indonesia, it was revealed that Indonesian SMEs are in the early stage of development and are reliant mostly on the domestic market. Thus, SMEs in the early stage may display resilience to external shocks as was observed in Indonesia. With regard to less job destruction, the main argument is that managers of small firms possess the power to adjust wages and benefits with market down turns, giving grounds for policy makers' suggestions for their exemption from minimum wage requirements.

24. Mr. Wu Xiaoling, Deputy Governor of the People's Bank of China, noted in his Videoconference on Promoting Micro Credit, that many of primary small producers were not aware of Government support programme and local implementing agencies were not efficient in policy publicity. (BIS Review 46/2004, www.bis.org)

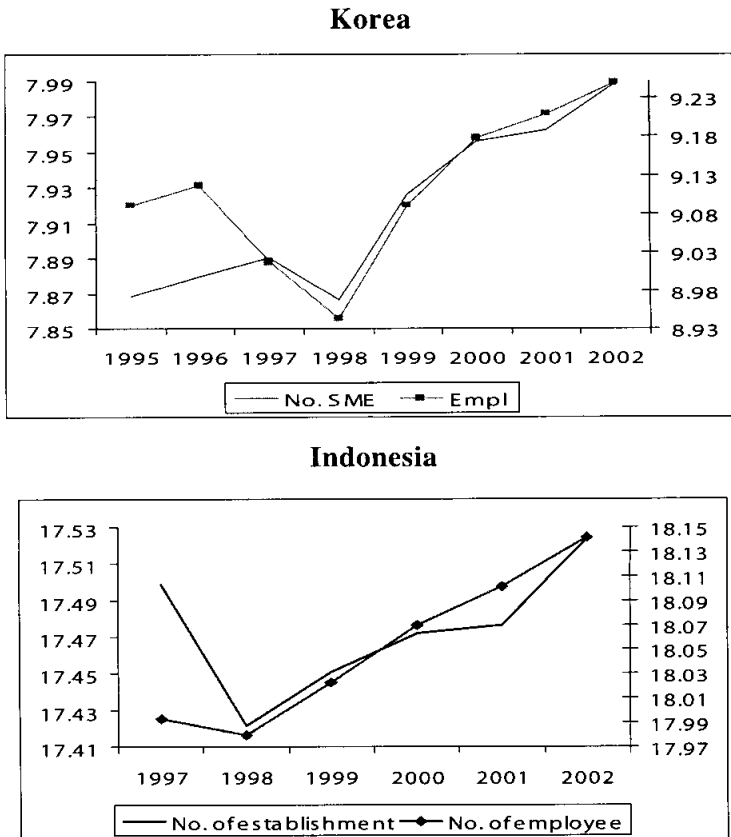
25. www.apec.org/apec2004/SMEWG/003

26. Haltiwanger (1999), World Bank (1998)

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Graph 1.6 shows the number of SMEs in Korea and Indonesia and their employment. The number of SMEs in both countries decreased from 1997 to 1998 and employment by SMEs also decreased. Because of their instability, the employment fluctuates more than overall employment (Graph 1.4). In the case of Indonesia, SMEs employ almost the entire labour force and thus there is no detectable difference in changes on overall and SME employment. The data are transformed in the log form and employment data is displayed on right axis for better comparison.

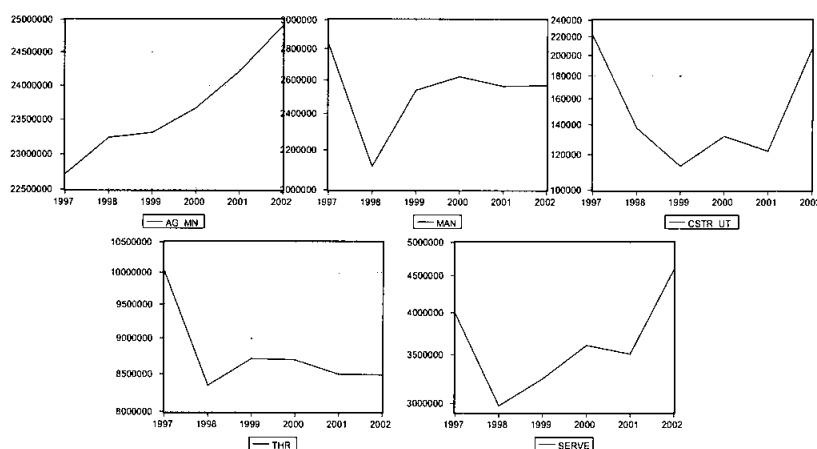
**Graph 1.6: Number of SME, Number of SME Employees
(Data In Natural Log Form)**



Source: Korean country researcher provided data for Korea and Ministry of Cooperative and SME of Indonesia publish data on the web.

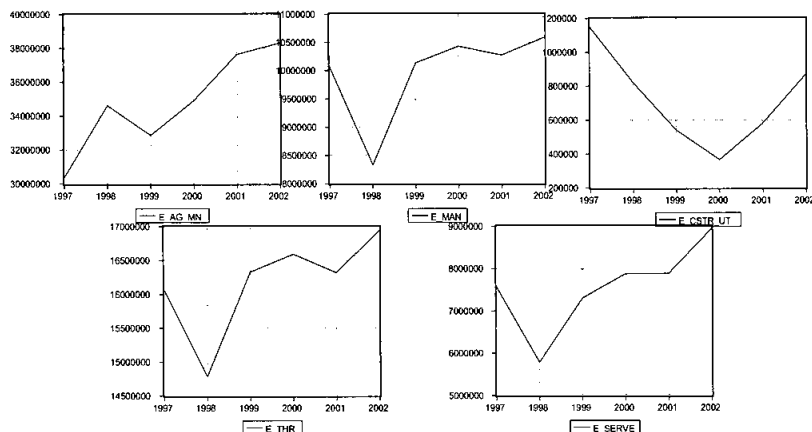
For industrial level data for Indonesia, the only country where data is available, the number of SMEs and their employment are shown in the Graph 1.7 and 1.8 classified by groups of industries: i) agriculture, forestry, fishery and mining, ii) manufacturing, iii) construction and utilities, iv) trading, hotel and restaurant, and v) finance, insurance, transport, communication, and service. The graph shows that the agricultural sector displays resilience as the number of SMEs in this sector has continued to rise, albeit at a slower pace, and the contraction in employment has been relatively mild. SME employment in the agricultural sector actually went up sharply in 1997, while it fell in the other sectors. It declined in the subsequent year as employment picked up in the other sectors. SMEs in construction and utilities sector were hurt by the crisis and have recovered slower than other industries. While the number of SMEs in manufacturing and commerce did not regain the level reached in 1997, the employment level increased in comparison to that of 1997.

Graph 1.7: Number of SMEs in Indonesia by Industrial Group (1997 - 2002)



Note :AG_MN: agriculture, forestry, fishery and mining; MAN: manufacturing; CSTR_UT: construction and utilities; THR: trading, hotel and restaurant; SERVE: finance, insurance, transportation, communication and service

Graph 1.8: SME Employment in Indonesia by Industrial Group (1997- 2002)
(Grouping is same as in Graph 1.6)



Note :AG_MN: agriculture, forestry, fishery and mining; MAN: manufacturing; CSTR_UT: construction and utilities; THR: trading, hotel and restaurant; SERVE: finance, insurance, transportation, communication and service

The number of SMEs and their employment in finance, transport, communication and service industries were hit by the 1997 crisis but recovered quickly.

However, from the charts, it is not conclusive that SMEs are resilient to crises. In contrary, SMEs in most of the industries, apart from agriculture, were hurt by the crisis. While it can be concluded that SMEs in the agricultural sector were resilient and outperformed the other sectors in the face of depreciating exchange rate²⁷, the impact of the crisis on SMEs in comparison to the large firms cannot be analysed without data. In light of this, it can only be assumed that SMEs may have the ability to recover more quickly than large firms from external shocks.

At the same time, the credit channel of monetary policy may impact SMEs differently from big firms. The early works of Gertler and Gilchrist (1991) show that the SME sector is dependent on the domestic financial sector and also on banks. It was argued that they also respond more quickly to monetary contractions. While this has nothing to do with resilience it does show that SMEs are more

27. Tambunan (2003) in fact argues some SMEs were gaining profit in crises-time due to exchange rate depreciation.

dependent on the domestic market including both goods and service and financial market. If policymakers are thinking about shifting debt to the SME sector, they benefit from the arguments of resilience of SMEs against external shocks and their flexible and quick respond to policy measures or contractions.

3.5 SME Sector in Relation to Institutions

It is generally agreed that government policy measures to pave the way for a conducive environment for SMEs is the best development strategy. Hallberg (2001) showed that from the industrial organisation theory point of view, natural resource endowments, policies, institution and technology determine the “equilibrium” size distribution of firms in general. Moreover, overly subsidised pro-SME policies tend to distort these resource and may impede firms from growing. Nonetheless, there are other related costs of doing business and can be particularly burdensome for SMEs. The other barriers to growth include restriction of access to markets, business costs in the form of levies or expensive dispute resolving, zoning and procurements procedures, labour market rigidities and lack of information. Alternatively, business environment elements that support SME sector growth include i) good property rights protection, ii) lower cost of contract enforcement, iii) easy entry to market and iv) efficient exit/bankruptcy system. These are confirmed to positively impact the SME sector in the empirical study by BDL (2003) using cross-country data.

Another dimension of institutional development is related to the financial and judiciary structure of the country. BDM²⁸ (2002), Klapper et al. (2002) shows that inefficiency and underdevelopment of financial/banking institutions may cause crucial deficiency in terms of providing financial capital to SMEs and SME development. Tze-Wei Fu et al. (2002) concluded that equity financing positively impact the profitability of Taiwanese SMEs, indicating the importance of the role of capital market for SME development. On the size of firm, BDM (2004) demonstrated in their cross country analysis on how firm size is affected by financial system development and efficiency of the legal structure. The cross-country regression analysed large firms, assuming that they are the least constrained in terms of access to external financing (Indonesian, Korean, Malaysian and Taiwanese firms in the sample). The conclusion was that strong financial institutions support firms to grow to the optimal size and firms tend to be smaller in countries where financial development is less sophisticated.

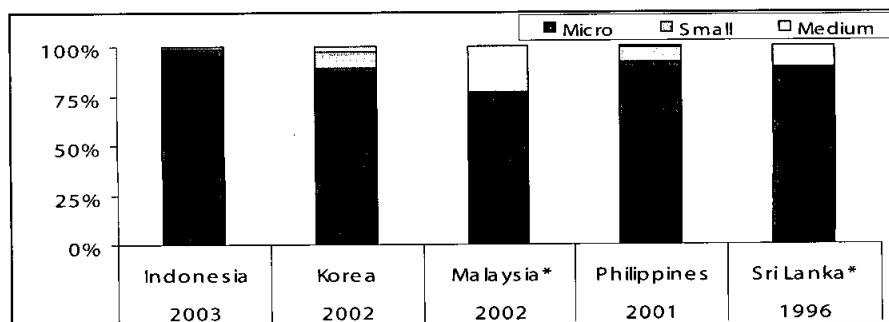
28. Beck T., Demircuc-Kunt A., and Maksimovic V., (2002); published as BDM (2005)

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According to Ayyagari et al. (2003), the SME sector is positively related to growth in the macro economy and market structure and adversely affected by inflation and market inefficiency represented by a black market premium. This cross-country study concludes that there is a positive relationship between the two variables of growth and SME sector size. However, while the two variables are inter-related, the direction of the causal relationship warrants further study. The authors believe that this interrelationship does not give conclusive evidence for encouraging subsidy based promotion programmes. What is clear is that the efficiency of the country's institutional settings and local agencies are supportive of business environment development and this influence the SME sector by reducing fixed cost of business, resulting in better realisation of local business opportunities (OECD (2002)).

In short, a good business environment in a growing stable economy with developed financial structure leads to a flourishing SME sector and in turn creates employment and domestic absorption. It may be that the direction of causation between economic growth and the size of SME sector is two ways but it is not easy to establish that SMEs cause growth as BDL (2003) argued, due to the heterogeneity nature of SMEs and their reaction to changing economic environment. Graph 1.9 shows SMEs' distribution by micro, small and medium scale enterprises in selected SEACEN countries.

Graph 1.9: Micro, Small and Medium Enterprises as Share of Total Number of SMEs in Selected SEACEN Countries



* Micro and small enterprises taken together

Source: Respective country papers

In Malaysia and Sri Lanka, micro and small enterprises are taken together and make up 77% and 89% of total number of SMEs respectively. In case of Indonesia and Philippines, medium enterprises are less than 1% (0.15% and 0.36%) of total SMEs. In Korea, micro, small and medium enterprises are 88%, 8% and 3% respectively of the total. It is difficult to conclude whether SMEs in SEACEN countries are generally smaller in comparison to the 1999 data published in OECD (2002) where the average is 92.8%, 5.8% and 1.4% for micro, small and medium enterprises respectively. Only in Indonesia is there a very high number of micro enterprises and in light of the argument presented, it may be worthwhile to analyse whether there is a cost imposed on micro and small firms in terms of institutional setting in Indonesia.

4. SME Financing in SEACEN Member Countries

As was stated in the OECD Outlook 2002, “the market place gaps that government financing programmes attempt to fill are as relevant today as when the first programmes were introduced”. It addresses issue of adequacy of previous policies, overly emphasised subsidised funding to SME, and being unable to nurture them to grow to be bankable. This is relevant to SMEs in SEACEN countries which are still small in nature even after half a century of developing this sector in a number of the countries. A large proportion of the small firms are still lacking the financial resources to grow, restructure and diversify and are factors that are shaping policy emphasis in the member countries. Most SEACEN authorities wish to see SMEs grow from small and disadvantaged entities into ones that are growing, bankable, self reliant, competitive and productive/innovative and as such policies are becoming more market completing than market creating or “distorting”. The earlier focus on cost of financing is becoming less relevant and priority is now on access to finance in a timely manner.

4.1 Source of SME Financing: Issues and Developments in SEACEN ²⁹

The literature review of the Bank of England (2001) emphasises information asymmetry in bank financing which causes financing gaps, debt and equity financing, venture capitalist, business angels network, and corporate venturing, public sector in relation to technology based SME, which is still relevant to SME

29. Review and statement of problems mainly from the BOE (2001) and OECD (2002).

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in general. Attention is usually devoted to the presumed financing gap which is created by various factors which discourages entrepreneurs from seeking external funding for expansion and starting new business and also makes financiers or banks reluctant to give credit to SMEs with growth prospects. The BOE (2001) mentions that the financing gap is a result of information asymmetry³⁰. The asymmetry results from non-disclosure of relevant information on the entrepreneur's side and as some studies have pointed out, may be due to the fear of losing control over business opportunity/initiatives³¹. This unwillingness of the entrepreneurs to disclose relevant information together with perceived constraints of the terms and conditions of the debt contracts discourage them from seeking external financing. At the same time, financiers uncertain how to discriminate SMEs according to their risk profiles because of this asymmetry, are therefore reluctant to finance due to its high cost of due diligence.

The gap is magnified as a result of institutional inefficiency as well. The situation worsens wherever there is loose enforcement of intellectual property rights, especially for technology intensive industries. The cost of financing issue has been discussed widely and it has been established that the relatively high cost of SME loans is due to information asymmetry on the one hand and lack of competition among financing institutions on the other. Information deficiency directly increases processing and monitoring costs of SME loans while the low competition gives the opportunity for banks to go after bigger clients with higher profit margins. However, recent innovations of micro financing deal with problems arising from enterprises being too small to be bankable. This is relevant for Indonesia where the majority of enterprises are micro³² in nature.

When debt and equity financing are compared, there is a certain traceable pattern. Some have argued that a bank centred financial structure place less emphasis on serving small firms than a system with a developed capital market³³ even though empirical studies such as the Bank of England (2001), APEC (2003) and others revealed that bank loans are important resources for SMEs. Funding from banks are dominant in the stages subsequent to the start-up. The BOE survey refers to the Cambridge University study, which shows that some 40% of SMEs can still get financing from banks for starting new businesses but this is in a situation where the financial system is functioning well and have few

30. Berger and Udell (1998).

31. Particularly see Hamilton and Fox (1998).

32. See more on micro lending in ADB (2000).

33. See the BOE (2001) for references

information problems. In Malaysia, about 47% of SMEs received external financing from banks while it is only 32% for Indonesia. However, recently Indonesian banks are increasing their focus on SMEs and have lent 51% of their loan portfolio to SMEs. Despite the successful development of SMEs in Taiwan, banking institutions are still reluctant to finance them, comprising only 20% of banks' portfolios, which is about 1/3 of SMEs' total operating revenue and falling with increasing share of direct financing. Over 73% of total external financing placed with Korean SMEs comes from banks and etc.

The analytical basis for the capital structure of small firms is from Myers (1984) or what is known as the "pecking order" theory. The theory postulates a firm's preference for the utilisation of financial resources as follows: a firm exhausts internal resources first and when needed, external financing beginning with debt financing followed by convertible bond or preferred equity and then the decision to issue equity. Due to asymmetric information, beginning with equity is not preferred since a firm will end up with a reduced intrinsic value. It represents SMEs well since they too use up internal resources quickly and there exist information asymmetry. Thus, potential equity investors tend to discount investments in SMEs more than a debt contractor in the presence of information asymmetry, an argument well taken as shown by data above.

The statement may not be the same when a corporate venture or venture capitalist enters as equity financier. This is due to the separation of knowledge about the expected product. An entrepreneur possesses specific knowledge on the production process and the financier will have the advantage for marketing it. In the subcontracting scheme mentioned earlier, the parent company internalises it wholly. See BOE (2001) on how entrepreneurs' relative benefit will be higher in the case of potential additional knowledge gained in corporate venture or venture capitalist, especially when they enter with convertible bond or preferred stock. Thus, a corporate venture's and venture capitalist's role in SME financing³⁴ will be greater at least at the seed stage and would be more relevant in technology based start-ups. When small firms enter into more knowledge based industries with higher value-added, entrepreneurs need to be protected from being exploited in the contracts with venture capitalists. Therefore, it is worthwhile studying further the structuring of financing such as quasi-equity financing, improving intellectual property enforcement and infrastructure for

34. OECD (2004)

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potential investors. In a few SEACEN economies, namely Korea, Thailand, Philippine and Malaysia, there was attention given to develop private venture capital. However, the high due diligence cost associated with small firms are still obstacles for venture capitalists to invest in SMEs.

The crucial element in developing equity investment is that it would lead to the development of a risk-reward-relationship. The risk associated with the entrepreneur's dependency on the financier is on control over business and financier investing in SMEs. Both require an exit mechanism and two likely exits are financier takeover and IPO. The latter is preferred because of a better risk reward for both. However, the listing fee and disclosure requirement would be expensive for a small firm. Korea and Thailand initiated a secondary stock market for SMEs to deal with these partially following the New Zealand initiative. On the other hand, the OECD (2002) mentioned that overprotecting SMEs from bankruptcy may actually lead to fewer opportunities to obtain external financing and thereby block risk from being rewarded.

Although banks are main financiers for existing SMEs in SEACEN countries, personal savings and loans from individuals are also important sources of financing while funding from the capital market and venture capital have only been developed recently. For example, Taiwan has successfully cleared SMEs' access to the capital market and Korea has begun to develop various forms of direct financing including IPO and company and/or personal bonds. The Taiwanese capital market for SMEs is increasing steadily, and Tze-Wei Fu et al. (2002) says that acquiring equity financing opens up options for profitable investment for SMEs. Their study reveals that there is positive relationship between profitability and equity financing and negative relationship between profitability and debt financing. The study indicates advantages of equity financing in small business and capital market's ability to distinguish SMEs with potential growth. The capital market could also possibly provide a convenient exit mechanism, contributing to the development of a risk-reward relationship as building ground for equity financing. Direct financing in Korea became active after the crisis. KOSDAQ regulations eased in the late 1990s in favour of SMEs. However, the Korean country chapter revealed that there are some inefficiencies in the regulations and funds channelled through the direct financing mode are insufficient for SMEs (Table 4.6, country chapter of Korea).

4.2 Financing Structure for SME in SEACEN Countries

SMEs are within the purview of policymakers and SME promotion policies tend to be coordinated at a high level, of which central banks form part of the coordinating bodies. In Malaysia, for instance, coordination is at the Prime Minister's level with Bank Negara Malaysia (BNM) being the secretariat. The Philippine's Development Council is at the ministerial level of which Bangko Sentral Pilipinas (BSP) is a member. This coordination effort is realised in SME development plans and strategies. The emphasis of promotion policies have shifted towards enhancing SMEs' competitiveness, encouraging them to be engaged in higher value-added industries with higher productivity, development and promotion of business development service, and which support SMEs' competitiveness strategy³⁵. However, as the environment they are operating in is changing, there may be more emphasis on innovative and knowledge based SMEs as in the developed economies. These are new challenges for commercial banks as core financiers of SMEs, to develop new products that can serve small borrowers who require flexibility in debt restructuring. Table 1.3 presents SME promotion policies in SEACEN countries under review, in terms of coordination, most recent/important policy documents or specially designed nationwide SME programmes/plans and policy emphasis.

Table 1.3: SEACEN Countries' SME Promotion Policy Coordination, National Programmes and its Focus

Country	Coordinating body	Policy document /Special Programme	Emphasis
Fiji	National Centre for Small and Micro Enterprise	Small and Micro Business Development Act ³⁶	Equitable income distribution, employment, sustainability
Indonesia	Ministry of Cooperative and SME	National Development Programme	Conducive business environment, access to resources, creative & competitive MSME

35. There are further detailed explanations for each country in the country chapters. Each country displays specific focus depending on their SMEs' level of development and institutional settings.

36. Strategic Development Plan for 2003 - 2005 also refers to SME development issues

Country	Coordinating body	Policy document /Special Programme	Emphasis
Korea	Presidential Commission on Small and Medium Enterprises; Small and Medium Business Administration	Comprehensive Plan for Enhancing the Competitiveness of SMEs 2004	Competitiveness, financial distress of SME, high-tech SME support & start-ups
Malaysia	National SME Development Council	2 nd Industrial Master Plan 1996 – 2005, other special programmes ³⁷	Shift to high value added sector, cluster based development, better policy coordination, wider coverage, database
Mongolia	Ministry of Trade and Industry		
Nepal	Department of Cottage and Small Industries		
Philippines	Department of Trade and Industry, SME Development Council	SME Development Plan 2004 – 2010, Magna Carta for Small Enterprise, Barangay Micro Enterprise Act	Competitiveness, productivity of SME, increase SME output, export oriented SME, creative start-up
Sri Lanka	Ministry of Industry and Investment Promotion	National Strategy for SME Development in Sri Lanka	Competitiveness, entrepreneurial culture, technology based SME
Taiwan	Ministry of Economic Affairs, SMEs Administration	Constitutional protection for SME	SME guidance & service, start-up support, technology & ICT, SME management, business environment
Thailand	Office of SME Promotion	National Plan for SME Promotion 2002 - 2006	Competitiveness, sustainability, environmentally safe, greater coverage & high quality product

Source: Country papers and other web based sources

37. Other 53 different targeted SME development programmes involving 44 different institutions, see country paper in Part II

Table 1.3 shows that most of the SEACEN countries coordinate SME promotion policies at the Ministerial level. In Malaysia, policies are coordinated at the Prime Minister's level while in Taiwan, it is at the level of Constitution of the Country. Philippines and Thailand are implementing special plans for SME development. In most countries, high level decisions focus frequently on SME competitiveness, their sustainability and engagement in higher value added industries. Government support of a sound business environment is the platform of most of support programmes.

As government financing initiatives and central banks' role in SME promotion are the prime focus of this study, Table 1.3 summarises the participating countries' profile in this regard. While many of the central banks do not supply funds directly to SMEs, they nevertheless ease access of funding for SMEs via intermediaries. The major financial intermediaries are shown in the Table 1.4. The central bank's main role is ensuring overall macro economic and financial stability and institutional strengthening of intermediaries. The Table shows that most central banks provide funding for SME development through special purpose intermediaries. However, the nature of these institutions is changing as well as the focus of their main activities. The Nepal Rastra Bank (NRB) and the BNM are involved with SME financing related institutions providing equity investment to them, while the Bank of Thailand share credit risk of SME loans with certain intermediaries. In general, commercial banks are increasingly participating in SME funding with central banks' encouragement.

Table 1.4: SEACEN Member Central Banks Involvement in SME Programmes

Country	Central Bank role	Financial institutions
Fiji		Fiji Development Bank and other commercial banks
Indonesia	Small loan support, funding for on-lending, capacity building & technical assistance to banks	Bank Rakyat Indonesia, Bank Tabungan Negara, Permodalan Nasional Madani
Korea	Funding for on-lending, small loan support	Industrial Bank of Korea, Credit Guarantee Fund, Small Business Corporation

Country	Central Bank role	Financial institutions
Malaysia	Secretariat to Council, holds special unit of SME for consultancy and problem solving, credit reference centre, special funds for SME Development	Small and Medium Enterprise Development Corporation, Perbadanan Usahawan Nasional Bhd., Malaysia Industrial Finance Bhd., Bank Pembangunan & Infrastruktur Malaysia Bhd., Malaysian Technology Development Corporation Bhd.
Mongolia	On-lends Government fund, credit information unit	XAS Bank, Trade & Development Bank, Mongol Post Bank
Nepal	Apex body for special projects, initiation of special projects, equity investment in intermediary, refinancing	Nepal Bank Limited, Ratriya Banijya Bank, Agriculture Development Bank
Philippines	Participation in the SMED Council, issuance of policies to address access of SMEs to credit sources, monitoring of compliance with the mandatory allocation of credit to SMEs.	Small Business Guarantee & Finance Corporation, Development Bank of the Philippines, Government Service Insurance System, Social Security System, Quedan Corporation, Land Bank of the Philippines
Sri Lanka	Apex agency for both donor funded and Government sponsored credit schemes	National Development Bank, DFCC Bank, Regional Development Bank, People's Bank and Bank of Ceylon
Taiwan	Funding for on-lending, problem solving centre	Tainan, Hualien, Taitung, Kaohsiung, & Taiwan Business Banks ³⁸ , Taiwan Cooperative Bank, Chang Hwa Commercial Bank
Thailand	Financial Master Plan: funding for on-lending, risk sharing, credit risk differentiation, credit bureau	SME Development Bank ³⁹ , Small Industry Credit Guarantee Corporation, Asset Capitalisation Bureau, MAI

Source: Country papers in Part II other web based sources

38. Specialised SME banks

39. SME Development Bank of Thailand was formed as re-establishment of Small Industry Finance Corporation according to SME Development Bank Act December, 2002

4.3 Bank Based Financing for SME and Central Banks' Initiatives

Going further on financing from banks, we adhere to the idea that better specialisation by banks will be of greater help to SMEs. However, it was found that central banks need more aggressive discretionary measures to boost loans to SME. SME financing problems comes not only due to existence of the gap, but from various different reasons caused by financial market and general level of SMEs' developments. On the borrowers' side, the lack of collateral, poor quality of borrowers' financial information, lack of track record of relatively newly established businesses, lack of knowledge about financial products and information on availability of assistance, are often cited as obstacles to accessing credit. On the other hand, banks also need to be innovative enough to serve small borrowers by introducing cost saving techniques in processing and monitoring. Some SEACEN members deal with these by developing specialised institutions to meet SME needs specifically. Others are compensating commercial banks in their specialisation on small lending by providing cheaper and conditional funds to banks. Central banks in Malaysia and Taiwan deal with financially distressed SMEs through special institutional structures.

The unavailability of banking service is another obstacle for SMEs in remote areas. Having a bank branch in a sparsely populated or low financial volume area can be expensive for commercial banks and is therefore, an additional argument for having specialised state owned institutions to fill the gap. In Mongolia, the geographical reach of banking services was set before the transitional period but maintaining a network of branches proved expensive for commercial banks and the Government had to recapitalise banks in case of insolvency. From the experiences of Bank Rakyat Indonesia, formerly a specialised Government institution, it can be seen that a banking structure is more suited for expanding the outreach of banking services. Bank Indonesia is currently pursuing policies to create more competition in rural banking and increase the range and affordability of banking services. The long term solution to providing better banking services for SMEs is to develop cheaper mass service techniques in general banking service to overcome information asymmetry problems, support banks in accumulating human capital to introduce greater flexibility in their products and ensure ICT intensive banking to deal with distance problems. To achieve this, the Government may have to establish pilot projects such as introducing specialised financial institutions that operate on market principles and/or compensate commercial banks for specialising on small loans by providing conditional refinancing from central banks. At the same time, central banks can share in the

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R&D costs in the development of new products and techniques or provide better database that supports bank risk analysis on SMEs.

Previously, large funds were dispersed through development banks at subsidised rates. These measures have since been halted and institutions are encouraged to be market based as much as possible. Thus funding for SMEs would be through fully licensed commercial banks or specialised financial institutions such as development banks. The Fijian and Indonesian examples show that on some occasions, specialised development banks may face a greater default risk and require a full license to provide broader services. However, development institutions are generally state owned and thus are easier for them to bear costs related to designing, delivering and consulting on products that meet SME needs that may be costly otherwise. For instance, while many of the housing banks around the world faced many obstacles, Thailand's has been successful because of limited political interference and its market based operations. The Thai Government transformed the former Small Industry Finance Corporation into a SME specialised financial institution extending loans, guarantees, equity investment and consultancy. Philippine's Small Business Guarantee and Finance Corporation provides whole sale loans to other intermediaries to be delivered to SMEs in addition to loans and guarantees. In Sri Lanka, the Government is looking to establishing a SME bank in the near future.

Central Banks' initiatives are summarised in Table 1.5 which shows that most central banks are channelling funds to SMEs, albeit with criteria or conditions for the end borrowers such as priority industry, ethnicity, gender, geographical location and etc. Funds are allocated through either banks committed to increasing access to SMEs or in the recent past have lent to SMEs or banks selected exclusively for the certain SME programmes. The minimum loan amounts that banks can extend to SMEs are imposed in several countries, but in Indonesia this requirement was prone to violation. Two central banks (the BI and the BOK) have removed this requirement. The BSP and the BOT have reduced the risk weight on SME loans in accordance with the Basel II Accord. A central credit information bureau is also a popular way of dealing with information asymmetry which works well in Malaysia. The Central Bank of Sri Lanka (CBSL) also initiated a credit guarantee scheme and is also involved with initial stages of SME development. A broad range of assistance is offered to banks such as providing training of bank personnel to revision of banking regulations. Licensing policies are also becoming more liberalised for banks and NBFIs. In terms of direct assistance for SMEs, BNM has been very successful through its SME

Special Unit which serve as an information source to SMEs, assisting them on loan applications, giving advisory service, evaluating the general financing needs of SMEs and building a SME financing database. More research work on SMEs is also being carried out by the various central banks in light of the competency of central banks in this area.

Table 1.5: Initiatives of Participating Central Banks

Initiatives	Measures taken by the Central Banks
Funding	Policy/soft loan through intermediaries, refinancing, on-lending of Government or IFI financed funds: (BI, BOK, BNM, BOM, NRB, CBSL, CBC, BOT) Fund rule to intermediary in form of credit ceiling, disclosure of banks' commitment: (BI, BOK) End borrower selection rule: ((BI, BOK, BNM, NRB)
Requirements imposed on operation of banking institutions	Loan portfolio share requirement/guidance: (BI, BOK, BNM, BSP) Reduced credit risk weight on SME loan, lower capital requirement for SME oriented banks: (BSP, BOT)
Support to reduce credit risk	Central Credit Information Bureau: (BI, BNM, BOM, BSP, BOT) Enhanced credit guarantee/insurance: (BI, BNM, CBSL, CBC)
Assistance to intermediary	Institutional strengthening by training bank officers, revising banks' regulations: (BI, BNM, BOM, NRB, BSP, CBSL) Opening market for banks and NBFIs, by liberalised branch licensing, allowing investment in another intermediary, licensing NBFIs: (BI, BOM, BSP)
Assistance to SME	Facilitating bank-SME dialogue, enforce greater transparency of banks' regulation, directing bank to build SME specialised structure: (BI, BNM, BSP) Direct support to SME with consultancy, providing information/guidance system: (BI, BNM, CBC) Problem solving centre for financially distressed SME: (BNM, CBC)
Research and information dissemination	Conducting SME research, survey; providing information dissemination system: (BI, BNM, BSP, CBSL, BOT) SME financing database: (BI, BNM)
Others	Equity investment in SME finance related entity: (BNM, NRB) Risk sharing arrangement with banks on SME loan: (BOT)

Source: Country papers in Part II

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Although countries still use soft loans or interest ceilings as part of their policy on financial assistance to the SME sector, the previous emphasis on cost of borrowing of small firm has diminished somewhat. The misallocation of financial resources through directed lending distorts intermediaries' incentive to take advantage of market opportunities is argument enough for less reliance on interest rate subsidies. While it may solve the problem of the high cost of borrowing partially, it does not resolve the issue of the accessibility to financial resources. This problem experienced with the first tier development bank centred policy was that it took away opportunities from banks and other intermediaries that might otherwise have served small entrepreneurs. It not only took away the market space issue, but in time there will be less specialisation in terms of developing techniques to serve smaller firms. Presently, when most countries complete financial liberalisation, intermediaries of the official financial sector, where mass-serving culture is not placed, are reluctant to be aggressive on needed small-scale loans with flexible conditions.

Most of the SEACEN countries' governments prefer to deliver funds to SME through commercial banks via conditional refinancing, where the central bank oversees its implementation. The total amount of loans dispersed as policy loans is usually not large taken as a share of the total external financing to the SME sector. Funding for these policy loans usually come from donor agencies, fiscal budget or even from central banks. Sometimes funds are channelled through selective banks. In Indonesia, the BI transferred implementation of policies to state owned institutions specialising in SMEs similar to Bank of Thailand. In contrast, in Korea, funds are allocated according to banks' ability to lend to SMEs. Philippine policy loans are delivered through the SBFIC as direct loans or through other intermediaries on contractual basis. The common features of these policy loans are that they have to comply with pre-specified criteria such as interest rate and priority industry rules.

Due to emerging challenges for SMEs their financial needs are changing. As noted before, SME policies in SEACEN countries are focusing on enhancing their competitiveness in the global market and encouraging them to produce goods with higher value added. SMEs often need financing for growth and restructuring and thus, to promote their development, there is need for a better information channel which would be imperative for quick decision making and overcoming asymmetric information difficulties. Collateral substitutes are also important to reduce the fixed cost of financing. In this regard, a credit guarantee system with Government involvement in the initial stages would be a good solution. In

case of Thailand, the researcher also refers to the relationship-based-lending practices and credit scoring, which can be another form of reducing heavy reliance of collateral. Alternative channels to banking financing are also important innovations. Specialised non-bank financial institutions (NBFI) are examples of private sector based initiatives that fill the financing gap of SMEs. Enabling access to the capital market is regarded as a way of getting fair credit risk weighting for SMEs. In Korea, for instance, top ranked SMEs are listed in KOSDAQ secondary capital market, Taiwanese SMEs are getting more funding from the capital market and Thailand initiated the Market for Alternative Investment as capital market for small businesses.

The credit guarantee system is a very important policy tool to improve SMEs' access to external finance. If the credit information bureau mitigates information asymmetry, the guarantee system reduces collateral cost. Both results in swift loan deliveries provided the system works efficiently. Malaysia's online credit reference contributed to SME financing considerably. This was also observed after enhancement of the credit guarantee system in Taiwan. Both involved third party information usage in loan application processing and hence credibility and easy verification are important, which can be given by the central bank.

Although banks are main financiers along with other finance companies (NBFIs and microfinance institutions specialised in SMEs), there are various challenges faced such as increasing competition and affordability of financial services, direct financing through venture capitalists, corporate ventures and business angels. However, these latter forms of financing do not publicly reveal information and as such have had limited success. Conversely, the supporting argument for these forms of financing is that they are suitable for SMEs, especially high-tech starters. OECD (2004) shows why banks might be particularly inconvenient for high-tech start-ups⁴⁰. According to this model, innovative SMEs will need risky start-up financing and probably explains the reason why central banker are interested in venture capitalists. The BSP only allows banks to invest in venture capital firms organised to assist small and medium scale enterprises and the investment qualifies in-lieu of SME loans for compulsory requirement for loans to SME as share of loan portfolio.

In summary, the SEACEN member banks have been very active in supporting the SME sector. Hence, policy coordination is gaining in importance

40. Look OECD (2004) for the model of small innovative firm's life cycle.

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and financing is only one element of a comprehensive SME promotion policy. In addition, in order for a policy to achieve good results, it should be coherent with SME development strategies. International institutions such as the OECD encourage innovations of SMEs and will contribute greatly to desired outcomes. Strategies listed by SMEs themselves to promote competitiveness and remain relevant in the market as presented in OECD (2000)⁴¹ includes: i) innovation, ii) information technology, iii) niche, iv) networking, v) clustering and vi) foreign direct investment strategies. As a policy reference, the cluster based support system is only seen in Malaysia.

V. Conclusion and Recommendation to Member Central Banks

5.1 Central Banks' Policy

SME financing remains an important policy agenda and crucially requires central banks' involvement and support. With multiple roles as monetary policy maker, regulator and supervisor of banks, as well as architect of financial infrastructure, central banks' actions may have implications on SMEs either directly or indirectly. In this respect, it would be worthwhile to highlight some important issues.

With respect to the existing or presumed financing gap, there is a general concern that the channelling of financial resources to SMEs are not optimal as banks, the core financiers tend to have higher charges for SMEs. Hence, changes in monetary policy to increase interest rate may hurt SMEs much more than the more established conglomerates. Secondly, the SME sector has proven to be dynamic and innovative and consequently, efficient and sustainable funding to the sector will contribute to the long-term dynamism of the whole economy. However, based on findings, banks are reluctant to provide funds to SMEs in the early stages of business establishment unless the enterprises can provide collateral and/or other forms of guarantee against default risks. As shown in Taiwan, the credit guarantee system could help overcome this problem (see section 4.2.1.3. of Taiwan Country Chapter).

Thirdly, if SMEs are resilient to economic shocks as shown in Indonesia during the financial crisis in 1997, it will be of interest to banks and other financial

41. OECD (2000) <http://www.oecd.org/dataoecd/20/1/2010176.pdf>

intermediations to increase credit to them during recessions. However, due to existing or presumed lack of credit worthiness of SMEs, banks often turn down their applications for loans during a recession. Thus, assistance by making available information such as credit worthiness of the individual borrowers may help to channel more loans to the SMEs. A good example of such an initiative is BNM's attempt to fill this information gap by making available credit information online. Finally, central banks' initiatives in drawing up lending regulations and procedures that are better suited to small borrowers and needs, would contribute to cost effectiveness in processing and monitoring loans while being flexible enough to cover a wide range of heterogeneous borrowers.

There are significant differences among the individual SEACEN economies on policy objectives, institutional structures and SMEs' development levels, upon which promotional policies are conditional. Therefore, it will be difficult to come up with general comprehensive recommendations. Despite these differences, SMEs in all SEACEN economies face similar challenges and opportunities in their business environments, as a result of intensified global competition, pace of technological changes, and financial liberalisation and deregulation. The current trend of increasing openness of trade and business networks has brought more intense competition in the domestic sector that directly affect the SMEs. Cheap goods from labour surplus countries such as China PR have driven prices and profits down. For local SMEs to survive, a drastic restructuring of their businesses may be required. On the other hand, advancement in ICT could help reduce operating cost. Globalisation may also create new opportunities for local SMEs to venture into international markets. Competitive pressure may lead to innovation and discovery of new niche markets for local SMEs. To realise these new opportunities, however, it is crucial that SMEs receive sufficient funding to restructure their businesses or to start up new business to take advantage of new opportunities.

The current trend towards consolidation of the financial sector impacts SMEs as well. Some argue that financial consolidation may result in higher cost for small borrowers, but others contend that the cost saving achieved through consolidation may lead to a fall in interest rate. One positive development is e-banking that may help to reduce the borrowing cost to SMEs. According to empirical study in the US, distance between bank branch and borrower no longer influences borrowing cost. However, an OECD survey reveals that SMEs have not been actively utilising e-banking, out of concern for safety and soundness of e-transaction services. Another positive development is that the new capital

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accord (Basel II) will actually help banks to lend to SME⁴². The question of whether innovative SMEs are more constrained from financial assistance than SMEs in general is still an open question without conclusive empirical evidence. However, based on a British study, the size of the borrower does matter in getting external financing.

As for SME financing in the SEACEN economies, SMEs seem to prefer to have sustainable access to financing, rather than cheaper but harder to obtain financing, although better risk pricing could help bring down borrowing cost and make it more profitable for them. In general, SMEs lack collateral and business track records, which are normally required by banks. Country researchers noted that better information and support to understand financial products designed for them could enhance SME access to finance. Even when many SMEs do not have serious problems getting loans, some SMEs still have to deal with financial distress in trying to restructure their business. In addition, while banks are the important financing source, SMEs commented that banks' borrowing procedure is too complicated for small borrowers. Generally, SMEs tend to stay small while the existing financial infrastructure does not seem to lend support to their growth financing or innovative expansion.

Most of the SEACEN central banks continue to provide support for SME policy loans, but now it is done mainly through banks and specialised financial institutions. The provision of subsidised funds directly to borrowers as in the earlier stage of SME development did not produce expected outcomes. These funds are small in proportion to total financing needs for the sector and often have other conditions, such as ethnicity, gender, priority industry or geographic location of final borrower. In addition, there are interest rate rules involving the provision of fund to selected conduit institutions at cheap interest rates with the aim that loans will be on-lent to SMEs at cheaper than market rates. However, such schemes could be a simple subsidy for SMEs, and has proven to be not very efficient because of market distorting externalities.

In several SEACEN economies, lending to SMEs is guided by mandatory loan portfolio share requirement that banks have to extend a minimum amount of SME loan at a certain percentage of total loans. However, in some economies, it is recognised that such mandatory requirement is not binding and prone to

42. Address by Mr. Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee of Banking Supervision, to the European Parliament Workshop on the "Consequences of Basel II for SME" (Caruana (2003))

violation and consequently it has been relaxed to guidance and moral suasion. This is also in line with the general financial liberalisation trend and the policy to move away from directing credit allocation. Another example of adjustment to be more market base is the BOK case. Under Aggregate Credit Ceiling Loan system, the BOK allocates funds that bear relatively low interest rates to banks according to their loan performance toward SMEs.

With respect to the heavy reliance on collateral by banks, we believe that there is a need for completing market mechanism or collateral surrogate that central banks may be able to play a role either directly or indirectly. In this respect, the set up of credit reference system, with direct involvement of central banks, and/or credit guarantee that central bank may indirectly initiate through banks, may be helpful. However, they are partial solution to the problem as they could not substitute collateral and do not provide information on borrowers' capital commitment to the projects. Setting up a credit reference system alone may also not be enough as it may not be able to channel credit especially small loans swiftly, even though the early results of such a scheme in Malaysia are encouraging. Meanwhile, for credit guarantee scheme to be effective, additional assistance may be needed. For example, credit guarantee system in Taiwan not only provides guarantee, but also help SMEs to review financial and other aspects of the projects, which enhance the chances of success in obtaining loans. One innovation to increase supply of loans to SMEs as cited in the BOT's paper is the introduction of relationship-based-lending practices that have resulted in positive outcome in lending without too much reliance on collateral. This and other innovations such as credit scoring are leading innovations have great potentials in enhancing credit supply that allows flexible cost management.

Central banks as compiler of financial statistics is also in a unique position to help banks obtain necessary information on SMEs. At present, SME statistics are scarce and their financial exposures and credit worthiness are not available. Currently there have been efforts to close this information gap and we believe central banks could help in building such database. Besides statistics, central banks could also institute discretionary measures to increase loans to the SME sector, such as lowering capital requirement, lowering risk weighting for SME loans, and encouragement of equity investment in venture capital funds. Some central banks, notably BI and BOM have also taken other initiatives to help develop and strengthen banks, and organise meetings involving banks, SME and policy implementing agencies. Banking bazaars at the BI branches succeeded as a convenient meeting place of banks and rural small borrowers. The BOM

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also lends its expertise in exchange rate in one Government project on small volume loan in rural area. The project funding comes from ADB and Ministry of Finance relent it to the BOM in foreign currency then the BOM lend it to banks in domestic currency.

In short, central banks in the SEACEN region use a wide range of tools to support SMEs and the support policies and measures are generally moving more toward market completing nature than market substituting. It is also observed that due to strong commitments by governments, and based on the past lessons, SME policies are better coordinated and integrated across government agencies and central banks.

5.1 Recommendations

Although promotion of SME is not the prime goal of central banks in SEACEN countries, involvement of central banks will continue so as to secure sustainable financing channel to the sector. In our opinion, there are three main areas where central bank can be involved in promotion of SME. They are: i) market infrastructure development, ii) enhancing availability of credit information, and iii) swift, safe and secure banking for small borrowers.

Market infrastructure development could come from strengthening and developing the intermediary institutions, with particular emphasis on specialisation on small borrowers and business development services. Central banks should also encourage and initiate innovation in lending practices to substitute or at least complement the current practice of collateral-based lending. In this respect, innovations such as relationship-based-lending practices and credit scoring have great potentials. To increase supply of loans to SMEs, central banks could consider allowing non-bank financial intermediaries to participate in soft loan funding to SMEs, or setting up specialised financial companies to serve SMEs, or promoting more competition among banks for better outreach of their services to SMEs. SME equity financing subsidiary of banks can be considered as another approach in fostering risk-reward relationship between SMEs and financiers.

To address information deficiency problems, central banks could facilitate development of credit information bureau to make available credit information concerning SMEs. To ensure smooth functioning of the credit information bureau, privacy and efficiency issues should be addressed and the system could be set up in collaboration with the appropriate private sector. In addition, credit guarantee

scheme may be necessary to address banks' fear of credit default risks. However, if credit guarantee scheme is used as collateral surrogate, consideration should be taken not to overlook the lack of information on borrowers' capital commitment. It is recommendable that SEACEN member central banks could share their experience and expertise in setting up credit information bureau, credit scoring and credit guarantee system among them. With the excellent research and data collection capacity, central banks could help in collecting and publicising SME financial statistics to foster research in this sector. More importantly, they could conduct R&D of lending techniques that could save processing and monitoring cost of SME loans, perhaps, jointly with banks.

Ensuring swift, save and sound banking services is also worth noting here. It may be helpful to develop a standardised approach for setting SME friendly application procedure, encourage banks to leverage more on ICT in delivering pre-application assessment of credit worthiness, and distribute necessary information templates for credit assessments. As SMEs benefit more from cluster based financial product packages, banks may need to target the correct segments and encourage cluster developments. In this matter, co-operation with SME clusters or NGOs will be useful.

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CHAPTER 2

THE ROLE OF CENTRAL BANK IN PROMOTING SMALL AND MEDIUM ENTERPRISES - CASE OF FIJI

**by
Lanieta Rauqueue¹**

1. Introduction

Small and medium-enterprises (SMEs) play an important role in the development process of any country. Evidence from other countries show that SME development is at the centre of many government policies. Government intervention has seen various economies having an increased proliferation of loans and equity guarantee schemes, Government grants, soft loan schemes, and so forth, with focus on small enterprises, perceived to be the main victims of funding shortages.

Such schemes have been traditionally prevalent in the United States, Western Europe and Japan (with particular focus on small high-tech firms). However, similar schemes have developed on a large scale in Eastern Europe, South America, Asia and Africa, where small enterprises are seen to be a solution to the development and/or unemployment problems.

In Fiji's case, the Government established the National Centre for Small and Micro Enterprises (NCSMED) in 2002 to support and promote small and micro enterprises, in order to cater for economically marginalised groups. Additionally, the Government is also trying to develop medium enterprises at this stage. The Government recognises that SMEs, if properly developed, could provide economic opportunities for a good portion of Fiji's labour force. Additionally, if adequately developed and supported, the SME sector could grow into a major employer and generate revenue for Fiji's economy.

The Government's objective to develop a successful formula for funding those who could not access money elsewhere to develop their business has been on the Fiji government's agenda well before microfinance had gained global prominence as an economic and development tool to promote more equitable growth. In 1951, the Agricultural and Industrial Loans Board was formed to

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provide necessary credit to SMEs, which proved extremely popular. This developed into the Fiji Development Bank (FDB) in 1967, which continued the work of the previous Board.

The current Government recognises the importance of SMEs in that in its *Strategic Development Plan for 2003- 2005*, it identified that the SME sector had the greatest potential for providing livelihoods to a large portion of Fiji's population. The Government also considers SME development as a positive form of rural development contributing directly to stemming the rural-urban drift and facilitating the development of trading centres, adequate infrastructure for rural businesses/dwellers, amongst other things.

2. Fiji's Small and Micro Enterprise Sector

2.1 Definition and Size

As to definitions on what constitutes a small, medium and micro enterprise², there is yet to be a universally accepted definition for SMEs. Various countries have specific definitions tailored to their requirements. However, the general criteria are commonly based on indicators such as number of employees, annual turnover, value of assets or investment and profit generated. While such definitions may be considered very basic, proposing a definition as the above is a relatively transparent method to identify which enterprises might benefit from special SME policy incentives. However, it is important to note that many SMEs do not maintain good financial/operational records, making the use of these definitions difficult at times.

Fiji's definition for micro, small and medium enterprises is spelt out in the *Small and Micro Enterprise Development Act of 2002* as follows:

- *medium-enterprises* - any enterprise that has turnover or total assets between \$100,000 and \$500,000 per annum, employing between 21 and 50 people;
- *small enterprise* - any enterprise that has a turnover or total assets of between \$30,000 and \$100,000 per annum, and employing between 6 to 20 people; and
- *Micro enterprise* – any enterprise which has a turnover or total assets not exceeding \$30, 000 and employs not more than 5 persons.

2. In this paper, SMEs is taken to mean both small & micro enterprises and/or small & medium enterprises.

The SMEs existing in Fiji are fairly diverse and can be further classified according to the orientation of their operations. Micro enterprises, for instance, can be divided into either *social* or *economic* enterprises (Vuidreketi, 2003). *Social* enterprises/entrepreneurs can be further divided into “survivalist” or businesses established as a necessity for survival to meet basic needs or “part-timer”, businesses carried out on a “needs basis”.

Presently, the nature and structure of Fiji’s economy is relatively more market-driven, and the small and micro enterprise sector has also emerged stronger in recent times. As for the size of the sector in the country, few formal studies have been carried out to determine the actual magnitude of the SME sector in Fiji. There is a general difficulty in obtaining updated data on SMEs from existing statistical reports (1996 Census and annual employment surveys) since most reports do not disaggregate data for micro or small firms. This restrains the conduct of detailed analysis on the contribution of the SMEs to development, amongst other things.

The NCSMED commissioned a preliminary study³ on the country’s SME sector in August 2003 that attempted to provide relevant and useful data on SMEs in order to better grasp issues such as the contribution of the sector to national development; and constraints and challenges faced by SME entrepreneurs, amongst other things (Vuidreketi, 2003). In fact, this study was constrained by the absence of data on the informal sector businesses in Fiji. Nevertheless, the survey highlighted certain important characteristics of the SME sector in Fiji.

2.2 Sector’s Contribution to the Economy

While the sector’s contribution to the economy is multifaceted, these roles and contributions can be classified into:

- Employment creation;
- Income Generation; and
- Other Socio-economic benefits.

3. Referred to in the ensuing portions of the paper as the NCSMED study/survey, findings for which were presented at the 1st National SME Forum.

2.2.1 Employment Creation

There is no argument that the SME sector provides employment opportunities to a considerable number of people in Fiji. In the absence of current data and information, the NCSMED study explained that the contribution of the sector to total employment can best be understood by discussing it within the context of the economic characteristics of Fiji's population based on the 1996 Census (Vuidreketi, 2003).

Hence, it is assumed that out of the 297,770 people that constituted the labour force in 1996, 149,670 were involved in various forms of informal self-employment while 20,313 persons were employed by "small enterprises" in the formal sector⁴. Therefore, this would mean that about 57 percent (169,683) of Fiji's total labour force were involved in various forms of business that fell under the definition of micro and small enterprises. As such, SMEs generate more employment as opposed to the paid/formal employment sector.

Estimates were also derived for employment generation in terms of gender and location. In terms of SME employment by gender, males predominate total employment numbers in both the formal and informal categories at 67 percent – meaning that for every female SME worker, there are 2 male SME workers (Vuidreketi, 2003). As for location of SMEs across the country, there is a slightly higher concentration of SMEs in the rural areas (54 percent). All these being said, there is still a considerable scope for the SME sector to make a larger contribution to national development in terms of employment creation.

2.2.2 Income Generation

Data constraints aside, SMEs contribute significantly to Fiji's economy. If one considers the output generated by the subsistence/informal sector of the local economy, this would at least give some indication on the level of income generated by SMEs. In compiling GDP, the Fiji Islands Bureau of Statistics includes the output generated by the informal/subsistence sector of the economy under the individual industries/sectors of the Fiji economy.

These include contributions made by the informal/subsistence industry of the Agriculture, Forestry & Fishing; Manufacturing; Wholesale & Retail Trade;

4. According to calculations published in the NCSMED study.

Transport; and Community Social & Personal Services sectors. On average, from 1996 to 2002⁵, the total contribution of the informal sector to Fiji's GDP was around 10.3 percent. In real terms, out of an average total GDP of \$2,602.8 million from 1996 to 2002, an average of \$267.4 million was accounted for by activities in the informal sector.

In terms of size, the informal/subsistence industry of the Agriculture, Forestry & Fishing sector accounted for the largest contribution to GDP, at an average of \$161.5 million from 1996 to 2002. The second largest informal sector contributor was the Community, Social & Personal Services Sector at \$40.8 million.

At the household level, it is estimated that there were approximately 92,689 households who in one way or another derived their income from SMEs, either formally or informally in 1996. This figure, according to the NCSMED study, was derived by dividing the total number of SME workers (169,983) by the average household number of 5.2 members (Vuidreketi, 2003).

2.2.3 Other Socio-economic Benefits

SMEs are also viewed as a link between larger/formal enterprises and traders. As such, these enterprises undertake 'small-run' production through sub-contracting. In fact, certain SMEs prosper because they fill niche markets that larger enterprises would find uneconomical to operate. The SME sector also provides an opportunity for small businesses/entrepreneurs to develop their management, financial and marketing skills.

Additionally, SMEs form a platform for women empowerment in that females are taking more proactive economic roles via participation in the SME sector. SMEs have been able to provide an alternative source of employment in a time when formal sector jobs have been scarce. The NCSMED survey revealed that 62 percent of the randomly surveyed small and micro entrepreneurs were women. The majority of these women were heads of their enterprises and actively involved in decision-making and management roles of their businesses (Vuidreketi, 2003).

SMEs help alleviate the negative consequences of job losses from the formal sector and other negative consequences of structural adjustment/reform policies.

5. Macroeconomic Committee Forecasts: October 2004

Since SMEs, in Fiji's case, are more concentrated in rural areas, they bolster the decentralisation efforts of Government and contribute significantly to rural development.

In addition, SMEs play a special role for financially disadvantaged households in meeting the demand for affordable and simple goods and services. SMEs are usually also owned within the communities in which they operate and this factor can assist considerably with sustainability and participative decision-making.

2.3 Special Promotional Programme

Since its establishment in 2002, the NCSMED has been working with support institutions in the private and public sectors to help SME owners and operators to develop their business skills and adopt new ideas and technologies of working smarter.

The Centre has also introduced an innovative business training programme, based on experiential learning to complement existing training packages, such as the '*Start your Business*' (SYB) course of the Ministry of Commerce, Business Development & Investment and the International Labour Organisation.

A first for Fiji this year was the hosting of the *National Small Business Awards* by the Fiji Development Bank (FDB). The Bank, in conjunction with the Committee for Enterprise Development (CED), is recognising innovative and sustainable projects in the SME sector. By having this award, the FDB hopes to promote more small business entrepreneurship to start, sustain itself and grow bigger. It seeks to recognize outstanding achievement in a range of practices relating to small business. Categories included food processing, beekeeping, agriculture, manufacturing, handicraft, tourism, floriculture, fabric arts, service and special award – for a unique attribute in the entrepreneur or business.

There is a growing popularity and presence of SMEs in the country, and the theme '*Inspiring Creativity and Innovation*' acknowledged the administrators' commitment to encouraging value adding, skills based and sustainable projects. The Awards is a result of the vision of the CED, comprising of service providers for SMEs, to promote SME development actively in Fiji.

The Award also acknowledged local journalists whose work increased awareness of small business development in Fiji. The 'Small Business Journalism Award' targets the radio, television, print media reporters and editors whose work increased public understanding of the importance of small business contributions to the economy. Entrants were judged on the content and depth of their articles published or broadcast on small business development in the country.

2.4 National Objectives & Strategy with Respect to SMEs

SMEs have become a key part of the Fiji Government's development strategy. The focus of Government support for the micro-enterprise sector emerged from the Government's commitment towards the alleviation and reduction of poverty⁶. In 1999, the Government established the National Micro-finance Unit (NMFU) to develop micro-finance services in Fiji with the objective of poverty alleviation through the provision of microfinance to promote employment and income generation. The NMFU aimed to achieve these objectives through establishing micro-finance institutions through NGOs, providing banking facilities for the poverty stricken, promoting micro-enterprise development and introducing necessary skills and business training for micro-entrepreneurs.

From this agenda also emerged a focus on micro enterprise development particularly with the cabinet approval of the Policy Framework for Small and Micro-Enterprises in 1999. The most significant outcome of the Framework was the endorsement to establish the NCSMED as the co-ordinating agency for SME initiatives and the activities of various SME providers.

2.5 National Strategies with Respect to SMEs

The *10-year Strategic Plan of the National Centre for Small and Micro-Enterprises Development* was launched in an effort to strengthen the role of SMEs in the economy. According to Nacanaitaba (2003), the Plan specifies the strategies and six main policy objectives options that the Government, through the NCSMED, would like to actively pursue.

6. According to the 1996 Fiji Poverty Report, 25 percent of the population live below the poverty line.

i. Mainstream SMEs in national development

The SME sector must be promoted as a credible and economical source for employment or self-employment, since the formal sector does not have the capacity to absorb all job seekers. SMEs, therefore, need to be accorded greater recognition and an SME culture needs to be developed in Fiji.

ii. Improve policies and regulations for SMEs

Government, municipal laws and regulations originally intended for large and formal businesses are commonly taken to also cover the operations of SMEs that are special in their own rights, by virtue of their small sizes and niche-market targets.

iii. Improve the co-ordination of SMEs training/development activities

Training is considered necessary in order to foster greater awareness of SME operations. The NCSMED also aims to extensively promote training for rural SMEs.

iv. Improve business support services/infrastructure

The Centre, with representatives of the Fiji Development Bank, Government and other NGOs engaged in SME development work are encouraged to share information regularly and to tailor-make their services to cater for SMEs.

v. Develop marketing for SMEs

The NCSMED will work with private and public sector stakeholders to assist SMES with securing markets for their products/services.

vi. Develop SME sector data and statistics

This is considered an important requirement since up-to-date statistics will provide policy makers/analysts with relevant information on the appropriate policies and strategies needed to develop the SME sector.

Other national strategies with regards to the SME sector have been expressed through forums, meetings etc. An inaugural 'National Forum for Small and Micro-enterprises Service Providers' was held in 2003 with the objectives of providing an opportunity for sharing information, ideas and views among SME support institutions, end-users, and other stakeholders. Additionally, there was a general need to create national awareness of the potential of SMEs to provide income and employment, as well as their need for a supportive policy and regulatory

environment. All these activities were geared to assist and enable more SMEs to emerge and thrive.

Post-forum developments saw Cabinet endorsing various recommendations aimed at strengthening the SME sector in the country. Also approved by Cabinet was the establishment of a *SME Advisory Enterprise*, under the NCSMED, to oversee the development of medium enterprises in Fiji. In addition, Cabinet announced that the Commerce and Finance Ministries would conduct a study to evaluate the feasibility of establishing a domestic credit guarantee in order to ensure access of affordable formal credit for SMEs. The scheme would address the current impediments of high cost finance and non-availability of alternative financial instruments to many entrepreneurs.

All the above-mentioned initiatives demonstrate the present Government's commitment towards increasing the prevalence of SMEs in the country. As far as policies are concerned, the following strategies reflect the broad aims of Government in relation to the development of the SME sector.

3. Assessment of Past Efforts

3.1 Major Factors Accounting for the Success or Failure to Develop this Sector

The SME sector in Fiji is generally not perceived as a priority area. This stems largely from a strong preference for people to look for secure career opportunities within organisations/Government rather than to self-employment or the SME sector. Additionally, the small enterprise "culture" is not well developed in the nation (Vuidreketi, 2003). Looking first at the constraints that exist in developing this sector, these can broadly be categorised into:

- Financial Constraints;
- Infrastructural Constraints;
- Marketing Constraints; and
- Legal Constraints.

3.1.1 Financial Constraints

The lack of accessible and affordable financial services for SMEs is considered to be a major constraint in Fiji. This is mainly due to the perception that the sector is not a "profitable market" for credit. SME entrepreneurs often

lack collateral, have low-credit worthiness in terms of business experience, low capitalisation which limits their borrowing capacity, and a majority of these entrepreneurs have an unproven management capability (lack business records and credit histories). As such, small firms are considered financial risks for commercial banks particularly and the return on small loans is considered minimal.

According to the NCSMED, all three tiers of the SME sector face the problem of accessing finance from the formal financial sector. The limited availability of financial services to micro-entrepreneurs is due to the lack of infrastructure and physical access to formal institutions, and perceptions of both the clients and the institutions. SME entrepreneurs are normally intimidated by formal institutions and commercial banks are usually reluctant to lend to the SME sector due to the high transaction costs involved in processing, administering and supervising these small accounts.

3.1.2 Infrastructural Constraints

In certain areas, there is no infrastructure like shelter for outdoor vendors or accommodation for overnight sellers at major towns/cities. Local SMEs have highlighted that having such facilities will greatly assist the profitability of SME operations. An added bonus would be to have these centres located in industrial subdivisions, as this would allow SMES to have access to larger businesses for the purpose of markets.

Rural SMEs also find it difficult to market their produce due to inadequate transport infrastructure (road, air services, shipping) in most rural areas. Additionally, the cost of basic utilities, import duties and taxes is often relatively high for most SMEs, both rural and urban, to meet. These high costs usually result in uncompetitive costing.

3.1.3 Marketing Constraints

SMEs often have limited marketing opportunities. This can either stem from location outside the city/town areas or a lack of innovative ideas that sees almost all SMEs in a particular area targeting the same market with the same products (copy cat syndrome). This problem is further aggravated by the lack of business knowledge that SME operators may have in facing competition provided by larger companies.

3.1.4 Legal Constraints

The regulatory requirements for the SME sector are relatively complex and not very 'user friendly', in particular for registration and business 'start-ups'. Certain restrictive local council legislations seem to impede SME operations, while also being too complex for SME compliance.

3.1.5 Other Constraints

Another significant constraint for SMEs is the lack of appropriate training and technical assistance offered to the sector. SME operators are commonly ill informed of various market operations and lack knowledge on how to price their products to achieve optimum margins. Since some SMEs do well enough to develop into larger businesses, a lack of training usually equates to a lack of the necessary management and financial skills for diversification and expansion of businesses. Sometimes SME entrepreneurs are unaware of the various service providers existent in the country.

For some local SMEs, their principal raw materials are imported, which means that these materials are relatively more expensive and sometimes not available on time. Additionally, the lack of updated data usually curtails the opportunity for SMEs to conduct proper market research.

In Fiji's case, with the establishment of the NCSMED as the focal point of SME initiatives, institutional constraints faced in other countries may be avoided. These include having a framework for the organised planning, implementation and co-ordination of activities within the sector. Furthermore, duplication and replication of programmes could be avoided.

3.1.6 Factors Contributing to Success of SMEs

However, this does not in any way suggest that all SME initiatives have been hampered by the above-mentioned factors, because certain SMEs have thrived in the very same conditions. Usually certain SMEs have managed to operate optimally by accessing finance from formal financial institutions and have been 'business-minded' about their operations. These SME entrepreneurs had acquired adequate management and technical expertise and therefore have been able to keep proper business records and manage their operations to meet demand effectively. Certain SMEs have even acquired additional assets through re-investment of profits.

Access to markets has also been a major factor for success. This means that successful SMEs have been able to attract and maintain a highly secured client base. Such SMEs have been able to withstand the competition provided by other larger companies. Additionally, other viable SMEs have been able to expand and venture outside their original operations to secure other than one source of income.

4. Central Bank Support

4.1 Formal Financial Sector: Is It Serving the SME Sector Effectively?

It would be appropriate to look at financial institutions that are presently serving the SME sector, in order to determine whether the financial sector is serving Fiji's SMEs effectively. On the other hand, it would also reveal whether the SME sector is responding well to the available initiatives provided by banks/formal financial institutions.

Firstly, the New Zealand Loans Scheme (NZLS) administered by the FDB is funded by the NZODA and has been characterised with a low repayment rate and a high rate of defaultment since its inception in 1989. This has contributed to the slow revolving of funds, resulting in the poor performance of the scheme. A study by the ESHDP (1996) revealed that major problems faced by clients included poor business and management skills, lack of business planning and misuse of funds for personal commitments, all of which have affected the sustainability of the scheme. The FDB also extends loans to SMEs through its other lending schemes.

The second scheme in operation is that of the Department of Co-operatives (DOC) which operates through the various DOC schemes and has had a relatively greater reach of the rural population of Fiji. The results of a ESHDP study (1996) of credit schemes benefiting disadvantaged groups in Fiji, indicated that the performance of co-operative schemes have been relatively more successful given the reasonable credit terms and conditions offered and the commitment of DOC staff to the effective operation of the schemes.

Thirdly, credit unions, established in 1965 through the Fiji Credit Union League, are prevalent in both the rural and urban areas. However, they have a bias towards providing more provident loans (for family/social commitments and emergencies) over productive loans (for income-generating activities). According to the ESHDP study (1996), the country's credit unions need to improve the

sustainability of their operations by charging interest rates that allow for full cost recovery.

Next is the Women's Social & Economic Development (WOSED) programme that was established in 1993. The scheme is still being partially supported by government and the programme's current repayment rate is around 98 percent. Fifthly, the NMFU is relatively new in comparison with other MFIs. According to Belloni (2001), repayments on NMFU's first loan cycle have been unsatisfactory, while the second loan cycle repayments have been varied. Since the scheme is still in its pilot phase, it may take longer to determine the real impact of the services NMFU provides to its different target groups.

Other financing sources include the Pacific Enterprise Development Facility (PEDF), which is a multi-donor funded agency (Australia, New Zealand, and Japan). Work on projects costing range between US\$5,000 to US\$5.0 million. The PEDF established effective pilot SME service providers network and arranged funding for 16 projects.

In addition, the 5 commercial banks existent in the country – Australia and New Zealand Banking Group (ANZ), Bank of Baroda (BOB), Colonial National Bank (CNB), Habib Bank Ltd (HBL) and Westpac Banking Corporation (WBC) – plus other Non-Bank Financial Institutions extend finance to the SME sector. In order to collect data on lending by financial institutions to these enterprises, the RBF conducted a survey in 2003. A survey form⁷ was sent to the five commercial banks, Fiji Development Bank, Credit Corporation and Merchant Finance with a timeline of one month for submission. The survey emphasised collection of data from these financial institutions to small and medium enterprises.

The major downside to this survey was the failure to obtain a good response rate. Only three commercial banks submitted information in accordance with the National Centre for Small and Micro Enterprises Development's (NCSMED's) definition for small and medium enterprises. However, these institutions represented only around 28 percent of the total commercial banks loans and advances as at 2002.

Other institutions, which collectively constitute a bulk of the market share in terms of commercial lending, were unable to submit loans and advances data

7. The survey form was designed in a similar format to the normal banking return but seeks to capture lending to Small and Medium Enterprises by sector.

for SMEs. These institutions do not store turnover and asset size of their clients in their databases. This information is essential in order to classify lending to the SMEs. Given the huge exposure of these institutions in terms of loans and advances, it was fairly difficult to collate data according to the NCSMED's definition. Some of these organisations were willing to provide data based on the level of credit to businesses. However, this classification does not fulfill NCSMED's definition for small and medium enterprises. The following is a summary of the aggregate data obtained from financial institutions that responded.

Table 2.1
Value of Loans (\$M)

	2002		2001	
	Small	Medium	Small	Medium
Total	5.273	34.631	4.731	28.597

Table 2.2
Number of Loans

	2002		2001	
	Small	Medium	Small	Medium
Total	249	310	211	250

From the above information, it is obvious that there are a number of existing institutions that serve the SME sector. Whilst accessibility to financial institutions may not be as large a problem for SMEs located in the urban areas, it is considered specific for those in the rural part of the country. The *Report of the 1st National SME Forum* highlighted that small enterprises face the problem of "restrictive loan requirements and long/delayed processing time" with regards to accessing finance from formal financial institutions. Similar constraints may be faced by medium enterprises.

Given the above information, we find that accessibility of SMEs to financial institutions is also a challenge in Fiji. Financial institutions need to be flexible in lending to SMEs, using criterions which consider the specific characteristics and

mode of operations of SMEs. A more flexible approach that is tailor made to SME needs would ensure sustainability of SMEs. There is a vital need for bank's to relax their loan requirements and improve the processing times of loan applications, given that SMEs have distinct characteristics and needs. Therefore, available support services must be responsive to these needs of the different SME segments. It is also important to consider the feedback received from various financial institutions with regards to financing the SME sector.

4.2 SME Financing Problems – The Banker's Perspective

The Fiji Development Bank is a substantial provider of finance to SMEs in the country and therefore it would be beneficial to highlight its perspective on lending to SMEs. According to Taoba (2003), there are various reasons why a loan application from SMEs, or for any of kind of enterprise for that matter, would be declined by the FDB at the loan enquiry stages. These reasons include:

- Previous 'bad debts' record with FDB;
- Inability to contribute equity (10% of project cost);
- Failed the Bank's aptitude test/Inability to complete Business Plan
- Inaccessible or remote location of project site; and
- High costs involved.

After the application stage, loans officers at the FDB then appraise successful applications in order to see whether these loans should be approved. As such, reasons for decline at this stage include:

- Non-viability of projects;
- Lack of collateral;
- Saturated markets for their products/lack of market; and
- Perceived lack of business/management skills.

The FDB also explained that common problems faced by SME enterprises they lent to were the high cases of mismanagement of funds, absentee management, lack of implementation of business management practices and entrepreneurs being financially overcommitted.

On a positive note, successful SME entrepreneurs, from the FDB's experience included those enterprises/entrepreneurs that maintained proper business records, had adequate management and technical expertise and were highly 'business

oriented' clients. Daily banking of cash takings was also seen as contributing positively to the success of SMEs. In addition, SMEs that had a manageable operation size that faced demand effectively often prospered. Minimum or non-existence of competition also helped SME survival plus having a secured client base (Taoba, 2003).

On a national level, the FDB highlighted that SMEs would thrive if they had an established link to ready markets, eg., the local broiler industry that supplies poultry to Crest Chicken Ltd. Additionally, Government commitment was seen as vital to support SME growth.

4.3 Reserve Bank of Fiji (RBF)'s Role in Developing Financial Market Channels to Increase Lending to the SME Sector

As is common across the world, the main hurdle that micro-entrepreneurs in Fiji face is accessibility to finance. Perhaps, this is an area where the RBF could be influential. At present, majority of Fiji's Micro Finance Institutions (MFIs) operate outside the formal financial and supervisory regulatory framework of the RBF. Co-operatives, credit unions and NGOs engaging in microfinance activities operate within their respective Acts. There is no doubt that as MFIs in Fiji extend their services and venture into banking activities as defined in the Banking Act of Fiji, they would automatically come under the regulatory and supervisory ambit of the RBF.

The RBF could play an influential role in developing SMEs in Fiji. The RBF's Vision is "*Leading Fiji to Economic Success*", which assumes a wider responsibility than just core monetary policy setting. Information papers on the involvement of RBF written internally suggest that the RBF play a "*promotional role*", which includes:

- Ensuring a stable financial and macroeconomic environment;
- Spearheading further research into the operations and viability of existing micro finance institutions (MFIs) and provide these to main players in the micro finance sector;
- Providing macroeconomic data and analysis of the economy to micro finance service providers;
- Researching and providing information on Fiji's semi-formal and informal financial sectors; and
- Facilitating training and institutional strengthening for those organizations that currently provide micro finance (on areas of expertise).

The specific contributions of the RBF to SME development are still at a discussion stage. Nevertheless, the RBF has been working on a rural banking initiative together with Government, commercial banks and other stakeholders. These stakeholders together form a Rural Banking Working Group with the RBF playing the Secretariat role. The working group has been studying the provision of banking services in the rural areas addressing the issue in two phases. The first phase of the rural banking initiative is to develop banking services in areas identified in the Workshop on Rural Banking and in towns and urban areas that do not presently have, or have only limited banking services. The second phase of the rural banking initiative will explore other areas outside of town and city boundaries, which do not have banking services, or have limited banking services.

To this end, the Reserve Bank has held individual meetings with commercial banks, the Ministry of Finance, the Fiji Development Bank, Telecom Fiji Ltd, Post Fiji Ltd, the Fiji Electricity Authority and other stakeholders to discuss the provision of banking services to the rural areas. In July 2004, the Reserve Bank submitted a Cabinet Paper to the Minister of Finance in support of the ANZ Rural Banking Project and the incentives requested from ANZ. The Reserve Bank requested that these same incentives be made available to all other commercial banks that may provide rural banking services.

The Cabinet approved the following incentives, to be provided to all commercial banks that would be delivering banking services to the rural areas:

- (a) the provision of tax deductions of 150% for each dollar of direct expenditure to commercial banks in their individual rural banking programmes;
- (b) the provision of duty exemptions to commercial banks for motor vehicles acquired to provide transport to its staff engaged in the programme or other similar incentives; and
- (c) Government's support of the rural banking initiatives of the commercial banks.

In addition to those incentives listed above, Cabinet approved the Government's support of the UNDP financial literacy awareness programme and to permit the involvement of District Officers in the ANZ Rural Banking Project. As at October 2004, the first mobile banking service via a vehicle was launched by the ANZ to service rural areas in the country.

The RBF's involvement in this rural banking initiative is one of the many roles it could play with regards to promoting the development of SMEs in the country.

5. Conclusion

The Government of Fiji has recently expressed its commitment to assisting and developing SMEs through various initiatives being channelled through the NCSMED. One of the reasons behind such a determined commitment by Government is the recognition, based on country experiences that SMEs help address two of the main objectives of any government – economic growth and poverty alleviation. SMEs in Fiji can also contribute to the realisation of these two objectives, provided a conducive environment is developed for the development and growth of SMEs. One of the main factors needed to underpin such an environment, is access by SMEs to finance. This is considered an area where the RBF could play an influential role. There are other areas of interest for RBF participation, such as training, institutional strengthening and raising public awareness.

A number of the initiatives currently being considered by the RBF would ensure that it plays a more active role in assisting SME growth in Fiji. The development of SMEs would require close collaboration and co-operation amongst relevant government institutions, NGOs and SME service providers. The establishment of a Working Group comprising the main micro-finance service providers, RBF, NGOs and Government Ministries would facilitate co-ordination, co-operation, monitoring of performance and fine-tuning of processes that would propel the development and contribution of SMEs in Fiji's economic growth forward.

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CHAPTER 3

THE ROLE OF CENTRAL BANK IN PROMOTING MICRO, SMALL AND MEDIUM ENTERPRISES (MSMEs): CASE OF INDONESIA

by

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Yunita Resmi Sari**

1. Introduction

During mid 1990s, Indonesia had enjoyed a remarkable economic growth of 7%-8% until the currency crisis undermined the economy leading to the low economic growth. For the last three years, however, Indonesia's economy has been developed favourably, as reflected by a stable economy growth of 4%-5%, controlled low rate of inflation and stable exchange rate of rupiah. The recovery and sustainability of the country's economy were, among others, contributory to the ongoing activities of micro, small and medium enterprises (MSMEs). MSMEs have historically played significant roles in Indonesia's economy so as to be the main players in economic activities, providing wide employment opportunities and served as the backbone for the development of local economies and communities.

This paper will provide an overview of the state of MSMEs in Indonesia, as well as its contribution to the economy and will particularly emphasise the role of Bank Indonesia in supporting the development of MSMEs. Section 1 begins with the definition of MSMEs in Indonesia, and its contribution to the economy. Section 2 discusses government policy in MSMEs development. Section 3 reviews Bank Indonesia's experiences and roles in supporting MSMEs development. Section 4 emphasises the contribution of Micro Finance Institutions (MFIs) to MSMEs development and Section 5 concludes the paper.

1.1 Some Definitions

MSMEs consist of micro, small and medium enterprises. For micro enterprises there are some definitions that are widely used, either by official institutions or international agencies that deal with micro enterprises development. The definition often used by the Government are enterprises which encompass productive

1. Prepared by Yunita R. Sari and Ridwan I. Situmorang, Analysts of Bank Indonesia, as part of SEACEN Research Project on Role of Central Bank in Promoting SMEs.

business, owned by Indonesian individual or family with maximum net assets of IDR50 million (USD5,000) excluding land and buildings, or maximum annual turn over of IDR250 million (USD25,000). Other institutions such as the Committee on Poverty Alleviation defines micro entrepreneurs as owner or person doing micro scale activity across economic sectors that possesses net worth, excluding land and building, to a maximum of IDR25 million (USD2500). From the perspective of labour force, some international agencies (Asian Development Banks, USAID, World Bank and International Labour Organization) define micro enterprises as a business that employed not more than 10 persons.

The definition of small enterprise has legal basis as stated in the Law on Small Enterprises, which is characterised as self reliant (not owned nor affiliated, directly and indirectly, to medium and large-sized enterprise), set up by individuals or entities (including cooperatives), owned by Indonesian citizen, has a maximum annual sales of IDR1 billion (USD100 thousand) or maximum net assets of IDR200 million (USD20 thousand), excluding land and building. Medium enterprises are being defined as productive enterprises with net worth more than IDR 200 million up to IDR 10 billion, excluding land and building.

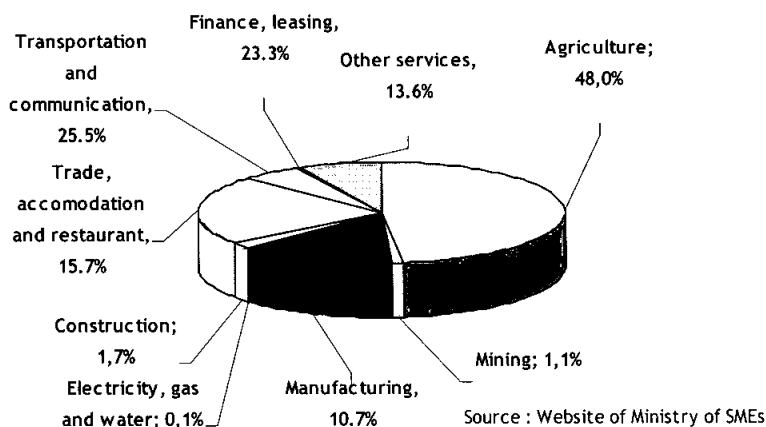
For statistical purpose, from the supply side or financial perspective, micro enterprises are funded by the so-called micro finance or practically considered as micro credit, which is any loan up to IDR50 million (USD5000), whereas small loan is any loan above IDR50 million (USD5000) up to IDR500 million (USD50 thousand) and medium loan is any loan above IDR500 million (USD50 thousand) up to IDR5 billion (USD5 million).

1.2 MSMEs Contribution to the Economy

MSMEs have long been the main players in the economy because of their significant proportion in Indonesia's economic activity in terms of number of enterprises, number of employment opportunities as well as their significant outputs. According to the Central Bureau of Statistics (2003), the number of establishments of small, micro and medium enterprises account for 99.9% of the total number of enterprises establishment or equal to 42.4 million unit enterprises.

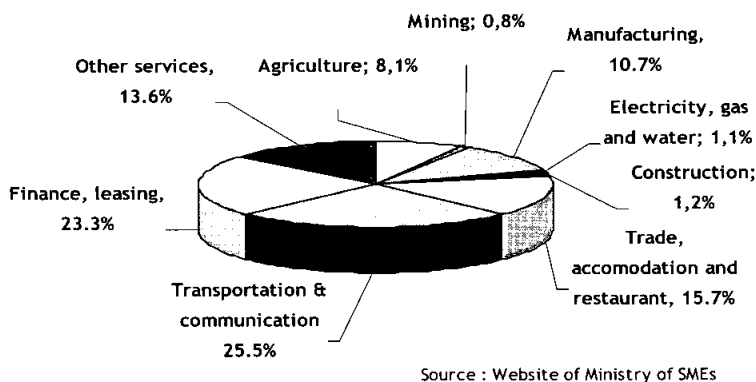
In terms of number of employees, the number of persons employed by MSMEs account for 99.4% of the total workforce. By industry, the largest number of employees of MSMEs is in agriculture industry (see Figure 3.1).

Figure 3.1
Number of Employees in MSMEs by industry (2003)



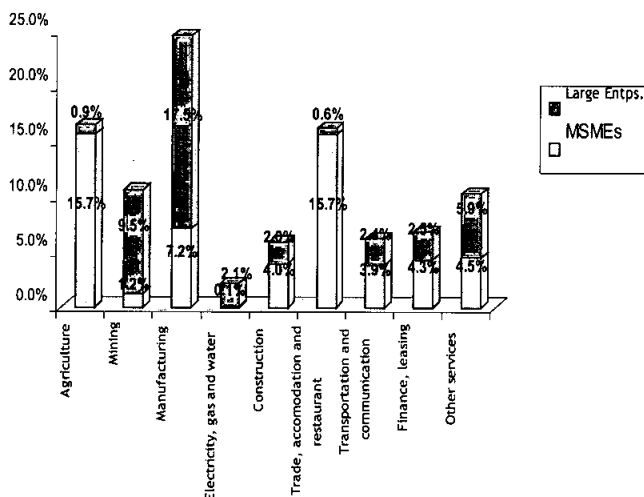
MSMEs are clearly labour-intensive with the investment needs relatively lower than those of large enterprises. In 2003, investment requirements for micro and small enterprises were 18.4% of total investment, while that of medium and large enterprises were 23.1% and 58.5% respectively. The investment for MSMEs is due to the necessity of having a business site rather than the application of technology. This was reflected by the investment portion of small and micro enterprises for construction which reached 86.6%, while the figure for medium enterprises was 81.7%. Across industry, the largest investment of MSMEs was in the transportation and communication sector (see Figure 3.2).

Figure 3.2
MSMEs Investment by Industry (2003)



The share of production value of MSMEs to GDP in 2003 is approximately 56.72%, slightly higher than that in 2000, which was 54.51%. By economic sector, the largest contribution of MSMEs to GDP is from trade, accommodation and restaurant sector (see Figure 3.3).

Figure 3.3
Contribution to GDP by Economic Sector



MSMEs are also important players in the development of regional economies and communities in comparison to large enterprises in terms of location, innovation of marketing, and flexibility in organisation. Most of MSMEs are located in rural areas that are linked to the local economy. Because their scale of business is small and is often directly affected by market changing conditions, most MSMEs have more flexibility and faster decision-making processes than large enterprises. In addition, MSMEs have the capability for creating new markets by responding to new opportunities and by taking advantage of innovations.

Moreover, the crises experienced by Indonesia in the mid of 1997 have demonstrated that MSMEs are able to endure difficult conditions much better than larger enterprises because most of their productions are based on local contents and are not dependent on imported materials, resulting in them being less affected by foreign exchange rate fluctuations. The ability to produce products

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which are based on domestic resources has enabled MSMEs to maintain competitive pricing for a wider reach of the local market.

1.3 Challenges for MSMEs

In spite of the many advantages, the development of MSMEs faces various fundamental problems and challenges. The economic crisis had seriously impacted the business climate in the country, including small and medium scale enterprises. The situation requires immediate recovery efforts for relevant institutions as well as addressing declining consumer buying power, and the increasing gap in financial supply and demand. At present, very few MSMEs in Indonesia have access to formal financial institutions, especially the banking sector. They also face structural problems which need time to be resolved, i.e., (i) limited access to productive resources; (ii) low quality of human resources; (iii) limited number of institutions providing business services; and (iv) distorted market mechanisms and high transaction costs.

Future challenges in developing MSMEs include the rapid economic globalisation and trade liberalisation which come with rapid investment capital mobilisation and declining product life cycles. From the economy development perspective, the improved capability and roles of MSMEs should not only broaden the economy base but also should contribute significantly to accelerating structural changes.

1.4 The Micro Part in MSMEs

MSMEs in Indonesia number some 42.4 million units with almost 99% in the micro segment involved for the most part in farming, informal trade and unskilled labour in the informal sectors. The importance of the micro segment in MSMEs has attracted the attention of practitioners, academics as well as bureaucrats as this segment is the focus of poverty alleviation policies.

The poor or what is termed as 'economically active poor' are mostly involved in micro enterprises. These activities can generate income to alleviate poverty. Accordingly, micro finance and the provision of financial services to low-income clients, including the self-employed are aims of MSME development. In addition to financial intermediation, many micro finance institutions (MFIs) also provide social intermediation services such as group formation, development of self-confidence, training in financial literacy and financial management for a group.

The role of micro finance is substantial in the development of MSMEs. However, the development approaches should vary according to the various segments of enterprises, i.e. micro, small and medium. However, this can be complicated as the existing policies or terminologies used are not so easily differentiated.

Out of a population of 210 million in Indonesia, about 17% live below the poverty line, with 66% of the poor concentrated in rural areas. The development of MFIs and micro enterprises is therefore crucial. This paper would highlight Bank Indonesia's role and strategies in its role as a regulatory and supervisory body for rural banks as well as the promoter of MFI.

2. Government Programmes to Develop MSMEs

2.1 National Development Programme (Propenas)

Government policy in developing MSMEs has long been focused on the financing gap of MSMEs, which is the main constraint for MSMEs development. Government policy in developing MSMEs has is an integral part of the Development Policy Direction and is contained in the "Guideline for the Government and the People of Indonesia" in the administration of state governance.

In line with the Law No.25 of 2000, the National Development Programme (Propenas), the framework for developing MSMEs (including cooperatives), comprises programmes for (1) creating a climate conducive for business development; (2) improving access to productive resources; and (3) developing entrepreneurship and competitive MSMEs.

2.1.1 Programme to Create a Climate Conducive for Business Development

The purpose of this programme is to develop, as broad as possible, business opportunities and guarantee business security taking into consideration economy efficiency principles as the prime condition for developing MSMEs. The objective is to reduce transaction costs and improving MSMEs scale of businesses in economic activities.

The scope of this programme comprises the following policies and steps:

- (1) Streamlining laws and regulations, simplifying bureaucratic licensing procedures, regional regulations and levies, improving law integrity and business protection against unfair competition;
- (2) Developing fiscal policies, tax policies, business sector policies including cross regional and cross-country trading and services, and investment policies for SME;
- (3) The provision of incentives and ease to developing a wider network system of MSMES supporting institutions in the regions such as (traditional) micro financing institutions (MFI), credit guarantee institutions and Business Development Services (BDS) providers, training, technology, information, and advocacy services. The incentive system should be delivered upfront simultaneously with strengthening institutions; and,
- (4) Improving stakeholders' competencies and participation in planning, implementation, and control of policies and development programmes for MSMES at national and regional levels in planning, implementation, and controlling of development policies and programmes, including developing the coordinating mechanism; and developing business ethics and business culture.

2.1.2 Programme to Improve Access to Productive Resources

The purpose of this programme is to improve MSMES competencies to exploit business opportunities and potential resources, emphasising on available local resources. The objective is the provision of supporting institutions to improve MSMES access to productive resources such as human resources, financing, markets, technology, and information.

The scope of this programme comprises the following policies and steps:

- (1) Improving the quality of MFI services and secondary financial institutions, mainly to support micro businesses at local levels by the following supporting measures: (a) protection of legal status, ease of obtaining operating licenses, and the provision of an incentive system; (b) improving managerial competencies and strengthening of capital supported by selective guarantees; and (c) developing a network system amongst MFI and between MFI and Banks to foster financing cooperation;
- (2) Expanding MSMEs financial resources by expanding, among others, credit

guarantee and venture capital services, supporting incentive system for foreign investors with equity financing in venture capital and developing a leasing industry providing fixed (investment) capital for MSMEs, developing financial access for MSMEs including developing a credit appraisal system and its information network;

- (3) Improving BDS provider institutions' competencies, technology, and information for MSMEs at local levels, and creating its network system by strengthening participatory and competitive management and simultaneously, developing a system for accreditation of BDS institutions and certification of BDS;
- (4) Developing an incentive system and strengthening training institutions for MSMEs, the management (board) and cooperative members, and a network of cooperation among training institutions;
- (5) Reorientation and restructuring training institutions or R&D institutions of various public agencies to become self-sustaining BDS providers for MSMEs and simultaneously improving and repositioning facilitators to become self-sustaining professional MSMEs consultants;
- (6) Strengthening the management of cooperatives as a platform for MSMEs to improve business achieving economies of scale and efficiencies simultaneously.

2.1.3 Programme to Develop Entrepreneurship and Competitive MSMEs

The purpose of this programme is to develop entrepreneurial attitudes and to improve MSMEs competitiveness with the objective of developing knowledge, entrepreneurial attitudes and improving MSMEs productivity.

The scope of this programme comprises the following policies and steps:

- (1) Socialising entrepreneurship and developing incentive systems for new entrepreneurs (business start-up);
- (2) Developing business incubators and technology, especially those managed by the private sector to support development of MSMEs and new technology-based start-ups and simultaneously developing venture capital financing and the provision of long-term credits;
- (3) Providing an incentive system and assistance to enhance development of technology-based MSMEs, among others, to support the development and utilisation of local technology innovation; commercialisation of technological innovation; developing business partnerships between MSMEs and foreign firms which implement technology-transfer or modern management methods;

and developing facilities for joint ventures for modernisation or improving added value of business.

- (4) Developing production and distribution networks by developing information technology; developing business groups and networks among MSMEs in a cooperative platform by vertical and horizontal integration; and developing networks between MSMEs and larger firms through business partnerships; and
- (5) Improving the quality of MSMEs with gender vision for creating entrepreneurs imbued with the cooperative spirit enabling to develop potentials, skills, and competencies for innovation and creation of employment.

2.2 Programmes at National Level to Promote Micro Sector with Specific References to Alleviate Poverty

The following is a range of poverty alleviation programmes with microfinance components that have national relevance:

- (1) Rural income generation project (RIGP/P4K) of the Ministry of Agriculture and BRI, which commenced in 1979, targeting households with income generating activities;
- (2) Family welfare income generation project that targets women who are economically active and belong to families that are not able to meet basic needs, and organise them into small groups consisting 20 members; and
- (3) The sub-district development programme the purpose of which is to alleviate poverty in backward villages, strengthen sub-district and village government in implementing government programmes, strengthening community participation and organisation, and building public infrastructure through labour intensive methods.

2.3 Government Special Fund for MSMEs

To date, there are two prominent Government special fund programmes for MSMEs. The first is intended to effectively extend the partnership fund programme (DPK) to broader micro enterprises, known as eligible micro credit without collateral (termed as KUM-LTA). The DPK is a part of the profit surplus from state owned enterprises mainly utilised to strengthen small-scale enterprises and cooperatives. The project utilise the DPK as a pledge for micro credit provided by certain commercial banks, state-owned financial holding corporations or pawnshops. The DPK will guarantee 10% of the loan, while the rest is the risk

of the loan provider. The maximum loan to micro enterprises under this programme is ten times of the DPK received by loan providers.

The second programme is the credit scheme funded by Government Bonds. As a substitute for KLBI, BI purchased Government Bond No.05 which was aimed at maintaining the continuity of financial assistance to MSMEs. The fund available from the Bond amounted to IDR3.1 trillion (USD0.31 billion) and was channelled by the Government to MSMEs through designated banks and non-bank financial institutions. The interest rate of the scheme is in line with the market rate and the credit risk is borne by the banks or non-bank financial institutions.

2.4 Programmes of Other Institutions

Over the years, there have been many MSMEs development programmes undertaken by various institutions. According to research by the State Ministry of Women Empowerment and Social Monitoring and Early Response Unit (SMERU) in 2003, during the period of 1997 to 2003 there were 585 programmes, schemes and projects carried out by 64 institutions aimed at strengthening and developing micro and small scale enterprises. These institutions comprise of government institutions, local and international non- government organisation (NGOs), companies and cooperatives, Bank Indonesia, commercial banks, donors and other institutions. In general, the programmes are in form of technical assistance or financial assistance or a mix of the two.

3. Bank Indonesia's Experience and Role in Developing MSMEs

Taking into account the significant roles of MSMEs in Indonesia economy, Bank Indonesia has long taken part in supporting the development of MSMEs. In doing so, Bank Indonesia has employed two approaches, which are the macro and micro economy approaches. Through the macro economy approach, Bank Indonesia's role is to provide stable and sound monetary conditions, which is a necessary condition for economic activities to flourish. In addition, Bank Indonesia also applied the micro approach aimed at providing the accessibility of MSMEs to financing and financial institutions. The role of Bank Indonesia in supporting MSMEs' development can essentially be divided into two phases. The first phase was during the period when Bank Indonesia was based on the Act No. 13 of 1968, and second phase started with the enactment of new Central Bank Act No. 23 of 1999.

3.1 Bank Indonesia Policy in Supporting MSMEs Development Prior to the Act No.23 of 1999

Before the enactment of Central Bank Act No. 23 of 1999, the involvement of Bank Indonesia (BI) in developing MSMEs was based on the Central Bank Act No. 13 of 1968, stipulating Bank Indonesia as an agent of development. BI was given a strong development mandate to improve the standard of living by regulating, safeguarding and maintaining the stability of the value of the Rupiah; and promoting production stability and development as well as expanding employment opportunities. The support of priority sectors was through liquidity credits (KLBI) for encouraging self-sufficiency in food, developing cooperatives and providing fund for MSMEs.

Based on the Act, Bank Indonesia's strategy in providing accessibility of MSMEs to financing and the financial institutions consists of four main strategies as follows:

3.1.1 Subsidised Credit Programme

The credit programme was introduced at the late 1960s to develop economy sectors which had potential or played significant roles in the economy. The credit programmes were on a lower interest rate (subsidised by Government), had simple procedures, longer loan maturity, no administration fee, and funded by Government out of its budget or Bank Indonesia's liquidity credit. The first phase of the credit programme was initially to help farmers in rice production and subsequently was extended to also help the small-scale entrepreneurs and cooperative members to expand and scale up their businesses.

About 20 schemes were introduced in the credit programmes. Out of these 20 schemes, the two most outstanding and successful programmes were the Credit for Farming (KUT or Kredit Usaha Tani) and Credit for Member of Primary Cooperative (KKPA or Kredit Kepada Koperasi Primer Untuk Anggotanya). The KUT was designed to help farmers increase their production and earnings, whereas the KKPA was to provide working and investment capital for cooperative members in all economy sectors. The KUT has a role in achieving food sustainability, while the KKPA helped the cooperative members to increase their business scale. 65% of the KKPA scheme was supported by BI's liquidity credit, with the interest charged to banks at 9% and to cooperatives at 16%. The KKPA, was divided into 6 specific schemes, i.e., KKPA for fishermen,

KKPA for poultry breeder, KKPA for Rural Plantation, KKPA for manpower provider service, KKPA in syariah principle, and KKPA for sugar plantation.

The monetary crises in 1997 was worsened by inefficiencies in economic and business management and created a crisis in banking system, which in turn caused increases in the interest rate and cost of fund. The high cost of fund resulted in fewer loan extensions to MSMEs, and also affected the extension of the credit programme which was partly funded by banks' fund. The increase in interest rate also meant that the interest rate applied to the credit programme was no longer applicable.

In order to lessen the impact of the economy crises to MSMEs, particularly to the farmers and micro and small entrepreneurs, Bank Indonesia adopted the following policies:

- 1) Softened the requirement for banks participating in credit programme and hence banks having problem due to monetary crisis were still considered to be participating banks;
- 2) Raising the share of Bank Indonesia Liquidity Credit in credit programme to 100%. The schemes of credit programme included Credit for Farmers and Credit for Cooperative Member;
- 3) Modifying some credit programme terms and conditions with adjustments in mechanism and procedure, among others the alteration of Credit for Farmers procedure from *executing* to become *channeling*, the increased role of primary cooperatives and the wider commodities financed by credit programme;
- 4) Creating some new schemes for MSMEs in order to promote the role of rural microfinance institutions, including rural banks, either conventional or based on syariah principle. These new schemes were credit schemes for rural banks, micro entrepreneurs, poultry – breeder, fishermen, Pegadaian (pawnshop) and local city transport.

3.1.2 Quota on MSMEs Lending

The quota on MSMEs lending (specifically to small-scale enterprises) was first introduced in the January 1990 Financial Reform. The idea behind this strategy was to encourage commercial banks to extend loans to MSMEs. According to this regulation, lending to MSMEs must be 20% (it was later revised to 22.5-25%) of net credit expansion. Banks that exceed the limit received

incentive payments while those that fell short had to pay a penalty which went into funding the aforementioned incentives. The amount of penalty was 2% times the balance of the minimum requirement of MSMEs less the actual MSMEs loans of each bank. As a result of this scheme, the ratio of MSMEs lending in 1997 was 22.7% compared to 17.5% at the end of 1989. MSMEs lending in 1997 was IDR50 billion, while in 1989 it was IDR14 billion.

This approach was revoked after a few years due to the moral hazard in the creation of false small-scale enterprises just to fulfill the requirement. As a substitute in creating a conducive atmosphere of financial access for MSMEs, Bank Indonesia issued a new regulation on Small Scale Credit, which strongly recommends commercial banks to make allocations in their loan portfolios for MSMEs, clearly stating in their business plans of loans to MSMEs for the next one-year and publish the outcome of the plan in their published financial statements.

3.1.3 Provision of Technical Assistance

The other strategy of Bank Indonesia in supporting the development of MSMEs is by providing technical assistance to the other wise "un-bankable" MSMEs which are mostly very small and simple in nature. The technical assistance has two facets which are to help MSMEs to be more bankable, and to help bankers in dealing with MSMEs. Bank Indonesia implemented several technical assistance projects and the most successful ones were the Micro Credit Project (PKM) and the Self-Help Group Linkages to Banks (PHBK).

(i) The Micro Credit Project (PKM)

The objectives of the PKM, which was partially funded by the Asian Development Bank (ADB), were to increase income and employment in rural areas, to alleviate poverty and to promote the participation of women in development activities. There were three scopes of PKM:

1. Lending to the poor and nearly poor for the development of micro-enterprises by using of sub-loans through the Micro Financial Institutions (MFIs) that comprises of rural banks and rural non-bank financial institutions;
2. Strengthening MFIs to enable them to provide viable small-scale financial services for the development and sustainable operation of micro-enterprises through provision of credit and training;

3. Strengthening of Non Government Organisations (NGOs) through the provision of credit and training to enable them to organise and to provide Self Help Groups (SHGs) with appropriate skills training and other services necessary for income-generating activities.

By nature, the PKM tries to support the development of micro enterprises through empowerment of the institutions in the respective areas. The services were extended to the technical and financial aspects, by providing training and consultancy to the participants, and credit lines for micro-entrepreneurs to develop their business and also credit lines to MFIs. The amount of initial credit extended to individuals can reach as high as IDR2 million (USD 200) and may be increased to IDR5 million (USD 500) depending on the individual's repayment performance. The requirement of collateral is not binding as it depends on judgment of the institutions extending the credit. The interest rate for the PKM is the market rate prevailing in the respective areas.

The project has a dual side strategy from the supply and demand side. The strategy from the supply side is to strengthen the rural financial institutions consisting of rural banks and the Village Credit and Loan Institutions (LDKP). The programme consisted of training the manager and staff of these institutions and provision of loans for motorcycles and computers. From the demand side, the strategy is to develop the micro businesses by distributing loans based on market rates through the BPR and LDKP. However, the programme does not include Islamic rural banking since the prerequisite of the ADB loan is interest-based.

The programme was a success as seen in the current repayment of loans as of December 2002 which stood at more than 90% and only 6% were doubtful and at a loss position. The number of institutions which participated in the project were 1,140 consisting of 843 rural banks, 226 LDKP, 65 LPSM and total borrowers reached 930,235 persons consisting of individual borrowers (84.19%) and group borrowers (15.81%). The success of the programme was due to the strict requirements for the BPR participating in the programme and the availability of technical services along with the financial services to the borrowers to strengthen their business activities. From the programme, it was gleaned that the low level income community including micro and small enterprises are good prospective customers.

(ii) *The Self-Help Group Linkages to Banks (PHBK)*

The PHBK Project (self-help group linkages to banks) was started in 1989² aimed at linking an independent group of micro entrepreneurs or “self-help group” to the banks. To nurture the linkages, BI relied on the services of “self help promoting institution” which include the Non-Government Organisations (NGOs). During the 1990s, PHBK utilised the BPR system to directly link the self-help groups in their local areas and eventually it is expected that the banks will be able to apply the system in extending small-scale credits to the self-supporting groups.

3.1.4 Institutional Development

The fourth strategy of Bank Indonesia in supporting MSMEs is by developing institutions to serve the MSMEs. MSMEs usually have difficulties in providing clear sufficient collateral and hence financial institutions that can best serve them are ones that are located closely and know them well. Therefore, it is important to develop financial institutions, commercial banks, rural banks or small financial institutions which have had a long tradition in serving MSMEs. In line to this strategy, Bank Indonesia promoted the establishment of rural banks (BPR) and Islamic (syariah) based banking operations. The development of syariah principle banking operations is because the majority of Indonesia’s population is Muslim and would therefore encourage them to deal with the banks based on the syariah principle rather than with conventional banks.

3.2 Role of Bank Indonesia in Promoting MSMEs Based on the Act No. 23 of 1999

Since the endorsement of the new Bank Indonesia Act No. 23 of 1999 as amended by Act No.4 of 2003, the core functions of Bank Indonesia are in monetary management, payment system and banking supervision. The different paradigm under the prevailing Central Bank Act is reflected in the diminishing role of Bank Indonesia as an agent of development as stipulated in the previous Act.

2. The project was under joint-cooperation with GTZ, a Germany Government Technical Assistant Agency. GTZ terminated the project in 1999 but was continued with further assistance from BI.

As has been mentioned earlier, as an agent of development, Bank Indonesia provided liquidity credits (KLBI) to promote the stability of food production, to expand employment opportunities and to develop priority sectors, such as securing self-sufficient food supply, cooperatives and MSMEs development. However, the channelling of funds had negative impacts such as inflationary pressure and banks' liquidity dependence on Bank Indonesia. Credit programmes with subsidised interest rate is also believed to cause market distortion and moral hazards due to the misconceptions of beneficiaries who confuse a Government grant from a loan.

Under the new Act, BI shall no longer extend any KLBI under the credit programme and the role and function of BI in extending such credit are transferred to the three state-owned enterprises, i.e. PT. Bank Rakyat Indonesia (BRI), PT. Permodalan Nasional Madani (PNM) and PT. Bank Tabungan Negara (BTN). The three enterprises will continue supporting the development of MSMEs with Government and public fund. BRI functions as the coordinator of credit for farmers, cooperatives and agribusiness while BTN functions as the coordinator of small housing credit scheme and PNM as the coordinator of other credit programme schemes. In addition to Bank Indonesia's liquidity credit, the transfer also includes the two-step loan from donor countries and technical assistance provided with the extension of credit programme. Meanwhile, some new schemes of the credit programme are extended by commercial banks with an interest rate subsidy from the Government.

Today, Bank Indonesia's role in strengthening and developing the MSMEs sector is of an "off-hands" mode. The aim is to achieve a sound and sustainable banking system so that MSMEs can gain access to financing. However, considering MSMEs' strategic role in economic recovery, BI still supports them indirectly, focusing on extending technical assistance to the banks and MSMEs. The main policies are creating a conducive climate to promote the intermediary function of banks through regulation, institutional development and capacity building as well as technical assistance.

3.2.1 Banking Credit Policy

In order to promote a sound and sustainable banking system and also to support the development of MSMEs, Bank Indonesia is continuing efforts to improve the intermediary function of banks and enhancing credit to MSMEs by the following policies:

1. Regulation on Small Scale Credit

The study conducted in 2000 on commercial bank practices on MSMEs lending has revealed that the regulation on the lending quota to MSMEs has resulted in moral hazard among commercial banks in their effort to achieve the minimum quota, particularly those which were not accustomed to MSMEs lending. This study was done in line with the commitments made to the Asian Development Bank (ADB) and the International Monetary Fund (IMF) to phase out the quotas and provide a replacement for them. A new regulation was implemented on 4 January 2001, which strongly recommends that commercial banks allocate part of their lending to MSMEs. Banks are to state their plans for MSMEs lending in their annual business plan, publish the achieved lending to MSMEs in the monthly report and announce the same in the public financial report to foster transparency and good governance.

The planned and achieved lending to MSMEs of 13 commercial banks with total assets accounting for 80% of the banking industry's total assets (systemically important banks) is presented in the following table.

Table 3.1
Business Plan and the Actual Credit to MSMEs

	Year of 2002	Year of 2003	Year of 2004
Business Plan (trillion IDR)	27.64	42.35	38.48
Achievement (trillion IDR)	32.65	26.99	72.03
Percentage	119%	64%	187.1%

2. Relaxing Banking Regulation within the Prudential Banking Framework

In order to encourage bank lending to MSMEs, Bank Indonesia has endeavoured to relax banking regulations within the prudential banking framework in line with practices of the Bank for International Settlement (BIS). One example is the issuance of Bank Indonesia's Regulation on the performance of loan amounting up to IDR500 million which is calculated based only on borrowers' payment capability. Previously, the calculation on loan performance also considered the economic condition and the punctuality of loan repayment. With this regulation,

the calculation on performance of MSMEs lending is more flexible, allowing bank to minimise its reserves.

Additionally, on January 2005, Bank Indonesia published a series of new banking regulations which are intended to strengthen the banking industry and to accelerate banking consolidation. Out of the eight regulations in the January Banking Regulation Package, two are for the promotion of bank lending to MSMEs, i.e. Regulation on Legal Lending Limit and Regulation on Debtor Information System. The Regulation on Legal Lending Limit (3L) allows a nucleus company to extend unlimited guarantee to small firms, cooperatives or farmers acting as business partner. This facilitates lending to oil palm industry which is normally made up of a big company as the nucleus and smaller estates as business partners. The Debtor Information System Regulation requires commercial banks and rural banks with assets of more than IDR10 billion to report all of their debtor and credit facilities to Bank Indonesia. Previously, only debtors with loans of more than IDR50 million should make reports. With this system, Bank Indonesia would be able to assemble a comprehensive database on commercial banks and rural bank debtors and will enable banks to exchange information on their MSMEs cutomers.

3.2.2 Institutional Development and Capacity Building

(i) Rural Banks (BPR)

Besides its main tasks of regulating and supervising banks, including rural banks, Bank Indonesia also supports the development of rural banks, taking into account the significant impact of BPRs on micro enterprises. Some strategies being implemented are as follows:

- a) Supporting the development of sound BPR industry by restructuring problematic BPRs that still have prospects for recovery through merger, aquisition or consolidation.
- b) Improving the regulatory and supervision, considering the specific characteristics of Rural Banks and applying a risk-based supervision approach. In addition, Bank Indonesia has upgraded the rural bank management information system in order to improve the supervision effectively.
- c) Strengthening the infrastructure of rural bank industry by measures such as enhancing the linkage programme between rural banks and commercial banks, improving rural banks' human resources, especially the directors through

CERTIF programme and making greater use of information technology that can support rural bank operation and supervisory function of Bank Indonesia.

- d) Building the capacity of rural banks by facilitating the establishment of joint facilities for the industry such as Apex Institution and empowering the association.

These policies are contained in the Indonesian Banking Architecture in the form of increasing competitiveness of rural banks by strengthening the linkage programme, facilitating joint facilities and simplifying process for opening of rural bank branch offices.

(ii) Linkage Programme

In order to encourage bank financing to MSMEs, Bank Indonesia is supporting a linkage programme between commercial banks with the rural banks and other micro finance institutions. The linkage programme aims to boost commercial bank loans to MSMEs in light of the promising market share of MSMEs. As a legal base of the programme, a Memorandum of Understanding (MoU) was made between the commercial banks and rural banks, stating that the banks will place some funds with rural banks. The linkage relationship is in the form of executing approach, meaning that rural banks have full responsibility of the utilisation of the fund, including repayment to the commercial banks regardless the performance of the loan.

Based on recent research, it was found that the linkage programme has increased rural banking capacity in providing credits to MSMEs, supporting the development of MSMEs. Practices such as fair interest rates charged by commercial banks, the possibility of transfer of knowledge and technology by rural banks, administrative procedures adjusted to the characteristic of rural banks have all contributed to the support of MSMEs. From 2002, when the programme was first promoted, up to June 2004, a total of 924 BPRs and 24 banks and PNM have participated in the programme with a total outstanding balance of IDR536 billions. In the future, there is a plan to link banks to BKKBN (National Family Planning Board) to extend services to small-scale group business especially women.

(iii) Facilitating Dialogue between Banking Sector, MSMEs Sector and Government Agencies

MSMEs have difficulties in acquiring information on bank services, especially loan products and procedures in credit application. On the other hand, the banking sector face problems in identifying prospective and potential MSMEs. Considering these difficulties, and to increase the intermediary function of banks, Bank Indonesia initiated a bazaar of banking intermediary in some Bank Indonesia branches, in order to assemble local banks and MSMEs. In the bazaar, the banks set up their booths and display available services and products, and also provide free consultation for MSMEs interested in applying for loans. As at the end of 2004, there were 16 Bank Indonesia branches which held the bazaar. The outcome from the bazaar has been very encouraging as there were not only diffusion of information but also credit agreements made between banks and MSMEs, and between banks and rural banks.

Other than bazaars, there were also initiatives to facilitate dialogues among the respective Government agencies and private sector to achieve understanding on strategies to increase the capacity of private sector to respond to banks' inquiries with respect to business licenses and land certification.

(iv) Increasing the Role of Credit Insurance

It has been a common problem of MSMEs in Indonesia, and perhaps in other countries as well, that even though they are feasible and have good business prospect, they do not have collateral to obtain bank loans. On the other hand, banks are required to act prudently and minimise credit risk as much as possible. To fill the gap, the presence of a credit guarantee scheme or credit insurance is necessary. At present, there are 2 credit insurance institutions in Indonesia which handle MSMEs loans, namely PT. Askrindo and Perum Sarana. However, the limited capacity and capability of these institutions have impeded their scope of service to MSMEs which are spread all over Indonesia. In view of this problem, Bank Indonesia has empowered PT. Askrindo by initiating an insurance credit scheme under the joint-cooperation with some regional authorities.

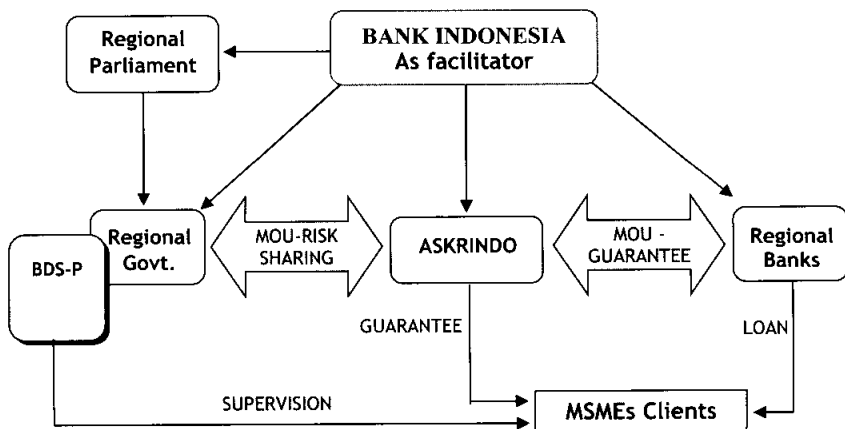
In the scheme, Bank Indonesia acts as a facilitator for the regional parliament, regional government, credit insurance body and banks. Upon recommendation from Bank Indonesia, the regional parliament grants approval to the regional government to fund the credit insurance body. The underlying agreement between

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the regional government and the credit insurance body is a Memorandum of Understanding (MoU) on risk sharing which settles the risk portion to be borne by each party. Between banks and the credit insurance body, there is another MoU which emphasise that the credit insurance body will guarantee MSMEs loan disbursed by the regional banks. The MSMEs clients then should be supervised by an independent body, e.g., a Business Development Service Provider (BDS-P).

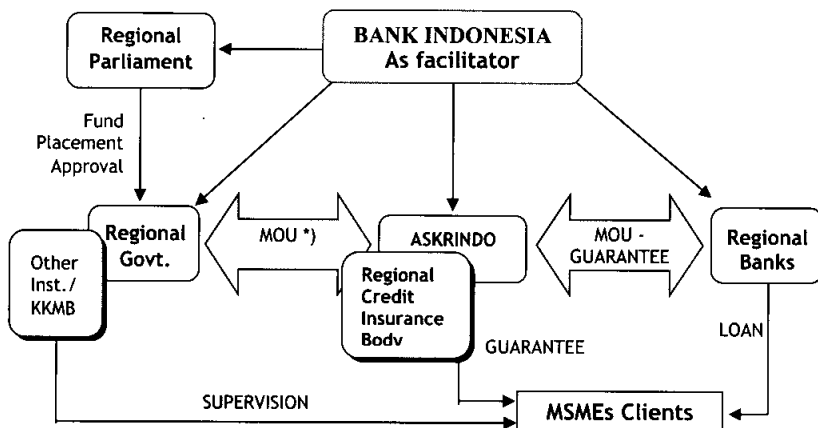
If there are no credit insurance body in the region, then PT. Askrindo takes the lead and acts as the regional credit insurance body (see Figure 3.4).

Figure 3.4
Insurance Credit Scheme where there is no Regional Government
Credit Insurance Body



On condition that the regional government has set up a credit insurance body, PT. Askrindo acts as the adviser and extends technical assistance to the body. It also has a MoU with the regional government which covers not only the risk sharing, but also the organisation of operating cost, office and man power (see Figure 3.5).

Figure 3.5
Insurance Credit Scheme with Regional Government
Credit Insurance Body



The response to the scheme has been very positive, as demonstrated by the signing of 4 MoUs between regional governments and regional banks.

(v) Promoting the Establishment of MSME Centre

Data on commercial and rural bank loans extended to MSMEs has shown that there are 17 million MSMEs clients served by the banks. This is only 42.5% of a total of approximately 40 million existing MSMEs. The low accessibility and the lack of information have been the main causes of for the lack of bank service for MSMEs. In light of this, Bank Indonesia has advised banks, for which the main targets are MSMEs, to establish a Centre for MSMEs in their branches to operate as an information centre and specialised unit extending services to MSME.

As a result, as of December 2004, there are 4 commercial banks, namely, BCA, Bank Danamon, BRI and Bank Niaga which have established MSMEs centres in various cities. Bank Danamon has even gone beyond this recommendation and have established a special unit, called the Danamon Save and Loan, to serve micro clients for savings and credit purposes.

(vi) Establishment of Credit Bureau

Before banks extend credit to MSMEs, basic information is required on MSMEs clients, especially those which have been served by other banks. This requirement can be met by the establishment of a Credit Bureau, which is a centre for data base on all bank borrowers. The Credit Bureau will maintain the profiles of borrowers from all commercial banks and microfinance institutions and the data could be utilised by banks in supporting their credit analysis. The existing Debtor Information System maintained by Bank Indonesia only assemble data on bank clients with a minimum loan of IDR50 million (USD50 thousand). Currently, Bank Indonesia in cooperation with banks, cooperatives and non-bank financial institutions, assisted by consultants, is in the progress of expanding the data base to include all bank borrowers and potential borrowers, including the micro clients. In the future, this information system would also include the data base of clients from non-bank financial institutions as well.

(vii) Initiating Legal Framework Provision for MFIs

The issue of legal framework for non-bank MFIs and non-cooperative MFIs has become strategic since most MFIs (which also collect funds from the public) are not under any legal framework. The current regulation, Banking Act No. 10 of 1998, stipulates that any party conducting business in form of collecting public funds, or deposits, are to obtain an operating license as commercial bank or rural bank (BPR) from Bank Indonesia, except if it is stipulated in a separate Act. Other institutions that have the right to collect public funds are cooperatives, as stipulated in the Cooperative Act.

The regulatory environment for microfinance institutions (MFIs) is very important if the microfinance sector is to achieve significant outreach on a sustainable basis and also for maintaining depositors' interest as well as people's trust and confidence in financial institution.

The Study by ADB (2001) reveals MFIs which do not accept deposits from the general public are not subject to prudential regulation or supervision by a government agency. To increase its capacity to extend loans to micro enterprises, MFIs need to have sufficient funds to extend credit or finance to micro enterprises and this can be resolved with the enactment of the regulation which gives the non-bank MFIs the legal framework permitting them to collect public fund. Specific regulations on microfinance are essential for empowering the MFIs, providing

them with a legal basis and clear direction on microfinance activities. In short, there is a need to formulate a national strategy on microfinance, which will have a role in the ongoing process of national poverty reduction strategy.

In order to protect small savers, strengthen existing MFIs and expand their services, Bank Indonesia has taken the initiative to form a working group consisting of relevant Government institutions, BRI and the United Movement for the Development of Indonesian Microfinance to formulate a draft of microfinance law. Other than the legal framework, the development of microfinance should be supported by capacity building in human resource, information technology and capital expansion. There is also a necessity to strengthen microfinance infrastructure such as improving networking and setting up a rating agency. To expand microfinance service, it is also essential to enhance the linkage programme between formal banks and microfinance institutions.

3.2.3 Technical Assistance

(i) Training for Bank Officers

The main technical assistance provided by Bank Indonesia is in form of training for bank officers, the aim of which is to disseminate information on the characteristics of MSMEs. Bank Indonesia also assists commercial banks on their linkage programmes with rural banks by providing information on rural banks and their supervision. The training provides bank officers with information on the profile and operations of rural banks and how to evaluate their performances. Bank Indonesia also provides training for facilitators in the development of bank linkages to self help groups. The training is carried out either by Bank Indonesia officers or consultants assigned by Bank Indonesia, while the programme is drawn up by Bank Indonesia or by the bank itself.

(ii) Research

For decades, Bank Indonesia has conducted numerous research on MSMEs in recognition of their economic prospects and potentials. One main research work which is being continuously conducted by BI is on commodity/business potential of MSMEs of every province and district in Indonesia. The research itself has been carried out since 1979, and is still being updated. The results or what is known as the Baseline Economic Survey is useful for regional governments in the development of their region, for entrepreneurs who plan to start up business

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in one particular region, and for traders who need information on the availability of some commodities or products.

The research on lending model of commodity prospective for MSMEs is being conducted continuously and is aimed at helping MSMEs in the assessment of the business feasibility of the commodities.

(iii) Information System

In order distribute the research results widely, Bank Indonesia has placed the information in an integrated information system, known as the Information System for the Development of MSMEs or SIPUK. The integrated Information System is internet-based, and accessible via Bank Indonesia's website at <http://www.bi.go.id>. It is a user-friendly information system consisting of the following sub-systems:

- a. Information System of Baseline Economic Survey (SIB)
- b. Information System of Export-oriented Agro-industry (SIABE)
- c. Information System of Lending Model for Small Enterprises (SI-LMUK)
- d. Decision Support System for Investment (SPKUI)
- e. Information System of Loan Obtaining Procedure (SI-PMK)

a. Information System of Baseline Economic Survey (SIB)

This sub-system is based on the Baseline Economic Survey (BLS), a research to determine the viability of commodity/sub-sector of economy related to MSMEs development of each province. The system, which is in form of interactive map of Indonesia archipelago, has greatly increased the speed of information dissemination. Users of the SIB are able to obtain information on potential and viability of economic sector or commodity to be developed, and identify business opportunities for MSMEs together with its supporting or inhibiting factors. To date, the SIB covers 31 out of a total of 33 provinces in Indonesia. The information of each province is updated every five years. The results are shown in the form of Priority Scale Lists of Sub-Sector/Commodity to be developed in each region (province, district, and sub district). They are grouped under "Very Potential", "Potential", and "Less Potential" based on six criterion, namely marketing, entrepreneurship, production technology, growth, infrastructure, and related government policy.

b. Information System of Export-oriented Agro-industry (SIABE)

The Information System of Export-based Agro-industry was first developed by BI in 1999 to provide information on potential exportable commodities to the community including banks, and foreign importers. This system covers the following information:

- Commodity profile, process technology, industry tree, origin of raw materials, export volume, export value, country of export destination, name of exporters, and regulation on tariff;
- Volume and value of export to the country destination from each province;
- List of exporters, including names, address, contact persons, telephone/facsimile, on each commodity and province;
- Potential province and district to produce export commodities; and
- Standard of quality control, tariff barrier, and export regulation.

This information system is intended to connect importers to local exporters, which in turn will increase volume and value of export and increase the inflow of foreign exchange into the country. To date, SIABE covers 16 clusters, of which each includes its derivatives of about 500 commodities in 23 provinces.

c. Information System of Lending Model for MSMEs (SI-LMUK)

SI-LMUK provides information of lending models for various small business activities based on research results carried out by Bank of Indonesia. To date, it contains lending models for 37 commodities covering marketing, production technology, financial, economic and environmental impacts. SI-LMUK is a reference for banks in financing certain commodities and MSMEs and in assessing financial feasibility of their prospective businesses in accordance to the banking standards.

d. Decision Support System for Investment (SPKUI)

SPKUI is a supporting information system of lending model (SI-LMUK) which provides a computer-based tool to help the users in simulating their businesses. The users can change the value of parameter(s) in the financial analysis of the lending model, for example the price of products, the production assumption, the cost of workers, etc, and the system will provide the evaluation of the financial feasibility such as the amount of investment, cash flow, IRR, NPV, PBP, and B/C. With this system the users are able to automatically and quickly calculate the amount of money required to start up a business for a particular commodity as demonstrated in the lending model. It is expected that users can use the results of simulation to figure out the business financial feasibility based on more realistic conditions.

e. Information System of Loan-Obtaining Procedure (SI-PMK)

SI-PMK illustrates a simplified procedure for obtaining small-scale business loans from banks and assists MSMEs in the application of bank loans as most MSMEs have not had any dealings with banks. The information includes loan definition, benefits, bank management, and a systematic procedure to obtain loans as well as business-feasibility analysis using financial ratios of the applicant.

(vi) Financial Consultants and Training for Business Development Services (BDS)

The limited access of MSMEs to banks and other financial institutions is mainly due to their lack of management capabilities, organisational structure, operational procedures or financial administration while banks have limited information on the potential of MSMEs to be financed and few personnel who have a real comprehension and knowledge of MSMEs. In view of this, BI is promoting the Business Development Services Provider (BDS-P) which will close the gap between the MSMEs and banks. While BDS-P has become significant, it still has vast room for improvement and BI is providing training for BDS-P on banking products, analysing micro enterprises performance and prospect, and assessing micro enterprises needs. As of December 2004, there are 821 consultants of which 510 BDS-P have been trained.

(v) Establishment of Service Provider Management Centre (SPMC)

As mentioned above, the BDS was set up to facilitate MSMEs' access to finance from banks and other financial institutions and in light of this, BDS have been established in every area close to MSMEs centres. However, since no standard of service and qualifications have been set, the services delivered are not up to the requirements of the Es and/or the banks. To overcome this, BI in cooperation with the West Java Regional Governance has established a pilot project of Service Provider Management Centre (SPMC), the purpose of which is to improve the quality of BDS services and productivity in promoting MSMEs to be eligible for financial support from the banks and other financial institutions. With the assistance from SPMC, the BDS is expected to be more professional and creative. Banks also gain to benefit with the decrease in their risk exposure to MSMEs due to better information available.

The SPMC improves the service quality of BDS by providing training, accreditation, certification and supervision. Up to December 2004, of the 125

BDS applicants, 59 met the criteria, 49 participated in basic training, and 21 BDS were accredited. Additionally, SPMC has successfully linked 1877 MSMEs to 10 banks and 2 syariah financial institutions, with a total credit of Rp21.8 billion.

The SPMC also monitors, supervises and evaluates the performance of the BDSP. Monitoring is done through monthly reports from the BDSP, information from banks and spot checking BDS operations. With the success of the pilot project, BI initiated a similar project in the East Java Province known as the Promoting Enterprises Access to Credit (PEAC), founded with the cooperation of the IFC and Swiss Contact. One programme of the project is on the development of the Certification Regulation and Standardisation of training materials for BDS-P.

4. Contribution of Micro Finance Institutions (MFIs) to MSMEs

4.1 Development of MFIs in Indonesia

The evolution of MFIs in Indonesia can be traced back a hundred years during the Dutch Colonial era. They played a strategic role in empowering low-income and small and micro entrepreneurs in villages. Various types of institutions such as paddy banks, village banks and petty trader banks had an important part in alleviating poverty in the village areas. Present day MFIs include the unit network of Bank Rakyat Indonesia (BRI Unit), rural banks (BPRs), cooperatives and commercial banks that provide microfinance activities. Indonesia has developed many types of MFIs and is said to have the "world's largest laboratory on rural financial market experiment".

The Indonesian Government played a significant role in microfinance development until the 1980's when the 1988 October Package shifted the role to societies or non-government authorities. According to an ADB study on the role of central banks in microfinance, Bank Indonesia's and the Government's involvement in microfinance has been considered successful, where the strategy has been to expand the outreach through a financial systems approach.

There are many types of microfinance institutions in Indonesia, in terms of organisation structure, purpose of establishment, culture as well as government policy behind the formulation of the microfinance institutions. In general, MFIs in Indonesia are categorised into formal and informal ones with the formal ones comprising of banks – rural banks (BPRs), commercial banks (BRI Unit) and

Village Credit Board, and non-banks consisting of savings and credit cooperatives and rural fund and credit institutions. There are also various kinds of informal MFIs such as Baitul Maal wat Tamwil (BMT)³, Non-Government Organisations (NGO) and Self-Help Groups, moneylenders, local sources of trade and consumer credit, and mutual credit arrangements and the indigenous forms of Rotating Savings and Credit Associations (ROSCA).

All these institutions play a vital role in developing rural areas because of the close proximity to the rural community, simplicity in loan procedures and personal approaches to customers. Besides institutional microfinance, other microfinance activities include microfinance system building, poverty alleviation and crisis related channelling of funds (see Appendix 3.2 for details).

Based on available data, the number of MFIs is roughly 54,000 units with savings amounting to more than IDR43 trillion (USD 4.7 billion) and loans of more than IDR35 trillion (USD3.8 billion). However, the contribution of non-bank MFIs, which make up more than 80% of all MFIs, is only 5% and 22% of total savings and loans respectively.

In evaluating the performance of MFIs, the most common measures focus on sustainability and outreach. By far, the single most important factor in sustainability is the ability to maintain profitability even though professional management and appropriate prudential regulation also play important roles. Outreach measures include the number of persons the system reaches terms of geographic coverage, sectoral coverage, gender, etc.

4.2 Rural Bank Industry

The rural banking industry, both conventional and Syariah, has shown impressive growth. From 2000 to 2003, the total assets of the BPR industry (comprising 2,141 units) grew by 39% from IDR4.7 trillion to IDR12.6 trillion, third party funds rose by 42% from IDR3.1 trillion to IDR8.9 trillion and loans increase by 35% from IDR3.6 trillion to IDR8.9 trillion. Loan growth was

3. Dr. Detlev Holloh in his Microfinance Institutions Study states that BMT is a non-bank saving and credit institutions based on Syariah Principles and its term expresses the BMT's social and business mission.

accompanied by improved loan quality as showed in a declining NPL ratio from 16% in 2000 to 8% in 2003. The NPL has continued to perform well as of the third quarter of 2004 indicating the sound operation of the bank intermediary function as well as rising public confidence and promising prospect of rural banks.

Rural banks established to serve the needs of MSMEs particularly for micro enterprises, is significant as shown by the number of clients served. As of September 2004, debtors counted for more than 2.1 million while depositors numbered more than 5.6 million.

4.3 BRI Unit

It is important to note the role of the Government Specialised Bank, Bank Rakyat Indonesia (BRI), is concentrated on rural operational banking. Based on an ambitious experiment in economic development, the Government in 1984 set out to transform 3,600 rural branches of BRI from highly bureaucratised, heavily subsidised conduits for agricultural credit into self-sustaining, profitable commercial financial intermediaries. Later on, these rural branches successfully spearheaded credit channeling to the impoverished rural areas.

The BRI Unit System has fulfilled and even surpassed the most optimistic predictions of what might be accomplished. In 1984 when the experiment began, the BRI Unit System lost more than USD24 million but in 1989 the System earned a profit of more than USD 25 million. From 1984 to 1990, approximately 7.9 million loans were extended by the BRI Unit. 115,000 loans are extended each month with a value of USD 50 million. The average loan size is currently USD 279. The system is, for all practical purposes, fully self-sustaining without any remaining external subsidy. By any standards, this has been a remarkable accomplishment even at the very early stage.

The success of the BRI Unit System has implications for a broad array of development issues such as financial policy, rural credit, micro enterprise, donor cooperation, and technical assistance. The lesson we learned is that the approach to supporting MSMEs development cannot merely rely on highly subsidised loans and top down initiatives but that the commercial approach is the best way to drive MFIs. The shift to the commercial banking approach reflected a consistent will to achieve three basic objectives, which are to move towards a predominantly market-based financial system, to provide effective protection so that the general public could benefit from the services offered by the financial system and to

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build a financial system that would support the stable, healthy growth of national economy.

5. Conclusion and Policy Recommendation

5.1 Conclusion

In summary, over the decades, the role of BI in promoting MSMEs has shifted from a developmental role, characterised by the extension of financial assistance, to a promotional one which is a more “hands-off” approach directed at strengthening and developing MSMEs through achieving a sound and sustainable banking system. The main policies of BI are for creating a conducive environment for financial institutions to improve their services as financial intermediaries, through creating a sound banking structure, providing a favourable investment climate by maintaining a stable macro economic condition, providing technical assistance, supporting the establishment of credit bureau and credit guarantee institutions and coordinating with the Government to mitigate risks in real sector.

On micro finance, Bank Indonesia and high level officials from the Ministry of Finance and other authorities have agreed to work coherently towards establishing a conducive environment for commercially-oriented microfinance such as liberalising interest rates and enabling deposit-taking as well as non-collateralised lending to facilitate institutional sustainability, deregulating market entry barriers to foster competition, and providing appropriate mechanisms for the exit of unsuccessful institutions. Furthermore, Bank Indonesia will work towards market orientation as interest rate subsidies will erode institutional sustainability and undermine deposit mobilisation.

In term of the PR industry, Bank Indonesia is also consistently developing the industry to increase its competitiveness by means of strengthening the linkage programme, simplifying BPRs branching process and facilitating the establishment of BPRs joint services facility. This is consistent with the Indonesian Banking Architecture, a programme to reinforce the structure of the national banking system in line with Bank Indonesia’s role in regulation, institutional development, capacity building as well as technical assistance.

5.2 Policy Recommendation

Although BI is strongly committed in promoting the development of MSMEs, it cannot act alone but instead must work and cooperate with all parties concerned including the Government (central and regional Governments), banking institutions and the MSMEs themselves. Each party should understand its role and organize themselves in the development effort to accelerate economic growth as the ultimate goal.

In the future, the role of Bank Indonesia in developing MSMEs will be via technical assistance and establishing SPMCs across provinces, and promoting the intermediary function of financial institutions. The measures shall emphasise on the development of financial institutions serving MSMEs and capacity building of MSMEs. Bank Indonesia shall also undertake competent research and survey on MSMEs, both in terms of policy foundation as well as policy development. Based on these quality research and surveys, Bank Indonesia will actively and continuously provide advocacies and recommendations to stakeholders, particularly the Government and banking society regarding the best practices on MSMEs development.

To effectively fill the financing gap for micro enterprises, MFIs have enormous potential to serve the needs of this segment. However, as most of MFIs are neither banks nor cooperatives and hence do not have legal basis to collect funds from the public to enhance services, a national policy on microfinance will be needed to provide the necessary legislation to strengthen the microfinance industry in Indonesia and alleviate poverty.

The Central Bank will also promote cost-effective and efficient ways to regulate and supervise microfinance institutions to protect small savers and create a level playing field among deposit taking institutions. The strategy to develop MFIs for poverty alleviation is in line with one of three strategies (triple strategy) that will carry out by the new Government, which is a strategy of “pro growth, pro employment and pro poor”⁴.

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MSMEs BANK LENDING IN INDONESIA

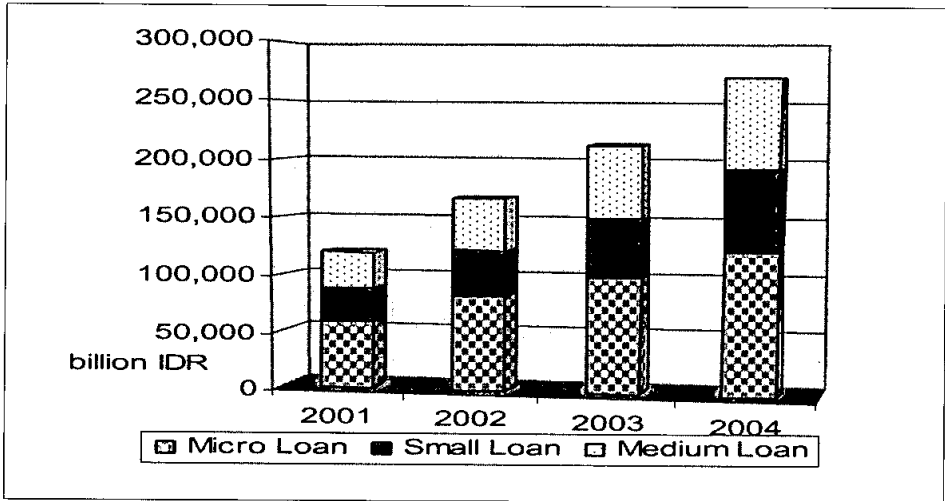
For years, the Government and Bank Indonesia have supported lending to MSMEs by providing credit programmes and the provision of quota for MSMEs lending by commercial banks. As noted, since the enactment of Bank Indonesia Act No. 23 of 1999, the policies have moved to more market based approach and therefore financing for MSMEs are provided mostly by commercial banks. MSMEs require credit from commercial bank because they have limited capital but the access to credit has been limited. Data on MSMEs shows that there are 18 million MSMEs accounts representing 42% of existing MSMEs meaning that 58% of this sector has yet to have access to banking facilities. One study from Akatiga⁵ reported that from a sample of MSMEs with legal status, only 32% have bank loans. However, during the last few years, commercial bank loans to MSMEs show an upward trend.

At the end of 2001, outstanding loans to MSMEs⁶ was 33.4% of total bank loans, while at the end of 2004, it has increased to 50.5%. The annual growth rate of MSMEs loans has persistently been higher than that for total bank loans. For instance, the growth rate of MSMEs loans in 2002 was 35.1%, while the growth rate of bank loans was 14.4%. In 2004, the rate is 32.5% compared with 27.3%. Of the outstanding MSMEs loans in 2004 amounting to IDR282,666 billion, 45.2% were loans to micro scale enterprises, while 25.6% were to small scale enterprises and 29.2% were to medium scale enterprises. The proportion has not changed much during the last four years. The average loan size of MSMEs has increased slightly from IDR10 million (USD1000) in 2001 to IDR15 million (USD1500) in 2004. However, taking into account the inflation rate over the years, the average loan size could be assumed to be more or less unchanged.

5. A private research institution focusing on MSMEs.

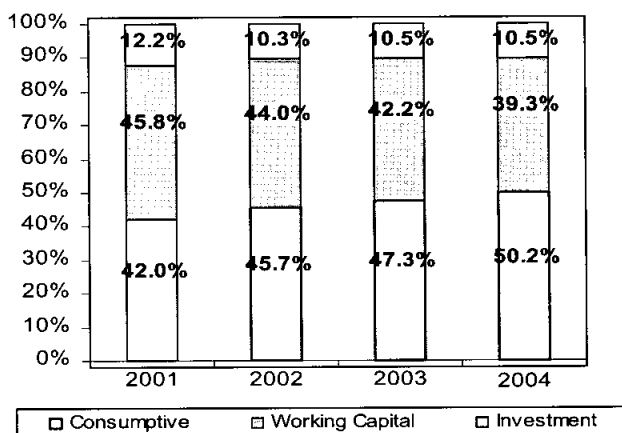
6. The definition for MSMEs loans here is based on the loan size. Consequently, there is a possibility of bias in interpreting data since the large businesses may be taking out multiple small loans and the data includes also consumer loans. Given the lack of data on underlying business size of the borrower, we consider this is currently the best approach to analyse the trend in MSMEs lending.

Figure 3.6
MSMEs Bank Lending by Loan Size



By type of loans, the data (Figure 3.7) shows that by the end of 2004, most of MSMEs loans are for consumption purposes (50.5%), while 39.4% are for working capital and 10.1% for investment purposes. These proportions have not changed since 2001. The consumption loans are not merely consumer loans as seen from a survey of commercial banks which revealed that banks have difficulties in classifying loans for the informal sector. For example, a loan for purchasing a motor bicycle for local transportation is classified as for consumption loans and it therefore a challenge for Bank Indonesia to construct a bank report system that is able classify the types of loans properly.

Figure 3.7
Proportion of MSMEs Loans by Purpose

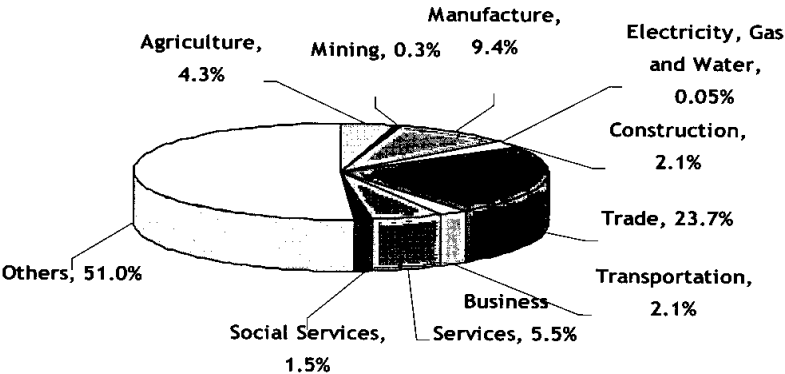


Examining the trend of MSMEs loan according to bank categories, there has been a remarkable change in the categories of banks extending loans to MSMEs. At the end of 2001, it was the state owned banks which dominated the MSMEs market (39.8%) followed by foreign exchange private national banks (34.2%). By the end of 2004, the foreign exchange private national banks surpassed the state owned banks by capturing 41.7% of MSMEs market. This is because the banks have begun to recognise that MSMEs were resilient during the crisis and their loans performed very well as indicated by low NPLs (3.4%) compared to NPLs of commercial bank loans as a whole (4.5%). Looking at the type of loans extended by each bank category, it is interesting to note that the State owned banks mostly lent for consumption purposes while the foreign exchange private national banks lent more for working capital, showing a positive trend in MSMEs lending. The private national banks are expected to become the future key players in MSMEs market with some showing keen interest in MSMEs financing such as Bank Danamon (one of the large banks in the country) which has set up over 2000 micro credit special units (called Danamon save and loan) serving the micro clients. If successful, it will be followed by other banks.

By economic sector, the biggest portion of MSMEs lending goes to the informal sector as reflected by 'Other' sector (51%). This sector is assumed to be a blend of consumption lending and other economic activities which are not captured by the other nine defined sector. This assumption is confirmed by the internal composition of MSMEs loans of this sector, which is dominated by loans

to micro-scale enterprise (70%). The second biggest portion of MSMEs lending is utilised for trade purposes (23.7%). This proportion of MSMEs lending by economic sector has not changed much over the last four years.

Figure 3.8
MSMEs Bank Lending by Economy Sector



PARTICIPANTS OF THE MICROFINANCE SECTOR IN INDONESIA

Institutional Microfinance	Programme Microfinance	Individual Microcredit
Commercial banks (mainly BRI Units) R&S: Bank Indonesia Level: District and sub-district Rural banks (BPRs) R&S: Bank Indonesia Level: sub-district	Microfinance system building ▪ Linkage project (PHBK) ▪ Microcredit project (PKM) Commercial relations between banks, LDKP, NGOs, self-help groups, and individual customers. Strengthening small financial institutions.	
Rural Credit Fund Institution (LDKP) R&S: Provincial Governments Level: sub-district and village Village Credit Institution (BKD) R&S: BRI on behalf on Bank Indonesia* Level: sub-district and village Village Saving and Credit Units (UED-SP) R&S: Ministry of Home Affairs Level: village R&S: Ministry of Finance Level: District and sub-district	Poverty alleviation programmes ▪ Rural income generation project (RIGP/P4K): commercial relations between BRI and small farmers groups ▪ Family welfare income generation project (UPPKS): subsidised credit to family welfare groups. ▪ Sub-district development Project (PKK): grant based revolving fund for sub-district financial management units. ▪ Urban Poverty Alleviation Project (P2KP): grant based revolving fund for village level financial management units. ▪ Similar regional projects	Moneylenders Traders Shopkeepers Neighbors Family members
▪ Saving and Credit Cooperatives (KSP)** ▪ Saving and Credit Units (USP) of Coop R&S: Ministry of Cooperatives Level: District and sub-district ▪ Saving and Credit Service points (TPSP) R&S: Ministry of Cooperatives and BRI Level: Village	Crisis-related channeling of funds ▪ Social safety net, i.e. PDM-DKE: grants to village and community groups ▪ community recovery programs: grants channeled through NGOs ▪ Fuel subsidies converted to funds channeled through cooperatives and microfinance institutions	
R&S: Non Regulated, apex organizations Level: Village	NGO Microcredit programmes	

R&S: Regulation and Supervision

Level: Location and predominant area of operation

* Note: BKD are recognised but not regulated as banks

** Include institutions such as credit unions, BMT that obtained the legal status of cooperatives

*** Include credit unions, BMT and other cooperative-like association, which do not have a clear legal status and operate as financial intermediaries; does not include credit channeling groups

Source: Detlev Holloh, Microfinance Institution Study, ProFI: 2001

CHAPTER 4

FINANCIAL SUPPORT FOR SMALL AND MEDIUM ENTERPRISES IN KOREA

**by
Chuljae Lim¹**

1. Introduction

In Korea, financial and tax policies have been put in place to protect and foster SMEs since 1960. Consequently, SMEs have played a central role in domestic production, employment, technical innovation and diffusion. Moreover, the contribution of SMEs to the domestic economy has served to provide dynamic growth momentum for the Korean economy and form industrial bases. What is more, SMEs and venture start-ups played a central role in turning the economy round following the Currency Crisis. Recently, however, their competitiveness has suffered as is evident from a comparison of the performance of large enterprises and SMEs. What is more, a rising number of SMEs have been in financial difficulties despite of quantitative expansion of financial support system for SMEs.

Meanwhile, The Bank of Korea, in support of financing sources for SMEs, supplied commercial banks with low interest funds in order to encourage their lending of funds to SMEs, and established rules such as requiring commercial banks to extend loans to SMEs above prescribed ratio of their loan increment. Since 1990, however, due to globalisation and the financial deregulations, The Bank of Korea has abandoned direct regulation and quantitative support in favour of indirect support including the 'Aggregate Credit Ceiling Loan' and the 'Loan Ratio Guideline' for SMEs, which were originally constituted as the 'Loan Ratio Requirement' for SMEs.

The paper provides a brief overview of current status of SMEs and recent policies of financial support for SMEs in Korea, and explores the implications on policies and the role of The Bank of Korea for financial support for SMEs.

1. Mr. Chuljae Lim is Senior Economist of the Monetary Studies Team at the Institute for Monetary & Economic Research of The Bank of Korea.

2. Current Status of SMEs in Korea

2.1 Definition of SMEs

The 'Framework Act on Small and Medium Enterprises' defines SMEs in terms of the number of employees and the amount of capital or of sales for every industry. In case of the manufacturing industry, SMEs are defined as companies which employ fewer than 300 persons or whose paid-in-capital amounts to less than 8 billion won. Nevertheless, no enterprise employing more than 1000 persons or whose total assets were more than 500 billion won would be classified as an SME.

Although an enterprise may satisfy the above conditions, it would still not be classified as an SME unless independence criteria for ownership and management are satisfied: an SME should not be a member of one of the nation's largest interlinked business groups that are subject to the regulation on cross investment (until the end of March 2005). An SME should also comply with the criterion that no firm, whose total assets exceed 500 billion won, should own 30% or more of its total shares (as of April 2005).

Among SMEs, those with fewer than 10 employees are classified as 'small enterprises', while those operate in the mining, manufacturing, construction and transportation sectors are classified as 'small enterprises' if they employ fewer than 50 persons.

Table 4.1
Definition of SMEs: Classification by Employees, Paid-In-Capital or Sales Amount

Industries	Standardised Industry Classification	Conditions
1. Manufacturing	D	Fewer than 300 workers or less than 8 billion won in Paid-In-Capital
2. Mining Construction Transport	C F 60~62	Fewer than 300 workers or less than 3 billion won in Paid-In-Capital
3. Retail Sales in Non-specialized Large Stores Hotels Computer and Related Activities	5211 55111 72	Fewer than 300 workers or sales of less than 30 billion won
4. Growing of Crop Seeds and Nursery Products Fishery Electricity, Gas and Water Supply Wholesale of Solid, Liquid and Gaseous Fuel and Related Products Condominiums Supporting and Auxiliary Transport Activities; Activities of Travel Agencies Post and Telecommunications Engineering Services Hospital Activities Motion Picture Industries Broadcasting	01123 B E 5171 55113 63 64 7432 8511 871 872	Fewer than 200 workers or sales of less than 20 billion won
5. Wholesale Trade and Commission Trade, except Motor Vehicles and Motorcycles Retail Sales via Mail Order Houses Door to Door Retailing of Merchandise Renting of Machinery and Equipment Professional, Scientific and Technical Services Business Support Services Performing Arts Industries News Agency Activities Amusement and Theme Park Operation Sewage and Refusal Disposal, Sanitation and Similar Activities	51 5281 52893 712 74 75 873 881 88992 90	Fewer than 100 workers or sales of less than 10 billion won
6. Others		Fewer than 50 workers or sales of less than 5 billion won

Note: One US dollar is approximately 1,050 won as of the end of 2004.

Sources: The 'Framework Act on Small and Medium Enterprises'

2.2 Contribution of SMEs to the Economy

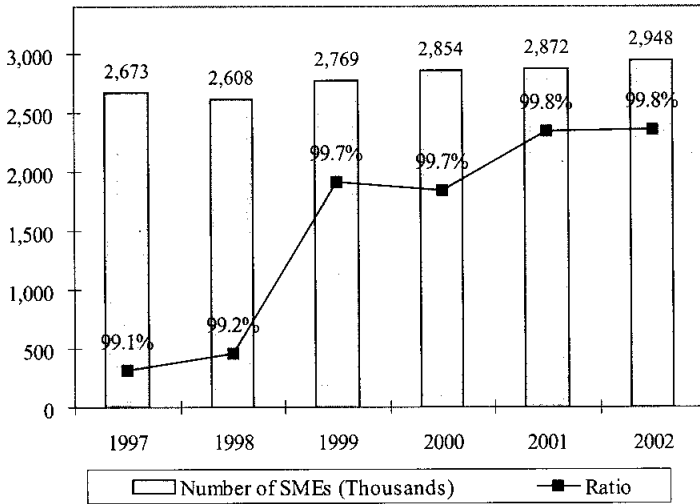
Socially and economically, SMEs are considered to make up the most important element of the Korean national economy since there was 2.95 million SMEs in 2003 -99.8% of total enterprises - and they employ 10.39 million workers², accounting for 86.7% of total employment. Following the Currency Crisis, the number of SMEs shrank temporarily only to pick up again later, as may be seen from Figure 4.1.

Figures 4.2 and 4.3 also show that the increase in employment at SMEs has made up for the decrease in that at the large enterprises since the Currency Crisis. Although the number of employees at SMEs did shrink temporarily during the crisis, it shifted back to a positive growth trend afterwards, and SMEs' share in total employment has seen a constant solid increase even during the crisis. Moreover, from Figures 4.4 and 4.5, it can easily be seen that the production and the value added by SMEs³ have expanded rapidly each year, which means that their share in the domestic economy has been increasing remarkably.

Figure 4.6 shows that 35% of the total number of SMEs operate in the wholesale and retail trade industry, followed by 24% in the accommodations and restaurants sector. In terms of the number of employees, the Manufacturing and Wholesale and Retail Trade sectors account for the biggest shares among the industries in which SMEs operate, as of 2002.

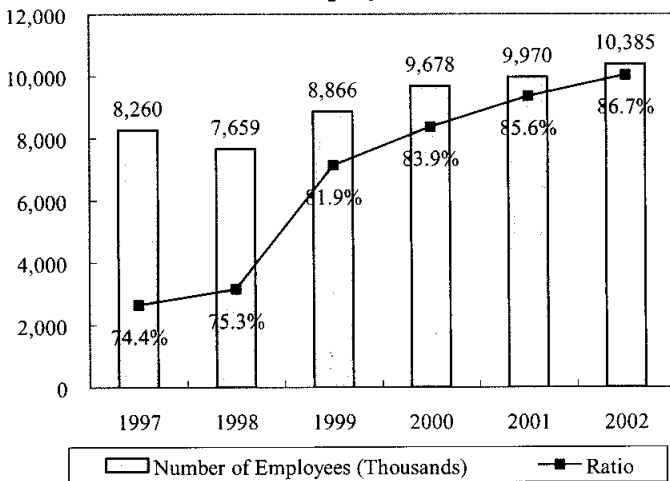
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2. Report on the Census on Basic Characteristics of Establishments includes all the establishments with more than one worker.
 3. Report on Mining and Manufacturing Survey covers all mining and manufacturing establishments with five or more workers

Figure 4.1
Number of SMEs



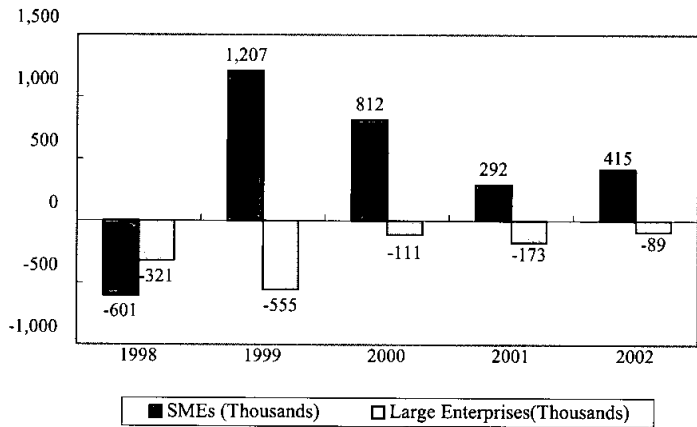
Source: KNSO, Report on the Census on Basic Characteristics of Establishments

Figure 4.2
Number of Employees in SMEs



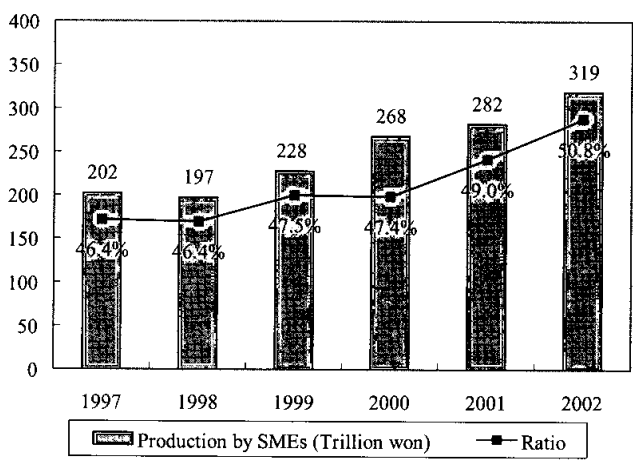
Source: KNSO, Report on the Census on Basic Characteristics of Establishments

Figure 4.3
Net Increment of Employees



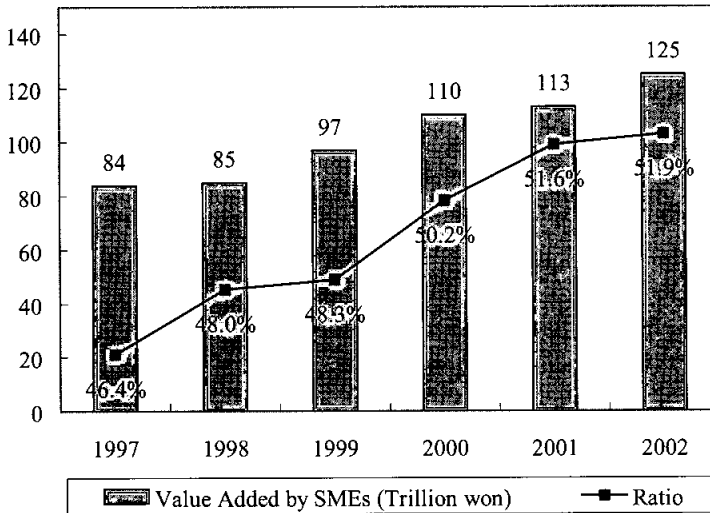
Source: KNSO, Report on the Census on Basic Characteristics of Establishments

Figure 4.4
Production by SMEs



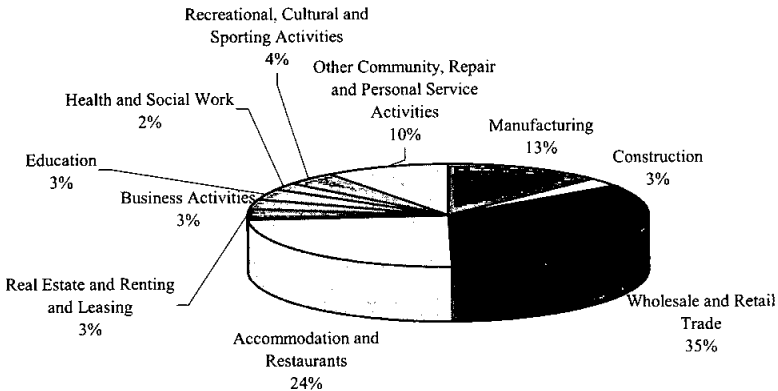
Source: KNSO, Report on Mining and Manufacturing Survey

Figure 4.5
Value Added by SMEs



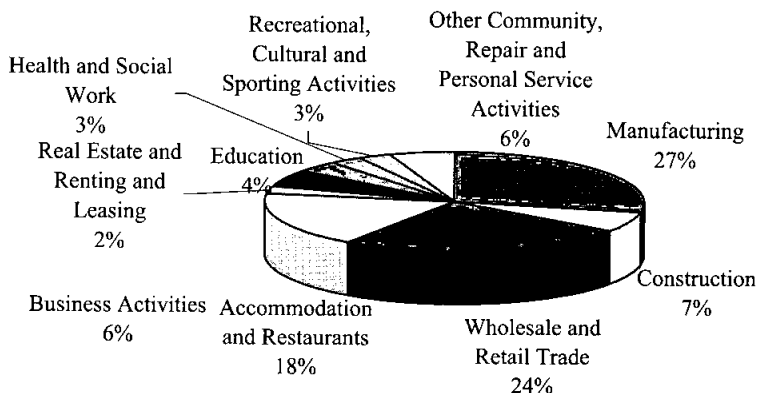
Source: KNSO, Report on Mining and Manufacturing Survey

Figure 4.6
Number of SMEs by Industry (2002)



Source: KNSO, Report on Mining and Manufacturing Survey

Figure 4.7
Number of Employees in SMEs by Industry (2002)



Source: KNSO, *Report on Mining and Manufacturing Survey*

2.3 Competitiveness of SMEs

However, despite their growing importance in the domestic economy, the difference between large enterprises and SMEs has widened in terms of profitability, financial structure, growth potential, and fund raising capability. Table 4.2 shows that the profitability of large enterprises operating in manufacturing has seen an increase on every measure, while that of SMEs has deteriorated further.

Table 4.2
Profitability of Large Enterprises and SMEs

(%)

	Operating Income to Sales ¹⁾		Ordinary Income to Sales ²⁾		Interest Coverage Ratio ³⁾	
	2002	2003	2002	2003	2002	2003
Large enterprises	7.5	8.2	5.4	6.0	255.4	428.8
SMEs	5.3	4.6	3.4	2.5	273.7	255.9
All enterprises in Manufacturing	6.7	6.9	4.7	4.7	260.3	367.1

Notes: 1) Operating Income / Sales

2) Ordinary Income / Sales

3) Operating Income / Interest Expenses

Source: The Bank of Korea, Financial Statement Analysis

Table 4.3 also shows that large enterprises have seen an improvement in their financial structure since their debt ratio and reliance on borrowings have declined and their net capital ratio has increased, while the figures for SMEs are rather dismal and their reliance on borrowings has risen. SMEs have also seen a big drop in their rate of sales growth compared to large enterprises, while they have to pay more to borrow from banks in terms of loan interest rates.

Table 4.3
Financial Structure of Large Enterprises and SMEs

(%)

	Debt Ratio ¹⁾		Total Borrowings and Bonds Payable to Total Assets ²⁾		Stockholders' Equity to Total Assets ³⁾	
	2002	2003	2002	2003	2002	2003
Large enterprises	128.9	113.5	31.2	25.9	43.7	46.8
SMEs	152.1	147.6	32.9	33.5	39.7	40.4
All Enterprises in Manufacturing	135.4	123.4	31.7	28.3	42.5	44.8

Notes: 1) Liabilities / Stockholders' Equity

2) (Total Borrowings + Bonds Payable) / Total Assets

3) Stockholders' Equity / Total Assets

Source: The Bank of Korea, Financial Statement Analysis

Table 4.4
Sales Growth of Large Enterprises and SMEs

(%)

	2001	2002	2003
Large enterprises	0.8	7.2	6.6
SMEs	3.4	10.2	5.4
All Enterprises in Manufacturing	1.7	8.3	6.1

Source: The Bank of Korea, Financial Statement Analysis

Table 4.5
Loan Rates for Large Enterprises and SMEs¹⁾

	(Annual %)			
	2000	2001	2002	2003
Large enterprises	8.75	7.69	6.17	5.98
SMEs	7.95	7.38	6.56	6.21
Enterprises Loan ²⁾	8.18	7.49	6.50	6.17

Note: 1) Weighted averages of interest rates on loans and discounts (newly extended)

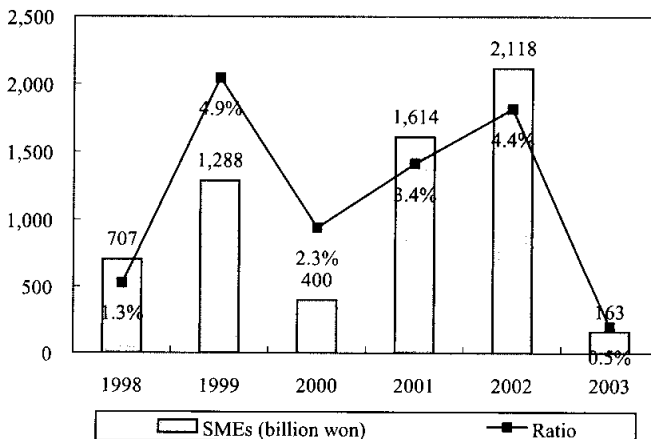
2) Excludes overdrafts and other revolving loans

Source: The Bank of Korea, Monthly Bulletin

2.4 Sources of Financing for SMEs

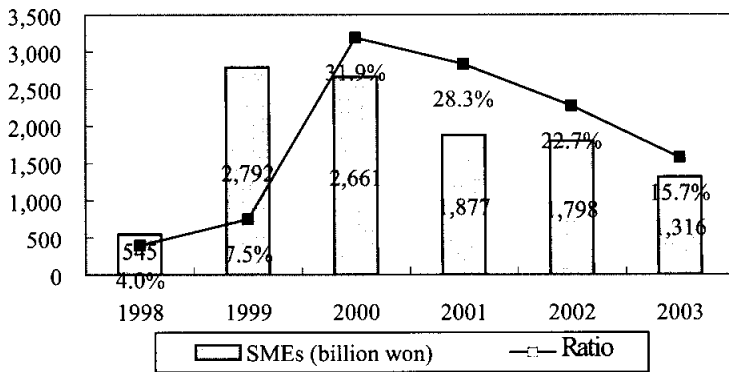
The share of SMEs in financing from the bond and stock markets is very small. Figure 4.8 and 4.9 show that share of SMEs in the stock market jumped up to 31.9% in 2000, largely due to the bullishness of KOSDAQ index from 1999, only to gradually decrease again due to their subsequent bearishness. Meanwhile the weight of SMEs in the bond market has been negligible over the same period.

Figure 4.8
Share of SMEs in the Bond Market



Source: Korea Federation of Small and Medium Business, Statistics on SMEs

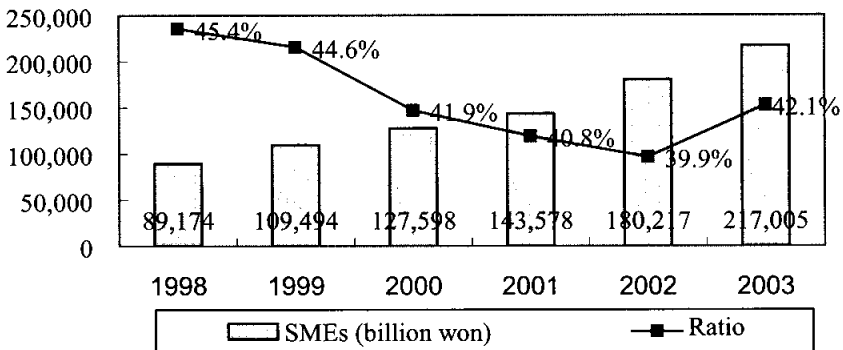
Figure 4.9
Share of SMEs in the Stock Market



Source: Korea Federation of Small and Medium Business, Statistics on SMEs

In the loan market, the share of SMEs has been increasing in terms of the amount of funds loaned although they have been losing market share in terms of the ratio of loans to SMEs to total loans made. The reason is that commercial banks emphasised lending to households in order to reduce loan risk after the Currency Crisis, which accounts for the reduction in the loan ratio of SMEs to 39.9% in 2002. Nevertheless, the ratio saw a small rebound in 2003 because banks became wary of lending to households owing to the rising credit risk involved.

Figure 4.10
Share of SMEs in Loan Market



Source: Korea Federation of Small and Medium Business, Statistics on SMEs

Recent surveys regarding the financing methods of SMEs show that they mainly raise their financial resources through banks, which account for 73.2% of the total. Government funds and non-financial intermediaries make up 19.4% and 3.4% of total sources respectively, while the bond and stock each represent only 0.5%.

Table 4.6
Share of Financing Methods of SMEs

(%)

	Banks	Policy Funds	Non-banks	Stocks	Corporate Bonds	Private Bonds	Foreign
2002	70.7	23.4	3.1	0.3	0.2	0.2	1.9
2003	73.2	19.4	3.4	0.5	0.5	2.1	0.9

Source: Korea Federation of Small and Medium Business, Survey on Difficulties and Bottleneck for SME

The surveys also show that the biggest problems for SMEs in financing through banks are represented by the practice of making loans based on credit certificates and collateral. The relatively high loan rates, the credit screening process, and difficulties in accessing credit loans are also among the problems that the SMEs surveyed encountered.

Table 4.7
Problems in Financing through Banks

(%)

	2002	2003
Collateral Requirements	17.5	20.4
Loans mainly made based on credit guarantees	24.5	22.2
Being required to deposit a certain amount of money	3.9	4.2
High loan rates	9.9	12.7
Difficulty in borrowing when most needed	5.9	6.8
Complicated process when borrowing	8.0	10.9
Difficulty in discounting bills	1.3	1.6
Difficulty in borrowing on credit	18.4	12.6
Sales amount plays the central role in borrowing	10.6	8.6

Source: Korea Federation of Small and Medium Business, Survey on Difficulties and Bottlenecks for SMEs

3. Recent Policies of Financial Support for SMEs in Korea

3.1 Changes in General Policies for SMEs

As Table 4.8 shows, today's policies for SMEs are focused upon improving their competitiveness rather than incubating and fostering them in the early stages. Although previous policies toward SMEs helped build a basis for their quantitative growth and enlargement of their production capacity, they failed to build up their competitiveness or encourage their development of technology. Because earlier policies were carried out regardless of SMEs' type or level of technology, focusing on presumed average SMEs, those with advanced technology or growth potential were unable to obtain adequate assistance. In addition, the emphasis on direct measure did not leave room for enhancing the competitiveness of SMEs via competition among them as well as cooperation between SMEs and large enterprises.

Moreover, the implementation of policies focused on venture start-ups after Currency Crisis brought about a backlash- what is termed the 'venture bubble' - due to excessive competition among government's departments in pursuit of expansion of the number of enterprises, and supporting policies were put in place only recently, long after the 'venture bubble' burst.

3.2 Financial Support Policy for SMEs

Financial support policy for SMEs has been in place in order to provide SMEs, which suffer from lack of credit and collateral, with enhanced access to financial resources as well as to reduce their fund-raising costs. This overall support policy mainly draws resources from two channels: funds from The Bank of Korea and commercial banks, and a government fund whose operation is entrusted to Small Business Corporation or financial institutions.

3.2.1 The Bank of Korea's Financial Support Policy for SMEs

The primary means employed by The Bank of Korea in supporting SMEs by lessening their financing costs is the Aggregate Credit Ceiling Loan, which provides banks with funds to be lent to SMEs at low interest rates. To supply banks with such funds, The Bank of Korea assesses banks' performance in extending 'corporate procurement loan,' 'electronically processed secured receivable loan,' 'commercial bills,' 'loans for foreign trade' and 'loans for the

Table 4.8
Changes in General Policies for SMEs

1960s: Initiation of SMEs Policies

- Drafting of legal framework for the support and fostering of SMEs
- SMEs Cooperative Act(61), Preferential Contract for SMEs(65), Loan Ratio Requirement for SMEs(65), Framework Act on Small and Medium Enterprises (66)



**1970s~1980s: Protection and Fostering of SMEs
by Designation of Reserved Business Areas**

- SMEs started to play a central role in producing and supplying parts and components following the launch of policies to promote the heavy and chemical industries
- Business Areas Reserved for SMEs (79), Credit Guarantee Fund (76), Small Business Corporation (79), and Korea Technology Credit Guarantee Fund (89)



1990s: Supporting Technological Innovation of SMEs

- Due to launch of WTO (95), SMEs policies have been modified to enhance globalization and competition
- End of Reserved Business Areas for SMEs (94), Introduction of Aggregate Credit Ceiling Loans (95), Reduction of Items for which Preferential Contract for SMEs apply (95), Act on Special Measures for the Structural Improvement of SMEs and Vitalization of Customary Markets (95), Small and Medium Business Administration (96)



**After Currency Crisis: Promoting Venture
Start-ups and Enhancing Competitiveness**

- Drawing up framework for strengthening fragile sectors such as small enterprises with an emphasis on venture start-ups
- KOSDAQ (96), Relaxation of conditions for KOSDAQ regulation and support of SMEs via tax policies
- Act on Special Measures for the Promotion of Venture Business (97), Act on Special Measures for Supporting the Small-scale Business (97), Act on Assisting Women Enterprises(99), Loan Ratio Guideline for SMEs (2000)

Source: Presidential Commission on Small and Medium Enterprises, White Paper on Small and Medium Enterprises

production of basic materials and parts.' In addition, it guides banks to expand their lending to SMEs through various devices such as Loan Ratio Guideline.

(i) Aggregate Credit Ceiling Loan

The Aggregate Credit Ceiling Loan was first initiated in March 1994, for the purpose of inducing banks to supply SMEs as well as export and regionally oriented businesses with the financial resources needed. For this purpose, the financial support policy involving automatic rediscounts was shifted over to the fiscal account, while an aggregate loan ceiling was set for 'commercial bill rediscounts,' 'loans for foreign trade' and 'regional SME funds,' which are operated under this Aggregate Credit Ceiling Loan. Table 4.9 shows that loans made under this system remain at 9 trillion won. Since such loans bear relatively low interest rates, 2% per year, they are the main resources that banks draw on when making loans to SMEs.

Table 4.9
Aggregate Credit Ceiling Loans

(Billion won)

1997	1998	1999	2000	2001	2002	2003	Oct. 2004
4,266	6,362	7,597	7,360	10,710	7,591	9,455	8,960

Sources: The Bank of Korea, Monthly Bulletin

Under this system, The Bank of Korea allocates funds to banks according to their loan performance toward SMEs, and regional branches of The Bank of Korea also allocate funds to local banks, taking into account the economic situation in the region where they operate. Credit ceilings for individual banks are set primarily according to their performance in extending 'corporate procurement loans,' 'electronically processed loans against credit receivables,' 'commercial bills rediscounts,' 'loans for foreign trade' and 'loans for production of basic materials and parts.' The credit ceiling of regional branches of The Bank of Korea are set by the directors of those branches who closely monitor banks' efforts to make loans to local SMEs as well as the economic situation in their districts. The aggregate credit ceiling is set quarterly by the Monetary Policy Committee in consideration of the economic situation and financial market sentiment.

(ii) Loan Ratio Guideline for SMEs

The Loan Ratio Guideline for SMEs⁴ was established on April 1965 to support them by enhancing their opportunities for loans and finance, since they would otherwise suffer prejudice in financing through banks due to their inability to meet criteria for banking loans or collateral. In the beginning, all commercial banks were required to provide SMEs with more than 30% of the increment in their Korean won denominated loans⁵. After December 1976, the loan ratio guidelines were differentiated to reflect differences in the financing and fund management ability of commercial banks.

Table 4.10
Loan Ratio Guidelines for SMEs

(%)

	Apr. 1965	Dec. 1976	Oct. 1980	Mar. 1985	Apr. 1986	Aug. 1986	Feb. 1992	May 1994	July 1997	Feb. 1999
Nation-wide Commercial Banks	30	30	35	35	35	35	45	45	45	45
Local Banks	30	40	55	55	80	80	80	70	60	60
Foreign Bank Branches In Korea	-	-	-	25	25	35 (25)	35 (25)	35 (25)	35 (25)	35 (25)

Note: Figures in parentheses are for Branches of Foreign Banks not taking out Aggregate Credit Ceiling Loans

Source: The Bank of Korea

4. Although originally established as Requirement Loan Ratio System for SMEs, it was modified in June 2000 because of its possible implication of the direct regulation of commercial banks' fund management by the central bank.
5. Applied to branches of foreign banks from March 1985(more than 25%)

In order to induce commercial banks to observe the loan ratio for SMEs, The Bank of Korea deducts a certain amount from Aggregate Credit Ceiling Loans to those banks that do not keep this ratio, providing the amount deducted to banks that comply with it.

3.2.2 Government's Financial Support Policy for SMEs

Insofar as it is not in breach of market principles, the government conducts various policies in order to enhance competitiveness and technological innovation on the part of SMEs as follows:

- helps SMEs easily access financial resources by lending public funds;
- supports high tech SMEs in financing through the bond and stock markets for the purpose of investment;
- provides credit guarantee services to eligible SMEs with low credit; and
- conducts tax policies that favor SMEs' technological innovation and competitiveness.

The Credit Guarantee System was also initiated in order to provide ample opportunities for SMEs lacking suitable collateral; three major guarantee funds, namely, Credit Guarantee Fund, Technology Credit Guarantee Fund and Regional Guarantee Fund, deal with general SMEs, venture start-ups and local small businesses respectively.

Table 4.11
Credit Guarantee Provided by Major Funds
and Government Contribution to Them

(Trillion won)

	1998	1999	2000	2001	2002	2003
Credit Guarantees	33.1	31.4	33.7	46.8	40.7	44.3
Government Contribution to Fund	4.4	1.4	0.8	1.5	0.8	1.0

Source: Small and Medium Business Administration, Statistics on SMEs

The government also provides funds directly to SMEs via the Small Business Corporation while making up the interest payment that the Small Business Corporation Fund is obliged to pay when issuing bonds in support of SMEs.

Table 4.12
Loans Provided by Government

(Billion won)

	1998	1999	2000	2001	2002	2003
Government Loans	2,487	3,168	2,374	2,627	2,645	3,091
Interest Margin Payment	101	919	89	30	128	56

Source: Small and Medium Business Administration, Statistics on SMEs

In addition, the government has a stake in the Venture Capital Fund for SMEs, which assists SMEs in launching into business. Meanwhile, the Industrial Bank of Korea, originally founded to assist SMEs, operates Special Funds for SMEs including Special Fund against Bankruptcy, and Small Enterprises Fund.

Table 4.13
SME-related Investment of Government

(Billion won)

	1998	1999	2000	2001	2002	2003
Investment in Venture Capital Fund for SMEs	9	77	275	122	86	140

Source: Small and Medium Business Administration, Statistics on SMEs

3.3 Assessment of Financial Support Policy for SMEs

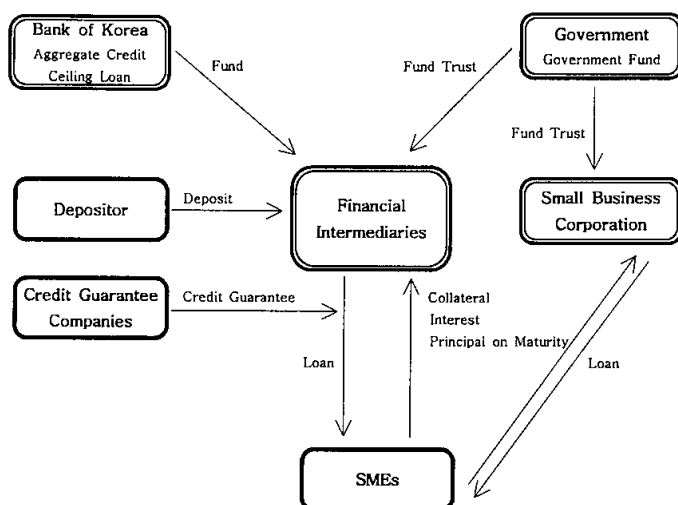
Although The Bank of Korea and government have played a major role in assisting SMEs, commercial banks have experienced considerable difficulty in meeting SMEs' needs:

- banks prefer short term loans against secure collateral while SMEs need long term loans based on credit;
- banks demand financial information such as sales amount from SMEs in order to make loans while SMEs favor loans based on their technology and potential; and
- banks are willing to lend to venture start-ups rather than invest in them due to high risk while venture enterprises consider investment the most appropriate method of financing.

Moreover, the policy brought about distortion and inefficiency in private financial markets because of the massive intervention involved, even though it did manage to expand financing opportunity for SMEs:

- it has been powerless to help SMEs without a certain record of historical financial information such as sales and profit;
- since financial support mainly concentrates on lending to SMEs rather than investing in them, periodic payment risk always exists in regard to SMEs, and banks cannot enjoy surplus profits from SMEs that they make loans to even when they succeed in business;
- because guarantee funds have taken on the task of screening SMEs applying for financial support, banks have not been able to develop their own capability for carrying out such evaluation, the consequence of which has been a seriously negative impact upon the expansion of credit to and investment in SMEs; and
- although an investment market for new technology start-ups including a venture capital market and KOSDAQ emerged rapidly helped by government policy after the Currency Crisis, the efficiency of resource allocation has been low, and moral hazard problems have dogged venture start-ups due to government intervention and the market's immaturity.

Figure 4.11
Flowchart for Financial Support for SMEs



4. Policy Recommendations for SMEs and the Role of the Bank of Korea

4.1 Policy Recommendations for SMEs

4.1.1 Support Based on Market Principles

Support for SMEs has shifted to an orientation toward market principles as against previous practices focused upon protecting and fostering SMEs. Nonetheless, deregulation as well as the simplification of official procedures for business license and lending are still needed in order to foster a favourable environment for SMEs; more indirect support initiatives inducing business realignment, upgrading management capabilities and boosting competitiveness of individual firms should then be put in place. Until recently, policies had been focused on inducing banks to give loans to SMEs in order to relieve their financial expenses. Therefore, SMEs have made little effort to build up their competitiveness, weakening the soundness of the financial situation of domestic banks.

Support in the early stage of the launch and incubation of small businesses are also required as the industrial structure becomes more advanced and the venture capital firms and private investor groups that assist new technology start-ups should sharpen their investment skills.

4.1.2 Transition from Quantitative to Qualitative Support

Policies for SMEs should change to enable them to induce the qualitative growth of SMEs rather than their quantitative orientation so far. For this purpose, policies for improving the innovation and competitiveness of SMEs should now be implemented, based on 'competition and cooperation' rather than the 'protecting and fostering' of the previous paradigm.

Although The Bank of Korea and government so far have taken various measures to assist SMEs, many are still in need of further funding. To relieve their chronic financial stress, qualitative policies focusing on increasing SMEs' access to financial resources must be put in place rather than quantitatively based policies emphasising expansion of the supply of funds.

In the same vein, the government needs to reinforce its support in providing management consulting to SMEs in order to increase their competitiveness because SMEs' weak capacity to compete is a main factor hindering banks from lending funds to them. Diversification of financial support is also needed that will induce venture capitalists or angel investors to take stakes in SMEs in order to stimulate start-ups as well as provide funds for firms adopting new technologies. Measures for the promotion of venture business should also be revised for this purpose by the year 2007, and the private investment markets including KOSDAQ, M&A and secondary markets should be deepened and broadened.

4.1.3 Long Term Integrated Plan for SMEs

In order to foster SMEs as the backbone of the Korean economy, the government unveiled a 'Comprehensive Plan for Enhancing the Competitiveness of SMEs' in July 2004, which sets out various measures to relieve SMEs' financial distress and strengthen their competitiveness. It selects 136 specific tasks in 9 areas classified according to type, growth stage and degree of cooperation between small and large enterprises. Responsibility for carrying out these selected tasks is assigned to 11 government agencies, namely, Small and Medium Business

Administration, the Ministry of Finance and Economy, the Ministry of Commerce, Industry and Energy, the Ministry of Labour, the Fair Trade Commission, the Financial Supervisory Commission, the Ministry of Construction and Transportation, the National Tax Service, the Ministry of Information and Communication, the Ministry of Planning and Budget, and the Ministry of Government Administration and Home Affairs.

The government also mapped out and began putting a package of measures, designed to revitalise the promotion of new technology start-ups with a focus on developing appropriate capital markets and infrastructure for such business, naming 2005 'the year of venture vitalisation'. The initiative lays stress on the differing roles of these elements in line with the stages of new technology start-ups' development; launch, development, and financial restructuring.

4.2 Role of the Bank of Korea in the Financial Support of SMEs

The role that The Bank of Korea has hitherto assumed to supporting SMEs has gradually declined in accordance with the shift in policy orientation toward promoting market principles. At the same time, the role of directly supporting SMEs has come to be assumed by fiscal funds. Consequently, The Bank of Korea has also changed its way of managing the Aggregate Credit Ceiling Loan and the Loan Ratio Guideline to embody market principles.

For example, it increases the credit allocation quota to banks whose ratio of loans to SMEs and ratio of loan rollovers for them are higher than those of other banks, thereby, stimulating the incentive for banks to expand their lending to SMEs. It also changed the Loan Ratio Requirement, dropping its mandatory nature, to the Loan Ratio Guideline, which relies on spontaneous cooperation of banks. This new system, however, bears much criticism from domestic banks and developed countries since it continues to stand in the way of optimisation of the management of their funds.

The Bank of Korea should assume the leading role in developing market friendly policies such as upgrading credit screening systems and strengthening management consulting in order to encourage financial institutions to allocate financial resources to SMEs efficiently without detracting from their profitability. Such policies would ameliorate current situation that banks operate in, because private banks face incomplete information about firms, and this situation becomes worse when banks are dealing with SMEs. It would be also worthwhile considering

the involvement of The Bank of Korea in the launch of a credit rating company specializing in SMEs and promotion of high yield bond market.

Meanwhile, in its policy decisions, the Monetary Policy Committee also takes into account the difficulties that SMEs face, largely due to protracted downturn of domestic demand and the heightened credit discrimination of financial institutions; twice in 2004 it lowered the rate on its Aggregate Credit Ceiling Loans (2.5%→2.25%→2.0%), thereby easing SMEs' financial expenses.

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Excerpt from Framework Act on Small and Medium Enterprises Act

Article 2 (Scope of Enterprise Owners)

- (1) A small and medium enterprise owner who is the object of the policy to foster small and medium enterprises (hereinafter referred to as the “small and medium enterprise policy”), shall be a person who operates an enterprises the scale of which is under such standards as determined by the Presidential Decree, and the substantial independence in the ownership and management of which conform to such criteria as determined by the Presidential Decree (hereinafter referred to as the “small and medium enterprise”), taking into consideration the specialty of the business category, number of the regular workers, scale of the assets, sales, etc.
- (2) Small and medium enterprises shall be classified into small enterprises and medium ones, under conditions as stipulated by the Presidential Decree.

Enforcement Decree

Articles 3 (Scope of Small and Medium Enterprise)

Small and medium enterprises as prescribed by Article 2 (1) of the Framework Act on Small and Medium Enterprises (hereinafter referred to as the “Act”) mean those satisfying all the standards of the following subparagraphs:

1. Any enterprise which satisfies the standards in the annexed Table 1 in terms of the business category of the main business run by the relevant enterprise, and the number of regular workers, the size of capital or turnover of the relevant enterprise. Nevertheless, an enterprise falling under any of the following subparagraphs shall be excluded:
 - (a) An Enterprise employing 1,000 or more regular workers; and
 - (b) An Enterprise that is a listed corporation or an Association-registered corporation as provided for in Article 2 of the Securities and Exchange Act and whose total amount of assets (referring to the total amount of assets indicated on the balance sheet as of the closing date of the immediately preceding business year) is 500 billion won or more.
2. An Enterprise that satisfies the standards in the annexed Table 2 in terms of the substantial independence of ownership and management.

Laws Related to SMEs

Korean laws relevant to SMEs consist of the Constitution, nine general laws, four special acts and other legislations.

Article 123 of “Constitution” provides for the protection and promotion of SMEs and the promotion of self-help organizations by the government.

The “Framework Act on Small and Medium Enterprises” stipulates the scope of SMEs, goals, the main directions of the supporting policies, regulations, etc. The scope and range of SMEs were partially revised to adjust to the changing economic environment in 1995.

The “Support for SMEs Establishment Act” stipulates various support systems for start-up companies like business incubators, indirect tax exemption and the like. Especially the “Act on Special Measures for the Promotion of Venture Business (enterprises)” brought into effect in 1997, sets out various support systems for fostering venture enterprises such as venture capital companies, limited-partnerships, start-up companies formed by universities or research institutes laboratories.

The “Act on Assisting Women Enterprise” provides a legal basis for a variety of active support programs to promote women’s start-ups, business management and general operations.

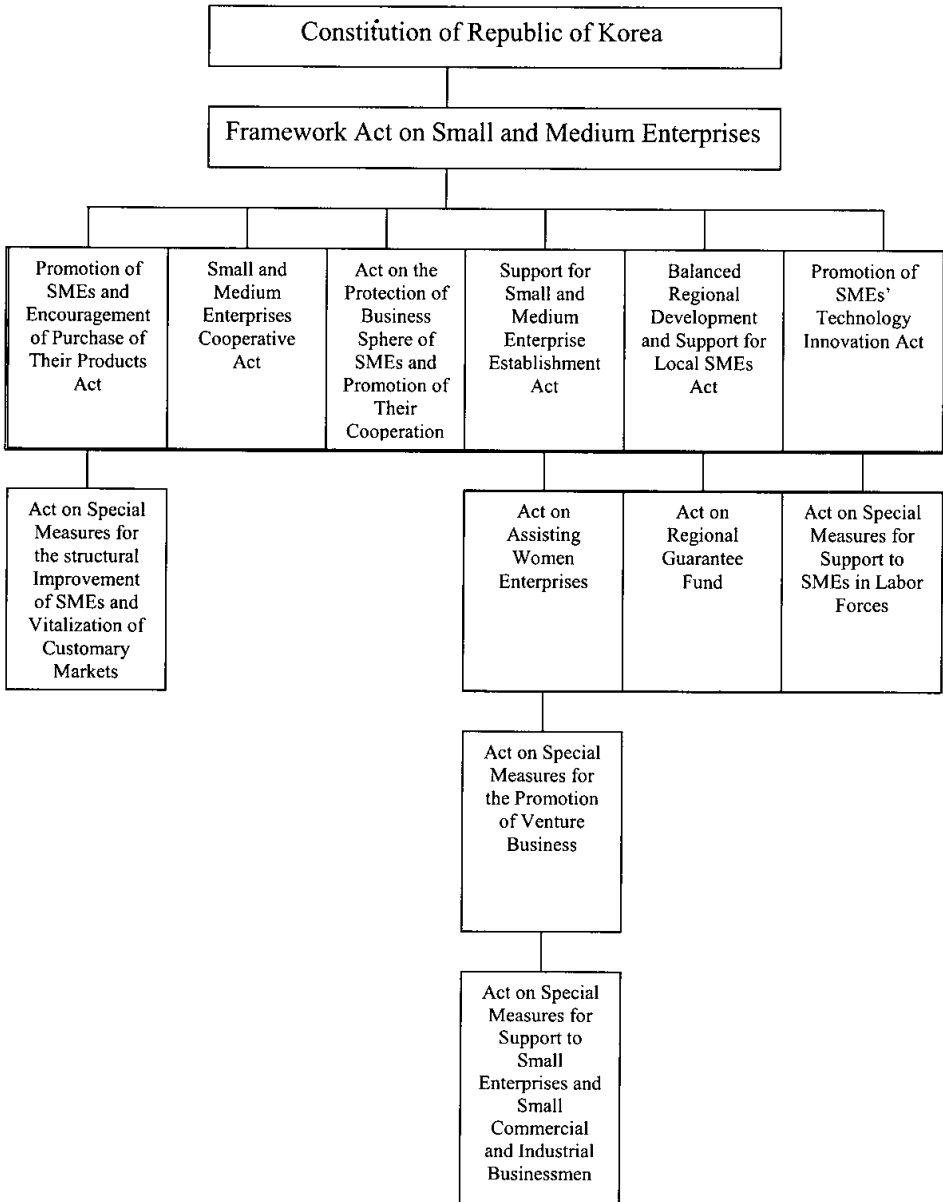
The “Promotion of SMEs and Encouragement of Purchase of Their Products Act” and the “Act on Special Measures for the Structural Improvement of SMEs and Vitalization of Customary Markets” stipulate the systems for promoting the procurement of goods made by SMEs, expanding the SMEs market and improving the structure and management of SMEs.

The “Act on the Protection of the Business Sphere of SMEs and Promotion of Their Cooperation” stipulate just necessary systems to prevent large companies from intruding into the SME business sphere and conducting unfair trading, thereby inducing the enhanced cooperation among companies.

The “Small and Medium Enterprise Cooperative Act” stipulates the systems concerning the organization of cooperatives and the operation of mutual assistance fund.

The “Balanced Regional Development and Support for Local SMEs Act” and the “Act on Regional Guarantee Fund” stipulates the systems to facilitate the start-up in regional areas and induce the balanced development between large cities and provinces by promoting regional SMEs.

Structure of Laws Related to SMEs



CHAPTER 5

ROLE OF THE CENTRAL BANK IN THE DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES (SMES) IN MALAYSIA

by
Jaafar Haji Bujang*

1. Introduction

Malaysia achieved independence in 1957. The economy then was fundamentally primary commodity-based with heavy dependence on rubber and tin which contributed about 70% of total export earnings, 28% of Government revenue and 36% of total employment. To address the structural weaknesses of the economy, the Government focused on diversifying and modernising agricultural production and intensified efforts towards rural development. Meanwhile, import substitution was the strategy employed to promote industrial development, which concentrated on basic resource-based industries. The agricultural diversification and industrial development strategies resulted in timber and palm oil emerging as important export commodities by 1970 and the manufacturing sector becoming the fastest growing sector in the 1980s with a growth rate of 10.4% per annum. Significantly, the manufacturing sector's contribution to GDP (22.6%) surpassed the agricultural sector for the first time in 1987. With the Government focusing on providing the necessary infrastructure and support services to enable the private sector to flourish, the contribution of the private sector to economic growth surpassed that of the public sector by 1989, heralding the transformation of the Malaysian economy to that of a private sector driven economy.

Responding to the 1997-98 Asian financial crises, the Government introduced a comprehensive National Economic Recovery Plan with six objectives – to stabilise the ringgit, restore market confidence, maintain financial market stability,

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strengthen economic fundamentals, continue with the equity and socio-economic agenda, and revive adversely affected sectors. In September 1998, the selective capital control measures were adopted and the ringgit was pegged at RM3.80 per US1 in order to stabilize the exchange rate. Other measures implemented included the setting up of the Pengurusan Danaharta Nasional Berhad to relieve the affected banking institutions of their non-performing assets, Danamodal Nasional Berhad to recapitalize the affected banking institutions and the Corporate Debt Restructuring Committee to facilitate corporate debt restructuring. These measures appeared to have the desired effects. Although the economy registered a negative growth rate of 7.4% in 1998, it grew at an average of 7.2% during the two years of 1999 and 2000. Per capita income in current terms, which had declined in 1998, rebounded to RM13,359 in 2000, surpassing the pre-crisis level.

The Malaysian economy experienced sluggish growth in 2001 but rebounded in 2002. The outbreak of the Severe Acute Respiratory Syndrome (SARS) and the war in Iraq did not adversely affect the growth of the Malaysian economy as the Government took effective pre-emptive actions. In May 2003, the Government introduced the Package of New Strategies aimed at promoting private sector investment, strengthening the nation's competitiveness, developing new sources of growth and enhancing the effectiveness of the delivery system. The implementation of the Package together with the more robust external demand and increased private sector activity contributed to a better than expected economic performance of 5.2% growth in 2003. This growth momentum continued in 2004 with a higher growth rate of 7.1%.

2. Overview of SME Development Initiatives

The Government's policy to support the SME sector commenced in early 1970s with the formulation of the New Economic Policy aimed at eradicating poverty and restructuring society. The poverty eradication programmes included the provision of improved inputs and facilities in existing agricultural areas, accelerated creation of productive employment opportunities, and the provision of social services and amenities such as education, health, housing, water and electricity so that the poor were able to increase their productivity and income through a fuller utilisation of their productive assets and skills as well as enjoy quality of life. The restructuring of society entailed the correction of economic imbalance so as to reduce and eventually eliminate the identification of race with economic function. The programmes included the modernisation of rural life, rapid and balanced development of urban activities, establishment of new growth

centres and the creation of a Bumiputera commercial and industrial community. The establishment of in-trust agencies such as Majlis Amanah Rakyat (MARA), Perbadanan Nasional Berhad (PERNAS), Permodalan Nasional Berhad (PNB) and the State Economic Development Corporations provided opportunities and avenues for Bumiputeras to participate in commercial-based activities.

In order to co-ordinate and streamline the various Government initiatives in the manufacturing sector, the Ministry of Industrial Development (as the Ministry of International Trade and Industry was known then) implemented the Industrial Master Plan (1986-1995). The Plan outlined the development of wide-ranging manufacturing sectors in line with the policy to promote export-oriented industries. Based on this outline, the development of SMEs was promoted with the aim of strengthening inter-industry relations. Under the Second Industrial Master Plan (1996-2005), two new strategies were introduced. The first strategy was to move along the value chain from assembly-based and low value-added activities towards higher value added activities such as research and development (R & D) and shifting the whole value chain to a higher level through productivity driven growth, utilization of high technology (automation / robotisation), emphasis upon knowledge and capital intensive manufacturing, innovation, best management practices and a more efficient utilisation of resources. The other strategy of the Second Industrial Master Plan is to promote cluster-based industrial development with emphasis on the development of competitive industry clusters through integration of key industries, suppliers, supporting industries, critical supporting business services, requisite infrastructure and institutions as well as generating backward and forward linkages, domestic spin-offs and value added and development of domestic SMEs.

Current SME development programmes cover a broad spectrum of SMEs' requirements. These include provision of soft loans and grants, promotion of venture capital financing, infrastructure development, marketing and promotion, education and training, technology and innovations, R & D, tax incentives, consultancy and advisory services, evaluation and monitoring. One of the main efforts of the Government involved linking SMEs with large companies and multi-national corporations (MNCs) as suppliers of parts and components under its market development programmes. For those SMEs that require financial assistance for working capital, purchase of fixed assets and project financing or to modernise and automate their operations, the Government has been providing soft loans and grants administered by or channeled through several ministries, agencies and financial institutions, to eligible SMEs. Tax incentives are also being provided to eligible SMEs mainly in the form of Pioneer Status and investment tax allowances.

To upgrade skills of employees in the SME sector, the Government provided training through 19 skills development centres, although the number of employees participating in these programmes is still insignificant. The Government has also initiated various infrastructure development programmes involving the development of industrial sites, common facilities for waste disposal, warehousing and employees' accommodation, as well as building factories affordable to SMEs.

While efforts on the development of the SMEs in Malaysia are broad-based and have been gathering momentum following the establishment of the National SME Development Council in August 2004. As a result of one of the Council's recommendations, a national database on SMEs is being developed and the lack of common definition of SMEs was recently redressed. In the absence of a time series data based on a common SME definition to be compiled under the comprehensive national SME database project, the information and statistics provided in this country paper are largely based on the findings of the survey undertaken in 2002 by the SME Special Task Force in Bank Negara Malaysia (2002 survey) as contained in its document, "A Comprehensive Framework for the Development of SMEs in Malaysia". This main source of reference is supplemented by information and data sourced from Bank Negara Malaysia's Annual Reports, the Ministry of Trade and Industry's Special Report on "Small and Medium Industry Development Plan (2001-2005)" and various documents published by other relevant ministries and agencies, including those available in their respective web sites.

2.1 Status of SMEs

2.1.1 SME Size

There are approximately 667,000 establishments in Malaysia. Of this, approximately 613,700 or 92% are SMEs. Individually, most SMEs in Malaysia are very small with 77% having total assets of less than RM5 million and 74% having less than 50 employees. As a group, the SME sector in Malaysia absorbs 33.3% of total employment. By contrast, the SME sector accounts for 69.5% of total employment in Japan, 78.1% in Taiwan, 75.3% in South Korea and 69.7% in Germany. In terms of contribution to GDP, where the SME data available is only in respect of the manufacturing sector (courtesy of SMIDEC), SMEs in Malaysia's manufacturing sector contributed 6% of the country's GDP.

2.1.2 Analysis of SMEs by Sector

The SMEs in Malaysia are involved in a wide range of economic activities. However, the key sectors are trading (33%), manufacturing (32%), services (23%), construction (8%) and agriculture & mining (3%). Up to 2004, the focus of support and assistance by MITI / SMIDEC was to the manufacturing and MRS sector. Within the manufacturing sector, the most popular business segments amongst the SMEs in Malaysia are the manufacture of textiles & apparel, wood-based products and food products.

In terms of loans exposure of the banking system as at 30 September 2004, almost two-third of the total loans were channeled to three main sectors, namely wholesale & retail trade, restaurants & hotels, manufacturing and construction, as follows-

	SECTOR	SME LOANS EXPOSURE
1	Wholesale & retail trade, restaurants and hotels	25%
2	Manufacturing	23%
3	Construction	13%
4	Purchase of non-residential property	10%
5	Real estate	6%
6	Business services	5%
7	Agriculture, hunting, forestry and fishing	5%
8	Others	13%

2.2 National SME Policy

Although official policy to support the SME sector had been instituted since the 1970s, the Malaysian Government specifically addressed various developmental issues pertaining to SMEs in the National Development Council (NDC) chaired by the Prime Minister. The NDC made the decision to implement a new set of policy guidelines for the development of SMEs on 7 January 1992. These policy guidelines cover the following four specific issues:

- SMEs should contribute to the development of a balanced economy and a more equitable distribution of income;
- SMEs should complement and support the large-scale, heavy and modern industries through a network of industrial linkages;
- SMEs should produce quality and high value-added products and services for the domestic and export markets and contribute to national output; and
- SMEs should increase their productivity through the use of modern technology and management practices to increase their competitiveness in the export market.

Especially for manufacturing companies, the proposed policies were designed:

- To promote human resource development;
- To encourage industrial linkages with large industries;
- To establish a comprehensive database and information system on SME development programmes;
- To provide technical support and management counseling services with the co-operation of other related agencies involved in the enhancement of SMEs; and
- To promote mutual co-operation among SMEs through amalgamation of business, technical co-operation, establishment of a mutual fund or a co-operative enterprise and procurement of common equipment.

The establishment of the National SME Development Council in August 2004 marked a significant milestone in the development of SMEs. This recent development is discussed in detail in Section 5.2.

2.3 Government's SME Development Programmes¹

The Government has implemented various development programmes to accelerate the growth of the SME sector. These programmes may be categorised

1. Excluding BNM's SME development initiatives, which will be discussed separately.

under soft loans and grants schemes, technology and innovations (including R & D), marketing and promotion, training and education, consultancy and advisory services, infrastructure development, evaluation and monitoring, tax incentives, policies and strategies. An overview of the ministries and agencies involved in the programmes are as follows:

AREAS OF GOVERNMENT INVOLVEMENT AND RELEVANT MINISTRIES / AGENCIES				
Soft Loans and Grants	Technology and Innovation	Marketing and Promotion	Education and Training	Consultancy and Advisory
MITI/MIDF	MITI/MTDC	MITI/MATRADE	MITI/SMIDEC	MECD/BPIM
MECD/PUNB	MOSTI/SIRIM	MOA/FAMA	MITI/NPC	MECD/PUNB
MTM/BPIM	MOSTI/MIMOS	MRD	MOF/BPIM	MITI/SMIDEC
MITI/SMIDEC	MITI/MIDA	MECD/PUNB	MECD/MARA	MECD/MARA
MOF/BITM MOA/BPM MECD/TEKUN MECD/AIM MOSTI/MIMOS MOF/BSN MECD/MARA MECD/PERNAS MOF/EXIM MOF/MECIB MECD/BKRM MYS/CGC MECD/AIM	MOSTI/TPM MOSTI/BIOTEK PMD/MIGHT MOA/MARDI PMD/MDC MITI/SMIDEC	MPI/MTIB MITI/SMIDEC	MITI/MTDC MRD MHR/HRDC	

AREAS OF GOVERNMENT INVOLVEMENT AND RELEVANT MINISTRIES / AGENCIES				
Infrastructure Development	Evaluation and Monitoring	Tax Incentives	Policies and Strategies	Venture/Equity Financing
MITI/SMIDEC MIDF/MIED MOF/BPIM MRD	MITI/SMIDEC MECD/PUNB MOF PMD	MITI/MIDA	MITI/SMIDEC	MOF/MVCM MECD/PUNB MTM/BIPM

Role Of Central Bank In Promoting SMEs In The SEACEN Countries

Abbreviations

1. MITI	Ministry of International Trade and Industry
2. MIDF	Malaysian Industrial Finance Berhad
3. PUNB	Perbadanan Usahawan Nasional Berhad
4. MECD	Ministry of Entrepreneurial and Cooperative Development
5. BPIM	Bank Pembangunan & Infrastruktur Malaysia Berhad
6. SMIDEC	Small and Medium Industries Development Corporation
7. BITM	Bank Industri & Teknologi Malaysia Berhad
8. MOA	Ministry of Agriculture and Agro-based Industry
9. BPM	Bank Pertanian Malaysia
10. TEKUN	Yayasan Tekun Nasional
11. MVCM	Malaysia Venture Capital Management Berhad
12. MIMOS	MIMOS Berhad
13. BSN	Bank Simpanan Nasional
14. MARA	Majlis Amanah Rakyat
15. MTDC	Malaysian Technology Development Corporation
16. SIRIM	SIRIM Berhad
17. MIDA	Malaysian Industrial Development Authority
18. MOSTI	Ministry of Science, Technology and Innovation
19. PMD	Prime Minister's Department
20. TPM	Technology Park Malaysia
21. MIGHT	Malaysian Industry Government Group for High Technology
22. MATRADE	Malaysian External Trade Development Corporation
23. FAMA	Federal Agricultural Marketing Authority
24. MRD	Ministry of Rural Development
25. MARDI	Malaysian Agricultural Research Development Institute
26. NPC	National Productivity Corporation
27. MOF	Ministry of Finance
28. Pernas	Perbadanan Nasional Berhad
29. BIOTEK	National Biotechnology Directorate
30. EXIM	Export-Import Bank Of Malaysia Berhad
31. MECIB	Malaysia Export Credit Insurance Berhad
32. BKRM	Bank Kerjasama Rakyat Malaysia Berhad
33. MTM	Ministry of Tourism Malaysia
34. MYS	Ministry of Youth and Sports
35. CGC	Credit Guarantee Corporation Berhad
36. AIM	Amanah Ikhtiar Malaysia
37. MDC	Multimedia Development Corporation Berhad
38. MECM	Ministry of Energy, Communications and Multimedia
39. MPI	Ministry of Primary Industries
40. MTIB	Malaysian Timber Industry Board
41. HRDB	Human Resource Development Council
42. MHR	Ministry of Human Resources
43. FRIM	Forest Research Institute of Malaysia
44. MNRE	Ministry of Natural Resources and Environment
45. MIED	Malaysian Industrial Estates Berhad

As shown above, the efforts of the Government in supporting the SMEs are broad-based. In the area of financing, excluding the funds administered by BNM, the Government has established a total of 104 financing schemes for SMEs mainly for nurturing and developmental purposes. Of these, as at end-September 2004, 32 financing schemes have been closed / terminated, having duly met their objectives. The 72 schemes that are still on-going involve a total allocation of RM10.3 billion, extended to eligible SMEs via 40 soft loan schemes (RM8.1 billion), 21 grant schemes (RM1.2 billion), 7 venture capital schemes (0.7 billion) and 4 other equity participation schemes (RM0.5 billion). As at end-September 2004, a total of RM14.2 billion (of which RM12.58 billion disbursed) had been approved to 802,152 applications under the schemes, administered by various ministries and agencies.

2.4 Key Government Agencies Involved in SME Development

While many other Government Agencies do play a significant role in supporting SMEs, the five key agencies that have been particularly active in supporting the development of SMEs in Malaysia are probably SMIDEC, PUNB, MIDE, BPIM and MTDC. Some background information on these Agencies is as set out below.

2.4.1 Small and Medium Industries Development Corporation (SMIDEC)

SMIDEC was established on 2 May 1996 by MITI as a specialised agency to further promote the development of small and medium industries in the manufacturing sector through the provision of advisory services, fiscal and financial assistance, infrastructural facilities, market access and other support programmes. Its objectives are to coordinate the overall development of local SMEs in the manufacturing and MRS; promote the development of a modern and sophisticated SMEs in tandem with the strategic direction of the overall industrial development; and to develop the small and medium industry into an efficient and competitive sector, capable of producing high value-added and quality parts, components and finished products for the global market.

In terms of financial assistance, SMIDEC provides, inter alia, grants to SMEs under ITAF 1 to undertake market facility studies, technology feasibility studies, business planning studies and domestic & export market strategy studies. Under ITAF 2, SMIDEC provides grants to SMEs for improvement and upgrading of

existing product, product design and process upgrading. Under ITAF 3, SMIDEC provides grants to SMEs for productivity and quality improvement and to achieve international quality standards and certification. Under the “Grant for Upgrading Engineering Design Capabilities”, SMIDEC provides grants to SMEs to enhance their engineering design capabilities in-house. These assistance schemes are matching grants where 50% of approved project cost is borne by the Government and the remainder by the applicant. As at end-September 2004, seven grant schemes promoted by SMIDEC were still open with a total allocation of RM180.97 million, of which grants of RM142.88 million were approved to 14,315 SMEs, of which RM107.7 million had been disbursed. A further two grant schemes, namely E-manufacturing / E-commerce and E-Dagang, with a total allocation of RM24 million had been closed after benefiting 3,818 SMEs. Apart from grants, SMIDEC is also promoting two soft loan schemes, namely the Soft Loans for SME and the Soft Loan for Factory Relocation with a total allocation of RM151.4, of which RM130.15 million has been approved to 172 SMEs (RM104.0 million disbursed). The two soft loan schemes are still open to eligible SMEs as at end-September 2004.

SMIDEC is equally active in providing non-financial assistance to SMEs. Among the development programmes and initiatives undertaken by SMIDEC for the promotion of SMEs in the manufacturing and MRS sector include the following:

- **Industrial Linkage Programme (ILP)**

This programme is aimed at developing domestic SMEs into competitive manufacturers and suppliers of parts and components and related services to MNCs and large companies. The industrial segments that are given priority under ILP are electrical & electronics, transport equipment, machinery & engineering and resource-based industries. To encourage participation in the ILP, Pioneer Status with tax exemption of 100% on statutory income for five years, or Investment Tax Allowance of 60% on qualifying capital expenditure incurred within a period of five years are provided to eligible SMEs. To promote the participation of the MNCs or large companies under this programme, expenses incurred in developing SMEs such as training, factory auditing and technical assistance will be allowed as deduction in the computation of income tax.

- **Global Supplier Programme (GSP)**

This programme is an extension of ILP. It involves training in critical skills and also linkage to MNCs and large companies. Through the linkage initiative of the GSP, SMEs are developed to be competitive suppliers of parts and

components, not only to MNCs in Malaysia, but also their worldwide operations through mentoring activities.

- **SME Expert Advisory Panel (SEAP)**

This programme involves the emplacement of retired experts at the factory sites of SMEs to solve specific problems. It is aimed to assist SMEs to upgrade their technological capability, to achieve efficiency and to increase productivity. Funding is also provided in the form of 50% matching grant with the remainder of the cost to be borne by the SME concerned.

- **Skills Upgrading Programme**

This programme is aimed at enhancing the skills and capabilities of employees of SMEs in the technical and managerial level, particularly in critical areas such as electrical and electronics, IT, industrial design and engineering fields. SMEs that send their employees for courses at any of the designated training providers will be eligible for 50% training grant from SMIDEC. Currently, SMIDEC has appointed 19 training providers to undertake technical skills training for SMEs.

- **HeadStart 500**

This is a new programme designed to provide SMEs with support services needed to accelerate their transformation from domestic oriented to global manufacturers. Companies that qualify for this programme will act as role models and, in turn, form smaller industrial clusters within their respective industries to support smaller enterprises. Participants will be assisted through the provision of integrated assistance packages comprising financial and technical know-how.

- **Enterprise 50**

This annual award programme recognizes the achievements of Malaysia's enterprising homegrown companies, which are well positioned for the future. A total of 50 winners are selected from amongst the nominations received, and the evaluation is based on the companies' management and financial performance.

- **Infrastructure Development**

SMIDEC, in collaboration with Malaysian Industrial Estates Berhad (a subsidiary of MIDF) and Selangor State Economic Development Corporation, has developed industrial estates all over the country to assist SMEs to operate

their business in approved areas or premises. SMEs are encouraged to relocate their business to the approved areas to ensure that SMEs have the foundation and the facilities to operate in the most conducive environment.

2.4.2 Perbadanan Usahawan Nasional Berhad (PUNB)

Perbadanan Usahawan Nasional Berhad (PUNB) was incorporated on 17 July 1971 to promote the development of resilient Bumiputera entrepreneurs in strategic industries; and to instill entrepreneurial culture amongst Bumiputera entrepreneurs and equip them with adequate knowledge and experience. PUNB provides an integrated package to develop entrepreneurs involving entrepreneur identification and selection, education and training, consultancy and advisory services, marketing assistance and corporate monitoring to ensure that the entrepreneurs are well disciplined especially in areas of finance, operational management and corporate governance. PUNB provides financial facilities in the form of Islamic-based venture capital fund. In line with the Islamic principles, PUNB participates in the venture as an active business partner with the entrepreneur. In general, PUNB provides financing in the form of ordinary shares, preference shares and / or hybrid of convertibles under the Islamic concept of *mudharabah* (trustee profit and loss sharing), *musyarakah* (joint stock profit and loss sharing), *musyarakah mutanaqisah* (diminishing partnership – sharing of the revenue with progressive dilution of shareholding), *istisna'* (deferred delivery sales), *murabahah* (mark-up sales), *al-Ijarah* (leasing – right to use of the asset), and Islamic convertible bond (hybrid product).

As at end-September 2004, PUNB administered five financing schemes with a total allocation of RM300 million. A total of 289 SMEs received approvals under these schemes amounting to a total of RM377.0 million, of which RM260.3 million had been disbursed. PUNB also provides financing through equity participation in 543 SMEs with total approvals of RM174.2 million, of which RM129.4 million had been disbursed.

One of the on-going financing programmes administered by PUNB is “Projek Usahawan Bumiputera Dalam Bidang Peruncitan” (PROSPER), which was introduced by PUNB in 2000 to increase Bumiputera participation in the retail sector. Under the scheme, Bank Negara Malaysia provided RM500 million to TPPT Sdn. Bhd. (a subsidiary of the central bank) at 2% per annum for the purchase of business premises for Bumiputera entrepreneurs. PUNB provides equity financing under the Islamic concept of *Musyarakah Mutanaqisah*

(partnership with decreasing equity) whereby 50% of the annual profit will be retained in the business as reserves, 25% for PUNB and 25% for the entrepreneur (must be used to buy back PUNB's stake). PUNB retains 1 golden share after the entrepreneur has purchased its entire stake in the investee company. As at 30 September 2004, PROSPER had sponsored 422 participants with PUNB's equity financing amounting to RM38.4 million.

2.4.3 Malaysian Industrial Development Finance Berhad (MIDF)

MIDF was incorporated on 30 March 1960 to promote the development of the manufacturing industry in Malaysia through the provision of medium and long term loans for the financing of new fixed assets for new industrial ventures as well as existing enterprises undertaking modernisation and/or expansion. Over the years, MIDF has enjoyed the benefit of being one of the development finance institutions (DFIs) designated by the Government to manage and disburse funds under the various special loan schemes to SMEs.

Following the Government's decision to create lead agencies towards a more focused approach in SME sector development in 1992, MIDF was appointed the conduit for channeling concessionary loans to SMEs under the Modernisation and Automation Scheme. Following the Asian Financial Crisis in 1997/98, the Government through Bank Negara Malaysia launched a number of funds to assist SMEs with concessionary loans to enhance and increase national output and assist viable companies facing cash flow problems. MIDF was designated as a conduit for two of these schemes, that is, the Fund for Small and Medium Industries (FSMI), which was later reconstituted into FSMI 2, and Rehabilitation Fund for Small and Medium Industries (RFSMI). When the Government received assistance under the Miyazawa Initiative in 1999, MIDF was designated to manage and disburse, together with 2 other DFIs, a fund of RM300 million to SMEs at a concessionary rate of 6.25%.

In 2003, MIDF was appointed as the implementing agency for the new Soft Loan Scheme for Factory Relocation initiated by SMIDEC. As at end-September 2004, MIDF administered 9 soft loan schemes still open to eligible SMEs, with a total allocation of RM602.2 million. A total of 1,283 SMEs had received assistance under these schemes with total approvals of RM1.176 billion, of which RM912 million was disbursed and RM612.1 million repaid. A further two soft loan schemes promoted by MIDF, namely, the ASEAN-Japan Development Fund and the Modernisation and Automation Scheme for SMI, with a total allocation

of RM149.4 million had been closed. These two funds had benefited 288 SMEs, which have since repaid RM254 million of the RM268.4 million disbursed.

2.4.4 Bank Pembangunan & Infrastruktur Malaysia Berhad (BPIM)

BPIM was launched on 3 August 1974 under the name of Bank Pembangunan Malaysia Berhad to encourage the involvement and promote the development of the Bumiputera community in businesses by enhancing access to financing and giving financial advisory services for the Bumiputera entrepreneurs, especially the Bumiputera SMEs. Subsequently, the institution expanded its activities to include financing of the country's main infrastructure projects which resulted in this development finance institution assuming its present name and its paid-capital being increased from RM105.5 million to RM1 billion and later to the present level of RM1.6 billion. BPIM is almost entirely owned by the Government.

As at end-September 2004, BPIM administered 11 loan schemes that are still open, with a total allocation of RM1.1 billion. A total of 1,905 SMEs had received funding under these schemes with total approvals of RM2.2 billion, of which RM899.4 million had been disbursed. A further 11 loan schemes had been closed with a total allocation of RM586 million, having benefited 2,061 SMEs. During the whole of 2004, BPIM's total loans to SMEs increased by 6.1% to RM1.7 billion. Financing to Bumiputera SMEs, which accounted for 83.1% of total loans outstanding to SMEs, expanded by 10.5% (2003: 4.6%) to RM1.4 billion.

Apart from financing, BPIM also provides advisory services, entrepreneurial training and project consultancy services to enhance the business capabilities of Bumiputera SMEs. As part of the efforts to promote the development of a viable and resilient Bumiputera commercial and industrial community, BPIM introduced two new packages known as "Premis SMI" and "Groombig". Under "Premis SMI", BPIM rented out 229 factory units at low rental rates whilst, under the "Groombig" programme, which is aimed at enhancing the performance of the larger-sized SMEs, the entrepreneurs were provided with loans, advisory services and training. To further assist SMEs, during 2004, BPIM launched seven new programmes, namely, the Entrepreneur Attachment Programme, Mentor Mentee Programme, Vendor Programme, Corporate Technocrat Programme, Women Entrepreneur Programme, Batik Entrepreneur Programme and Craft Entrepreneur Programme.

2.4.5 Malaysian Technology Development Corporation Berhad (MTDC)

MTDC has been particularly active in promoting technology upgrading among SMEs through two grant schemes and various other initiatives. The first grants scheme is known as the Technology Acquisition Fund (TAF), which is designed to assist SMEs through the introduction and utilisation of modern and efficient technology in the manufacturing and physical development of existing and new products or processes and to enhance the competitiveness level of firms to enable them to compete globally. It covers technology licensing and the acquisition of patent rights, prototypes and design. The other grant scheme is the Commercialisation of R & D Fund, which is intended to enhance the competitiveness and capability of the Malaysian industrial sector by promoting the commercialisation of R & D results undertaken by local institutions and research institutions, companies and individual researchers or investors. The Fund provides partial grants to qualified R & D projects to be commercialised up to a maximum of 50% to 70% or RM2 million, whichever is lower, for market survey and research, product / process design and development, standards and regulatory compliance and intellectual property protection, and demonstration of technology. The above two funds administered by MDTC, which was introduced in 1997 with a total allocation of RM138 million, had benefited 72 SMEs with total approvals of RM66.8 million, of which RM33.9 million had been disbursed as at end-September 2004.

In addition, MTDC has introduced its Technology Development Clusters Programme to enhance the competitiveness of all major sectors of the economy though higher investments in R & D activities, overcome shortage of skills and knowledge workers, and strengthen collaboration among public research institutes, universities and industry. The programme involves the establishment of five incubation centres / clusters, namely Universiti Pertanian / MDTC Incubation Centre (focusing on IT and multimedia), Universiti Malaya / MDTC Incubation Centre (focusing on advanced electronics), Universiti Kebangsaan Malaysia / MDTC Smart Technology Centre (focusing on biotechnology and environmental engineering), Universiti Teknologi Malaysia / MDTC TechnologyDevelopment Centre (focusing on software development) and Universiti Utara Malaysia / MDTC Technology Centre (focusing on internet security). These incubation centres complement other Government incubation centres, such as Multimedia Development Corporation, Technology Park Malaysia and Kulim Hi-Tech Park.

3. The Central Bank's SME Development Initiatives

Bank Negara Malaysia has also undertaken various initiatives to enhance access to financing by SMEs. These initiatives may be categorised under financial and non-financial initiatives, as follows:

(i) Financial initiatives

- The establishment of Special Funds for SMEs;
- The establishment of the Credit Guarantee Corporation;
- The provision of financing for the purchase of business premises under PROSPER;

(ii) Other initiatives

- The establishment of ERF to assist Bumiputera SMEs;
- Encourage banking institutions to lend to SMEs;
- The establishment of Small Debt Restructuring Scheme for NPL borrowers;
- The establishment of the SME Special Unit.

3.1 Establishment of Special Funds for SMEs

Bank Negara Malaysia has established various funds for SMEs to ensure that the specific economic sectors get access to financing at reasonable cost and to increase the productive capacity of the specific economic sectors. To maximise outreach to the SMEs, the funds are channeled to the participating financial institutions (PFIs) through their branch networks. To mitigate the risk on the part of the Government and Bank Negara Malaysia, the PFIs would bear the credit risk and the applicant is subject to the normal credit risk assessment based on the applicant's risk profile. As the PFIs bear the credit risk, accessibility by a new start-up business to the Special Funds will be based on the same or normal credit risk assessment of the PFIs, i.e. business viability and other factors such as character, repayment capability, capital commitment and business condition. The loans have tenures of between 3 and 8 years and were structured as such in order to facilitate rollover of the loans to allow other SMEs to have the opportunity to access the funds. Generally, the purpose of financing under the Special Funds is to finance working capital in the form of overdraft facility.

Currently five Special Funds with total allocation of RM8.9 billion are open to eligible SMEs with lending rates lower than the market, ranging from 3.75%

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to 5.0% per annum. They are the New Entrepreneurs Funds 2 (NEF2), Fund for Small and Medium Industries 2 (FSMI 2), Fund for Food (3F), Bumiputera Entrepreneur Project Fund (BEPF) and the Rehabilitation Fund for Small Businesses (RFSB). An overview of the status of these funds is as follows:

Allocation*		Approvals*		Disbursed*	Repaid*	Outstanding*
Fund	Amount (RM million)	Number Of cases	Amount (RM million)			
1 NEF2	2,000	2,948	1,886	1,542	101	1,422
2 FSMI2	4,500	6,239	4,172	3,312	355	2,860
3 3F	1,300	8,829	1,528	1,418	685	702
4 BEPF	300	1,079	499	412	328	67
5 RFSB	800	23	11	5	0	5
TOTAL	8,900	19,118	8,096	6,689	1,469	5,056

*As at 31 December 2004

NEF 2 was launched in July 2001 with an initial allocation of RM900 million to stimulate the growth of Bumiputera SMEs. The Fund is a continuation of the New Entrepreneurs Fund, which was terminated on 15 July 2001. The allocation was increased in June 2004 by RM300 million and in September 2004 by 550 million to its current level of RM2 billion. Funding per eligible customer is up to a maximum of RM5 million with maximum tenure of 8 years at an interest rate of 5%. As at end-2004, a total of 2,948 SMEs were granted assistance under the Fund with total approvals of RM1.9 billion, of which RM1.5 billion had been disbursed.

FSMI 2 was launched in April 2000 with an initial allocation of RM2 billion to promote SME activities in both the export and domestic sectors. The allocation was increased in June 2004 by RM1 billion and in September 2004 by RM1.5 billion to its current level of RM4.5 billion. As at end-2004, a total of 6,239 SMEs were granted assistance under the Fund with total approvals of RM4.2 billion, of which RM3.3 billion had been disbursed.

3F was launched in January 1993 with an allocation of RM1.3 billion to increase food production in Malaysia. Maximum funding is 90% of total project

cost or RM5 million per customer; whichever is lower, with a maximum tenure of 8 years at an interest rate 3.75%. Viable projects include primary food production, integrated agriculture and processing and / or distribution of food, subject to the raw materials coming from domestic sources. However, at least one-half of the total production is sold in the domestic market. As at end-2004, a total of 8,829 entrepreneurs had been granted assistance under the Fund with total approvals of RM1.5 billion, of which RM1.4 billion had been disbursed.

BEPF was launched in February 2001 with an allocation of RM300 million to assist Bumiputera entrepreneurs who have been awarded contracts / projects by the Government or Government related agencies, statutory bodies and reputable private / public companies. The loan amount per eligible customer is 60% of the contract value less advance given by the Government (if any) or RM3 million for a maximum tenure of 5 years at an interest rate of 5%. By end-2004, a total 1,079 entrepreneurs received assistance under the Fund with total approvals of RM499 million, of which RM412 million had been disbursed.

RFSB was launched in November 2003 with an allocation of RM800 million to assist viable SMEs facing temporary cash flow problems. As at end-2004, 23 SMEs were allocated with RM11million from the Fund, of which RM5 million had been disbursed.

Overall, a total of 19,118 SMEs had obtained assistance under all five Special Funds promoted by Bank Negara Malaysia with total approvals of RM8.1 billion, of which RM6.7 billion had been disbursed.

3.2 Establishment of Credit Guarantee Corporation (CGC)

The principal objective of CGC is to assist SMEs enhance their access to credit facilities. Since its inception in 1972, CGC has played an important role in assisting SMEs with insufficient or without any collateral to obtain financing from banking institutions by providing guarantees.

In 2000, Bank Negara Malaysia injected RM1 billion into CGC to strengthen its capital position to enable CGC to provide more guarantees (bringing the central bank's shareholding in CGC to 79.3%). In addition, CGC has taken the following measures to enhance its role as a guarantee provider:

- Introduced Direct Access Guarantee Scheme (DAGS) in 2000 where all loan applications which need guarantee cover would be processed by CGC and successful applications would be forwarded to the banking institutions;
- Increased its branch network to 16 branches;
- Launched 'I-Guarantee' in 2001 to enable SMEs to submit loan applications directly via the website;
- Launched the revised and liberalised New Principal Guarantee Scheme and Islamic Banking Guarantee Scheme to facilitate SMEs obtain higher financing;
- Introduced the Special Relief Guarantee Scheme to provide coverage for working capital provided by banking institutions for businesses affected by SARS, especially those involved in the tourism industry;
- Engaged consultants under its Business Advisory Service Entity Plan to assist SMEs, particularly in preparing business plans and financial documents; and
- Launched its Client Service Centre to cater for enquiries pertaining to matters such as information on the guarantee schemes offered and application procedures by potential borrowers, as well as enquiries from the banking institutions about the status of applications and claims.

Currently, CGC manages six guarantee schemes, as follows:

(i) Direct Access Guarantee Scheme

Under the scheme, applications for a term loan, fixed loan or overdraft can be made directly from CGC using a standard application form. Guarantee coverage is 100%. The loan amount ranges from RM50,000 to RM1 million subject to a maximum of RM500,000 each for working capital and asset acquisition. Maximum tenure and lending rate are 5 years and BLR + 1% per annum respectively.

(ii) New Principal Guarantee Scheme

Under the scheme, all applications for term loans, overdraft, letters of credit, trust receipts, export credit refinancing, bills purchased, bankers acceptances, shipping/performance/bank guarantees, hire purchase and leasing facilities can be made from any participating institutions. Guarantee coverage ranges

from 30% to 90%. Maximum loan size is RM10 million per customer. The maximum lending rate is BLR + 2% for loans below RM1 million. Beyond this amount, the lender is free to determine the margin.

(iii) Flexi Guarantee Scheme

Under the scheme, the loan application for all types of facilities is made through the institutions participating in FSMI 2, RFSMI and NEF 2. Maximum loan amounts are RM3 million for FSMI 2, RM5 million for RFSMI and RM5 for NEF 2. Maximum lending rates are 5% per annum for FSMI 2, 4.5% per annum for RFSMI and 5% for NEF 2. Maximum tenures are 3 years for FSMI 2, 7 years for RFSMI and 8 years for NEF 2. The guarantee coverage ranges from 30% to 80%.

(iv) Islamic Banking Guarantee Scheme

Under the scheme, all applications for Islamic banking facilities are made through commercial banks and finance companies offering facilities under Islamic concepts. Customers must be SMEs. Financing rates are the same as NPGS with the maximum amount of financing being at RM10 million per customer.

(v) Small Entrepreneur Guarantee Scheme

Under the scheme, all applications for term loan or overdraft can be made through the participating financial institutions. Maximum loan amount is RM50,000 per customer. Maximum tenure and lending rate are 5 years and BLR + 1.5% respectively. Guarantee coverage is 80% of the facility.

(vi) Franchise Financing scheme

Under the scheme, all applications for term loan, overdraft or trade financing facility will be made to the two participating institutions, Malayan Banking Berhad and Bumiputera-Commerce Bank Berhad. Maximum lending rate and tenure are BLR + 1.5% and 5 years respectively. Guarantee coverage is 80% for the unsecured portion and 90% for the unsecured portion.

In 2004, CGC's total guarantees outstanding recorded a strong growth of 9.9% (2002: -3.9%; 2003: 18.3%) to RM3.3 billion as at end-2004. This was mainly attributed to the strong performance of DAGS as well as the revised New Principal Guarantee Scheme (NPGS) and the Islamic Banking Guarantee Scheme (IBGS), which recorded a growth of 144.1% (2003: 158.3%). Since the introduction of DAGS, guarantees outstanding under this scheme continued to

rise markedly as the new scheme enabled more SMEs to gain access to the scheme. Guarantees outstanding for the Flexi Guarantee also expanded significantly by 108.5% to RM547.6 million mainly due to the higher demand for loans extended under the FSMI 2 and NEF 2. Meanwhile, the revised NPGS and IBGS had enabled SMEs from all economic sectors to obtain a higher financing up to a maximum of RM10 million from the financial institutions (previously RM5 million – RM5.75 million). Increasing preferences of SMEs for Islamic financing also contributed to the favourable performance of IBGS

3.3 Participation in the PROSPER Programme

Although Projek Usahawan Bumiputera Dalam Bidang Peruncitan (PROSPER) is administered by PUNB, Bank Negara Malaysia's involvement in supporting SMEs through the scheme is by providing RM500 million to its subsidiary, TPPT Sdn. Bhd. (at 2% per annum), for the purchase of business premises for Bumiputera entrepreneurs under the scheme. (Please refer to paragraph 22 for further details of the scheme).

3.4 Establishment of ERF Sdn. Bhd.

ERF Sdn. Bhd. (ERF) was established in 1989 to rehabilitate Bumiputera borrowers under the various schemes administered by ERF namely Tabung Pemulihan Usahawan, Tabung Projek Usahawan Bumiputera, Tabung Pemulihan dan Pembangunan Usahawan and Tabung Pemulihan Perniagaan Kecil. In 2002, the role of ERF was expanded to act as a one-stop centre for Bumiputera SMEs obtaining financing, advisory and training services.

Since its establishment, ERF has approved loans amounting to RM1.3 billion to 2,000 Bumiputera borrowers. In addition, 747 Bumiputera entrepreneurs participated in courses and trainings conducted by ERF while 2,791 entrepreneurs participated in 27 seminars, dialogues and road shows organised by ERF.

3.5 SME Financing Extended by Banking Institutions

The banking institutions under the supervision of Bank Negara Malaysia, particularly the commercial banks (including Islamic banks) and finance companies, continued to support the SMEs strongly, channeling more funds for their activities. This commitment was further reinforced by the availability of dedicated SME units in almost all the commercial banks. For some institutions, the SME unit

undertakes activities beyond the provision of financing, to include developmental and support services such as identifying and structuring financial products and services to meet the requirements of SMEs, conducting training and workshops, and providing other advisory services such as financial and cash management.

To enhance the efficiency of the loan approval process, banking institutions are required to display a Client Charter on processing of loans to SMEs disclosing the following:

- (i) The necessary documents and information which should be submitted to the banking institution to support the application;
- (ii) The eligibility criteria for obtaining loans and definition of project viability; and
- (iii) Duration taken by banking institution to process a loan application, which is 30 days upon receipt of complete submission.

In addition, banking institutions are also required to inform applicants on reasons for loan rejections as well as what corrective measures that could be undertaken by the unsuccessful applicants to ensure that their loan applications will be considered favourably in future.

In supporting the Government's aspirations, Bank Negara Malaysia has issued lending guidelines to banking institutions in relation to lending to SMEs whereby banking institutions are required to submit their respective lending budgets to the SME sector on a yearly basis which will be monitored by the central bank to ensure compliance. If the banking institution's budget falls short of Bank Negara Malaysia's internal target, the respective institution will be imposed a new target. Targets set were based on the capacity of the respective institutions. Penalties in the form of placement at Bank Negara Malaysia of funds equivalent to the amount of shortfall at zero interest rates would be imposed on institutions that failed to meet the lending targets. For the period of July 2003 to end-2004, banking institutions have approved new loans of RM44.8 billion to SMEs. This has exceeded the target of RM26.7 billion to be achieved for the period of July 2003 to end-December 2004 by 67.4%.

Total outstanding SMEs loans had increased from RM70.5 billion as at end-2000 to RM74.6 billion as at end-2001. As at end-2002, total SME loans remained

at RM74.6 billion. On-going efforts by Bank Negara Malaysia to strengthen the SME financing infrastructure have been important in providing adequate and cost effective funding to support the growth of SMEs. In addition, with on-line credit reference services provided by Central Credit Reference Information System (CCRIS) since October 2001, banking institutions have been able to accelerate loan processing and assess the viability of SMEs, given the comprehensive and current credit profiles of all borrowers available in the system. As a result, outstanding loans to SMEs grew strongly by 10% in 2003 to reach a record high of RM82 billion, representing 17.3% of total loans outstanding. The loan growth momentum continued unabated in 2004. As at end-2004, the SME loans extended by the banking institutions amounted to RM88.3 billion, an increase of 7.7%. NPLs of SMEs have declined by 11.4% to RM10.6 billion as at end-2004 to account for 12.0% of total loans to SMEs (end-2003: 14.6%), reflective of the improving financial position of SMEs.

The Islamic banking sector has also been focusing on providing financing to SMEs. The total financing facilities provided by the Islamic banking institutions to the SMEs increased by 77.1% from RM3.5 billion as at end-2002 to RM6.2 billion as at end-2003. In 2004, the increase was by 29.6% to RM8 billion as at end-2004. Islamic financing contributed 13.8% of the total financing extended by the banking system to the SMEs as at end-2004 as compared with 7.5% as at end-2003 and 4.7% as at end-2002.

3.6 Establishment of the Small Debt Resolution Scheme

One of the problems faced by SMEs is the existing NPLs, which constrained their ability to obtain new loans despite having on-going and viable businesses. The Small Debt Resolution Scheme (SDRS) was established on 1 November 2003 to facilitate the restructuring of NPLs of SMEs with on-going businesses. The SME Special Unit at Bank Negara Malaysia serves as the Secretariat to the committee. Under this scheme, an 11-member Small Debt Resolution Committee was established to undertake independent assessments on the viability of the businesses, and loan restructuring and financing requirements of the SMEs. SMEs with an aggregate NPL of up to RM3 million with the commercial banks, finance companies, Islamic banks, BPIM and BITM are eligible to apply for assistance under the scheme. As the debt restructuring process may involve the provision of new financing to the businesses with an allocation of RM800 million. In this regard, eligible businesses may obtain new financing at a financing rate of 5% per annum for a maximum of 5 years.

As at end-2004, a total of 228 applications with total NPLs of RM180.2 million were received since the establishment of the scheme. Of these, 116 applications with NPLs of RM81.8 million have been approved for restructuring under the scheme, whilst RM10.5 million in new financing was approved to eligible borrowers under the Rehabilitation Fund for Small Businesses. The performance of the scheme has demonstrated that the restructuring of NPLs is more important than the provision of new financing to ensure the viability and sustainability of financially distressed companies.

3.7 Establishment of the SME Special Unit

As part of the initiatives to enhance access to financing to SMEs, the central bank has established the SME Special Unit in May 2003 to assist SMEs in the following areas:

- To provide information on the various sources of financing for SMEs;
- To facilitate loan application process for SMEs;
- To deal with problems faced by SMEs in accessing financing; and
- To provide advisory services on other SMEs financing requirements.

The role of the SME Special Unit has been expanded to include:

- Coordinating, monitoring and evaluating the financing needs of the SMEs;
- Formulating policies and strategies to enhance access to financing by SMEs;
- Establishing and maintaining database on SME financing; and
- Enhancing SMEs' awareness on various financing sources.

3.6 Survey On SMEs

To ascertain the problems faced by SMEs in Malaysia, BNM conducted a survey in 2001 to assess the needs and problems faced by the SMEs. The findings of the survey are as follows:

(i) Distribution by Economic Sector

SMEs are involved in a wide range of economic activities. The key sectors are trading (33%), manufacturing (32%), services, construction (8%) and agriculture & mining (3%). However, only SMEs involved in manufacturing sector are supported and assisted by MITI/ SMIDEC.

(ii) Distribution by State

Survey respondents are mainly located in Selangor, Federal Territory (FT), Sabah and Sarawak. Approximately 31% of the SME businesses are concentrated in Selangor / FT while about 17.4% of SMEs set up their businesses in Sabah and Sarawak.

(iii) Ownership Structure

Approximately 88% of the SMEs are family-owned businesses. About 72% of the SMEs operate as private limited companies. The share of foreign ownership in SMEs is small, with foreign participation in less than 15% of SMEs surveyed. More than two-thirds or 74% of the SMEs are non-Bumiputeras. The Bumiputera SMEs are mainly involved in the trading and manufacturing sectors.

(iv) Size

In terms of size, SMEs in Malaysia are generally very small. About 77% of the SMEs have total assets of less than RM5 million, whilst 74% have less than 50 full-time employees.

(v) Financial Position

During the economic slowdown in 2001, 29% of the SMEs surveyed were already insolvent, while 33% were at about break-even. About 70% of SMEs surveyed have sales turnover of less than RM10 million with 50% reporting sales of less than RM6 million. Due to their small size, the majority of the SMEs cater mainly for the domestic market. Only 8% of the SMEs export their products. About 86% of the SMEs source their raw materials from the domestic market.

(vi) Sources of Financing

Approximately 62% of the SMEs indicated that they have no problems obtaining financing. The banking sector is the main provider of funds to SMEs. About 47% of SMEs reported that they borrow from banking institutions to fund their business operations. Approximately 32.4% of the

SMEs are self-financed whilst 11% rely on other sources of financing such as family, friends and supplier credit. Only 4.1% of the SMEs borrow from the development finance institutions. Venture capital financing and private sector grants accounted for 0.9% and 1.1% respectively.

(vi) Usage of Technology

Only 5% of the SMES have fully automated their operations. In addition, 48% of the SMEs reported low usage of computers in their daily work. The inability to leverage on technology results in activities that are less competitive and has hampered their ability to compete in the global market place.

(vii) Training

About 43% of the SMEs do not provide training to their staff. Of those that provide training, their programmes have generally involved technical training consisting of basic on-the-job skills. Only 43.6% of SMEs that provide training have training modules on business and management areas, which are critical for the efficient management of business operations.

(viii) Advisory Services

Approximately 52% of the SMEs did not have access to advisory services. Only 14% of the SMEs drew on advisory services from the Government Agencies. Others relied on the private sector.

(ix) Marketing Strategies

More than 60% of the SMEs rely on their own marketing efforts to sell their products whilst 21% sell their products through trade fairs. Only 7% sell their products via trading companies.

In summary, the survey findings have confirmed the overall view that SMEs still lacked the size, efficiency and comparative advantage to compete and contribute effectively to the economy. Concerted efforts are, therefore, needed to enhance their competitive position so that they can grow, expand and achieve a higher level of performance. Based on the findings of the survey, BNM recommended "A Comprehensive Framework for the Development of SMEs in Malaysia" to promote an enabling environment for SME development in Malaysia. The Framework outlines the challenges face by SMEs and the recommendations on how to overcome these challenges.

4. Challenges Faced By SMEs

Given the recent developments in the global and regional markets, the SMEs in Malaysia are facing mounting pressures from within the domestics as well as abroad. SMEs will need to enhance their competitiveness and efficiency in order to sustain their core activities. The main challenges facing the SMEs are summarised, as follows:

(i) **Adapting to the changing environment**

Being small, SMEs have the potential to be agile and the institutional capacity to adapt to the rapid changes arising from the new economic environment. Currently, many SMEs are constrained from growth due to lack of skills and capital. The performance gaps between SMEs and the larger players remain significant as SMEs lack the institutional capacity to withstand emerging challenges within the domestic as well as international markets. It is therefore imperative for the SMEs to become stronger players and have the flexibility to adapt to the changing environment.

(ii) **Ability to compete and remain relevant with the emergence of stronger competition from emerging economies**

In a more competitive environment, SMEs in Malaysia need to improve their efficiency and effectiveness to compete with the regional and international players. At present, the domestic SMEs are generally small in size and involved mainly in lower value-added activities. These factors combined with the lack of market information, have affected their ability to compete in the international markets. Efforts, therefore, need to be intensified to strengthen the domestic SME sector and assist the SMEs to better position themselves in tapping onto new market opportunities, as well as in facing the challenges arising from increasing trade liberalisation and globalisation.

(iii) **Greater access to skills and leveraging on technology**

With the advent of new and emerging technologies, it is important that SMEs apply ICT in their production process and to capitalise on technology as a means to achieve operational efficiency. SMEs also need to invest in intellectual capital in order to acquire the talent necessary to fulfill the demands for better technical and management skills.

(iv) **Stronger business culture and entrepreneurial spirit**

Having the necessary infrastructure and incentives to nurture the SMEs will not be sufficient. The SMEs themselves will have to inculcate sound business

culture and develop strong entrepreneurial spirit that will sustain their core areas of strength and ensure their long-term viability.

- (v) To be less reliant on Government subsidies / incentives

Currently, subsidised interest rates and guarantees are provided to facilitate financing to SMEs. Moving forward, it is important that SMEs mature to become financially sustainable to reduce reliance on Government incentives and subsidies in managing their businesses. The challenge is, therefore, to enhance the SMEs' capacity to access and sustain financing from the alternative source provided by the market.

5. Recommendations

BNM has concluded its 2002 survey on SMEs with a series of recommendations to enhance the SME sector in Malaysia, including as follows:

- (i) Review of the roles and responsibilities of Government ministries and agencies involved in SME development;
- (ii) Establish a high level SME Council;
- (iii) Establish a central training institute that provides coordinated, comprehensive and forward-looking training programmes for SMEs;
- (iv) Establish an advisory and information centre;
- (v) Promote an education system that inculcates the spirit of entrepreneurship;
- (vi) Encourage quality accreditation of products;
- (vii) Enable SMEs to leverage on marketing networks of trading companies and MNCs;
- (viii) Encourage participation of banking institutions and DFIs in the provision of financing and advisory services to SMEs;
- (ix) Accelerate the development of the venture capital industry;
- (x) Rationalise and consolidate the various Government Funds for SMEs;
- (xi) Enhance credit guarantee schemes by CGC.

5.1 Inter-Ministry SME Steering Committee

In October 2002, an Inter-Ministry SME Steering Committee was formed to take forward the above recommendations. The Committee has conducted assessments on the existing infrastructure for SME development to identify areas of resource duplication among the various Government ministries and agencies, and to address gaps in the existing infrastructure for SME development. This undertaking involved -

- (i) A review of the roles and responsibilities of the ministries and agencies involved in SME development;
- (ii) An assessment on the need to form a central coordinating body for SME development; and
- (iii) An evaluation of the feasibility of enacting an SME Law to coordinate efforts for SME development.

For greater focus and enhanced coordination, the Committee proposed that a permanent institutional framework be established in order to enhance the Government's capacity and ability to continuously promote the development of competitive and resilient SMEs across all sectors. Having a formal structure dedicated to the development of SMEs would result in greater synergies and synchronization of efforts among the various stakeholders involved in SME development, while ensuring that SME development issues across all sectors are appropriately identified and addressed. Following the Steering Committee's recommendations, the Government has agreed to establish the National SME Development Council.

5.2 National SME Development Council

The National SME Development Council was established in August 2004 to coordinate policy objectives and to ensure the effective implementation of policy measures to develop this sector. The Council will function as the highest policy-making body to chart the future direction and strategies for SME development and will be chaired by the Prime Minister. The Council will provide the strategic framework for more focused and coordinated inter-agency efforts on SME development to oversee the efficient coordination and to ensure effective policy implementation and outreach. The formation of

the Council represents the Government's commitment to the development of SMEs at the highest level.

5.2.1 First National SME Development Council Meeting

The Council held its first meeting on 13 August 2004. At this meeting, the terms of reference of the Council were determined, as follows:

- (i) Formulate broad policies and strategies to facilitate the overall development of SMEs across all sectors;
- (ii) To increase the focus of the roles and responsibilities of Government Ministries and Agencies responsible for SME development;
- (iii) Enhance inter-Ministry and Agency cooperation and coordination to ensure effective implementation of SME development policies and action plans; and
- (iv) Encourage and strengthen the role of the private sector in supporting the overall development of SMEs.

Bank Negara Malaysia has been appointed to act as the Secretariat to the Council.

At this meeting, the Council also discussed, inter alia, the various definitions of SMEs that would adequately apply for the manufacturing, agriculture, agro-based and services sectors, the establishment of a national SME database and current SME development programmes, as set out below:

(i) Definitions

The Council agreed on the need to have specific definitions for SMEs according to the specific and unique nature of their activities across all economic sectors. The Council also agreed in principle for the definitions to be based on annual sales turnover and number of full-time employees across these sectors. This would provide for the effective formulation of policies and support programmes aimed at target sectors within the economy, facilitate the provision of technical and financial assistance, and allow for the identification of SMEs in the various categories and levels. In addition, the definitions according to economic activity will facilitate the identification of

issues and prospects of the sectors concerned to enable the appropriate policy actions to be taken. It will also allow closer monitoring of SME performance and contribution to the economy. Please read the Appendix for details of the SME definition.

(ii) Establishment of a National SME Database

The Council decided that the Department of Statistics would establish and maintain a comprehensive National SME Database. The database will provide policy makers and industries with relevant and timely information to monitor developments in the SME sector including their operational conditions, financial status and development requirements. The Council further decided that a baseline census of all enterprises and businesses would be conducted nationwide. This would assist the Council in assessing the current status of SMEs, their requirements and identify important issues relating to their performance and development. Information compiled from the census would also facilitate the formulation of policies to promote SMEs as an important driver of growth and in the formulation of strategies for the forthcoming 9th Malaysia Plan.

(iii) SME Development Programmes

The Council also discussed the SME-related development programmes by the various Ministries and Agencies that were already in existence. These programmes were aimed at meeting different objectives for different target groups, such as rural industries, Bumiputera entrepreneurs and micro enterprises. The Ministry of International Trade and Industry and its Agencies, the Malaysian Industrial Development Authority (MIDA) and SMIDEC have been asked to look into the development of SMEs in the services sector. To expand the coverage of the support programmes in the services sector, SMIDEC has been given an allocation of RM14.4 million. The four sectors that have been targeted are distributive trade (wholesale and services), logistics, professional services and manufacturing related services.

5.2.2 Second National SME Development Council Meeting

The Council held its second meeting on 2 December 2004. The meeting discussed, inter alia, the definitions for SMEs (details in the Appendix), new initiatives to improve access to financing for SMEs and measures to strengthen the infrastructure for SME development, as follows:

(i) Access to Financing

The Council agreed to the introduction of an interest subsidy and securitization of SME loans to encourage further lending by financial institutions to SMEs. The interest subsidy provided by the Government will enable SMEs with higher risk profile to obtain financing at lower costs. The ability of financial institutions to securitise SME loans in their portfolio will further increase their capacity to lend to SMEs.

(ii) Coordinated Training and Human Resource Development for SMEs
Pembangunan Sumber Manusia Berhad (PSMB), an agency under the Ministry of Human Resources, has been appointed as the coordinating authority to oversee and coordinate overall training and human resource development for SMEs. The role of PSMB will, therefore, be expanded to include:

- Identification of training needs of SMEs across all sectors of the economy;
- Coordination, monitoring and evaluation of SME training and development programmes conducted by Ministries and Agencies; and the
- Development of a formal training accreditation system for SMEs.

(iii) Enhanced Management and Publication of SME Information

The role of the Secretariat function, which is currently under Bank Negara Malaysia, has been expanded to oversee and coordinate the monitoring, evaluation and publication of SME statistics and reports. Apart from meeting the information requirements of SME policymakers, the Secretariat will also be responsible for developing Key Performance Indicators (KPIs) to monitor and evaluate the progress of SME development, and will oversee the management of the National SME Database, which is being set-up by the Department of Statistics. The Secretariat will also publish annual reports on SME development for the benefit of policy makers and the SMEs, thereby improving the availability of SME information in the market.

(iv) Strengthening the Marketing and Promotion of SME Products and Services

Coordinated efforts to strengthen the marketing and promotion of SME products and services would focus on four main areas, namely:

- Supply of industrial parts and components to MNCs and large companies;
- Supply of consumer products to major retail outlets;
- Using intermediaries as a channel to enable SMEs to penetrate the export market; and
- Enhancing the marketing of services provided by SMEs.

(v) Establishment of SME Bank

The Council approved the concept of establishing a specialised financial institution to nurture and meet the unique needs of SMEs. The banking system, with large financial resources and extensive outreach, will continue to be the main provider of funds to SMEs. The set-up of a dedicated SME Bank will complement the banking institutions through provision of financial and non-financial services to SMEs, including ancillary services and credit information. Besides financing, the SME Bank will focus on nurturing the SMEs and creating an entrepreneurial society.

(vi) Interest Subsidy

Viable SMEs are currently being assisted through special funds established by the Government to obtain financing at relatively lower costs. As a strategic initiative to further extend accessibility to financing at reasonable costs to more SMEs, while reducing the Government's financial outlay, the Council has approved the introduction of a mechanism to provide interest subsidy on SME loans to selected priority sectors extended by the banking institutions.

(vii) Securitisation of SME Loans

To provide greater flexibility to banking institutions in managing their SME loans portfolio and further enhance their financial capacity to provide lending to SMEs, the Council approved a framework to facilitate the banking institutions to securitise their SME loans. The securitization framework would also enable SMEs to indirectly tap the capital market for financing, thus broadening the sources of funding for them.

(viii) New Trade Financing Arrangement for SMEs

In an effort to encourage SMEs to participate in the export markets, especially in the non-traditional markets and with members of the Organisation of Islamic Countries, new trade financing arrangements for SMEs that are

more accessible and with lower financing costs will be introduced. Under the arrangements, the SMEs would be able to obtain financing for pre- and post-shipment from banking institutions and the Malaysian Export Credit Insurance Berhad.

5.2.3 Third National SME Development Council Meeting

The Council held its third meeting on 9 June 2005. Among the SME development initiatives discussed were as follows:

(i) New Trade Financing Products for SMEs

As part of the efforts to enhance access to financing to SMEs, the Council agreed on the introduction of the Multi Currency Trade Finance Facility and Indirect Exporter Financing Scheme, to be launched in the third quarter of 2005 and available under both conventional and Islamic financing. These products are aimed at encouraging SMEs to export their goods and services to the non-traditional markets, especially to the member countries of the Organisation of Islamic conference. With these products, SMEs can obtain both pre- and post-shipment financing at attractive financing costs with no collateral requirement, while credit risks will be shared between the banking institutions and Malaysia Export Credit Insurance Berhad.

(iii) Online Training Portal for SMEs

The Council endorsed the rollout of the Human Resource Development Portal (HRD Portal), a web-based training portal developed by Pembangunan Sumber Manusia Berhad to enable employers and training providers to interact online as one training community. The HRD Portal will assist employers to search, identify and register for training programmes online and, at the same time, allow training providers to offer their training programmes and activities online. By providing access to a central pool of training information, the HRD Portal will facilitate and encourage employers, particularly SMEs, to retrain and upgrade the skills of their employees in order to enhance productivity and competitiveness.

(iii) Framework for SME Development Planning

The Council approved the adoption of a new policy formulation and evaluation framework to enhance the effectiveness of all Government's programmes to support SMEs. The framework involves the identification of broad strategic priorities and targets for SME development, as well as the establishment of comprehensive key performance indicators to evaluate effectiveness of SME

development programmes by all Ministries and Agencies involved in SME development. The aim is to provide a national blueprint for the development of competitive and resilient SMEs.

6. Conclusion

It is recognised that the SMEs represent an important segment in the economic growth process. They form an integral part of the value chain as downstream suppliers or service providers to the larger corporations in the overall production network. The SME sector in Malaysia has the potential to provide a strong foundation upon which future industries can be nurtured to anchor Malaysia's development across all economic sectors, including ICT, services, manufacturing and agriculture. Indeed, the SME sector in Malaysia can be a significant contributor to the overall development process, from a production-based economy towards a knowledge- and technology-based economy.

As an organisation charged with the responsibility of maintaining financial stability, Bank Negara Malaysia certainly has an important role to play and is already actively assisting the development of resilient SMEs, especially as regards access to financing. A strong private sector, which is well supported by a resilient SME sector, will spur economic growth and contribute towards the development of a strong banking sector. Given these linkages, Bank Negara Malaysia is well motivated to forge closer collaboration with all ministries and agencies involved in the development of the SME sector. The establishment of the National SME Development Council provides an ideal platform and mechanism on which this collaboration can be forged and enhanced.

To date, the Council had held three meetings. The important decisions already made on such key issues as SME definitions, proposed setting up of a national SME database, an SME bank and training infrastructure for SMEs are timely. Given that this new developments merely represent the initial steps towards capacity building, and the evidently strong commitment shown at the highest level towards this sector, the SME sector in Malaysia is expected to grow from strength to strength. And Bank Negara Malaysia, as Secretariat to the Council, will continue to enhance its collaboration with the other Government ministries and agencies involved to ensure coordinated and smooth development of the sector.

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STANDARD DEFINITION OF SMES

The National SME Development Council, which was established in August 2004 as the highest policy-making body to chart the future direction and strategies for SME development, had at its second meeting held on 2 December 2004, defined SMEs as follows:

In terms of Annual Sales Turnover:

Size	Manufacturing (including Agro- Based) & Manufacturing-Related Services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than RM 250,000	Less than RM 200,000	Less than RM 200,000
Small	Between RM 250,000 and less than RM 10 million	Between RM 200,000 and less than RM 1 million	Between RM 200,000 and less than RM 1 million
Medium	Between RM 10 million and RM 25 million	Between RM 1 million and RM 5 million	Between RM 1 million and RM 5 million

In terms of Number of Full-Time Employees:

Size	Manufacturing (including Agro- Based) & Manufacturing-Related Services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than 5 employees	Less than 5 employees	Less than 5 employees
Small	Between 5 and 50 employees	Between 5 and 19 employees	Between 5 and 19 employees
Medium	Between 51 and 150 employees	Between 20 and 50 employees	Between 20 and 50 employees

Based on the table, SMEs may also be defined in the manner as set out below.

Primary Agriculture

General Definition:

“A small and medium enterprise in primary agriculture is an enterprise with full-time employees not exceeding 50 or annual sales turnover not exceeding RM5 million.”

Specific Definitions:

“A micro enterprise in primary agriculture is an enterprise with full-time employees of less than 5 or with annual sales turnover of less than RM200,000.”

“A small enterprise in primary agriculture is an enterprise with full-time employees of between 5 and 19 or with annual sales turnover of between RM200,000 and less than RM1million.”

“A medium enterprise in primary agriculture is an enterprise with full-time employees of between 20 and 50 or with annual sales turnover of between RM 1 million and RM5 million.”

Manufacturing (including Agro-Based) and Manufacturing-Related Services (MRS)

General Definition:

“A small and medium enterprise in manufacturing (including agro-based) and MRS is an enterprise with full-time employees not exceeding 150 or with annual sales turnover not exceeding RM25 million.”

Specific Definitions:

“A micro enterprise in manufacturing (including agro-based) and MRS is an enterprise with full-time employees of less than 5 or with annual sales turnover of less than RM250,000.”

“A small enterprise in manufacturing (including agro-based) and MRS is an enterprise with full-time employees of between 5 and 50 or with annual sales turnover of between RM250,000 and less than RM10 million.”

“A medium enterprise in manufacturing (including agro-based) and MRS is an enterprise with full-time employees of between 51 and 150 or with annual sales turnover of between RM10 million and RM25 million.”

Services Sector (including ICT)

General Definition:

“A small and medium enterprise in services is an enterprise with full-time employees not exceeding 50 or annual sales turnover not exceeding RM5 million.”

Specific Definitions:

“A micro enterprise in services is an enterprise with full-time employees of less than 5 or with annual sales turnover of less than RM200,000.”

“A small enterprise in services is an enterprise with full-time employees of between 5 and 19 or with annual sales turnover of between RM200,000 and less than RM1million.”

“A medium enterprise in services is an enterprise with full-time employees of between 20 and 50 or with annual sales turnover of between RM 1 million and RM5 million.”

MRS may be defined as activities or services, other than manufacturing activities that are performed to support or complement the manufacturing activities with a view to the usage, sale, transportation, delivery and disposal of the manufactured products. They include all the upstream and downstream activities in the value chain. The main activities under MRS presently include the following -

- (i) Research and Development
 - Product / process development;
 - Software development;
 - Software integration;
- (ii) Product and Process Design
 - Design;
 - Prototyping;
- (iii) Distribution and Logistics
 - Logistic services including warehousing, transportation, freight forwarding, supply chain management and distribution;
 - Cold chain facilities and services for food products;

- Regional establishments such as operational headquarters, international procurement centres, regional offices, representative offices and regional distribution centres;

(iv) Marketing

- Branding;
- Packaging;
- Market research;

(v) Environmental Management

- Energy conservation / efficiency services;
- Energy generation activities, using renewable energy sources (biomass, hydro power and solar power);
- Storage, treatment and disposal of toxic and hazardous wastes;
- Waste recycling activities (agricultural wastes or agricultural by-products, recycling of chemicals and petroleum waste);
- Specialised services centres;
- Engineering consultancy services in environmental, such as EIA consultancy and environmental pollution;

(vi) Other related services

- Engineering support services such as metal castings; metal forging; metal surface treatment / finishing; machining; moulds, tools and dies; power metallurgical parts; heat treatment; mould texturing; metal stamping; galvanizing, shearing or slitting of metal sheets or related engineering services; overhaul, repair, reconditioning, modification or servicing of turbine engines, components or subassemblies; servicing and upgrading of machinery and equipment;
- Integrated central utility facilities;
- Irradiation services;
- Gas sterilization services;
- Total chemical management system; and
- Calibration and testing.

The above list may be expanded to include other related activities that may be identified from time to time.

Prior to the recent announcement by the National SME Council on a common, single definition of SMEs, the definition of an SME varies amongst the various Government ministries and agencies based on their respective criteria. Two definitions were then quite commonly used. The Ministry of International Trade

and Industry (MITI) and its specialised agency, namely the Small and Medium Industries Development Corporation (SMIDEC), had defined an SME as a company in the manufacturing or MRS sector having an annual sales turnover of RM25 million and full-time employees of not exceeding 150. On the other hand, other parties, including Bank Negara Malaysia, had defined an SME as a company having a shareholders' fund of not exceeding RM10 million.

The new definition of SME has several advantages over the earlier definitions. For instance, while one earlier definition only covered the manufacturing and MRS sector, the new definition spans three key economic sectors, namely primary agriculture, manufacturing / MRS and services and each of them is separately defined. The other earlier definition, which was solely based on shareholders' funds, did not offer breakdowns of SMEs in terms of size and economic sectors. On the other hand, the new official definition provides a clear distinction between enterprises that belong to the micro, small and medium categories.

It is envisaged that standardising the definition of SMEs within the national context will enable effective policy setting to target sectors within the economy, facilitate the provision of technical assistance and improve the channeling of financial benefits and other incentives under various policies. It allows for the physical identification of SMEs at the micro-level, encourages the formation of SME associations at the macro-level, and facilitates better articulation of the problems and prospects of the sector. Standardising the definition of SMEs will also support the collection of relevant and comparable SME data for data-building purposes.

CHAPTER 6

SMALL AND MEDIUM ENTERPRISES IN MONGOLIA

by
Ariunkhishig Gonchidorj¹

1. Introduction

Poverty is one issue which the whole world struggles with that cannot be ignored but which there is no perfect solution for. Today, over a billion people are still trying to survive on less than 30 USD a month. The best way to alleviate poverty is to boost economic development, especially in poor countries. One would not argue that establishing a favourable environment for micro, small and medium scale enterprises (SME) to flourish and the provision of necessary financial and social assistance to these enterprises would be the best possible solution.

Development of SMEs not only helps to alleviate poverty but is fundamental for sustainable growth and prosperity of the economy. There have been arguments as to whether SMEs can provide jobs to the unemployed. Some say that since SMEs are quite risky, SME entrepreneurs usually dangle between the edge of success and bankruptcy. On the other hand, it could be a great opportunity for people with creative ideas and talents to run their own businesses. In addition, when bigger companies lay off their employees during recessions, SMEs may be crucial for the survival of the resulting unemployed. Moreover, countries with a strong SME sector and supporting policies tend to have a more developed economy. However, SMEs face various obstacles and the main aim of this paper is to identify major constraints and challenges faced by the SMEs in Mongolia and to recommend measures to overcome them. The paper also delves into The Bank of Mongolia's role in promoting SMEs.

2. Mongolian SME Sector

At the beginning of the 1990's, Mongolia embarked on the transition from a centrally planned economy to a market based one. From the beginning of the transition till date, state properties have been privatised and many private enterprises have been established. In addition, as the market became more liberal, many

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private firms, especially, micro and small economic entities started their operations. In other words, the establishment and development of the private sector was initiated only in 1990s. While the SME sector is still in its infancy, there nonetheless have been successes as well as challenges.

As of the end March 2004, according to statistics of the National Statistics Office, a total of 32.4 thousand legal economic entities were registered, 26.5 thousand of which are actively operating. Over 90 percent of them are privately owned and are on the increase as a result of privatisation. About 61 percent of the active economic entities are operating in the capital city of Ulaanbaatar. Currently, the percentage share of the private sector as a proportion of GDP² is around 75 percent. The major sectors are agricultural, transportation and communication and retail, wholesale and repair of personal and household goods and the total share of the above mentioned sectors reached 63.9 percent of GDP at the end of 2003. However, as Mongolia does not have an official definition for SMEs, it is not possible analyse each sector in detail.

The Government of Mongolia issued Regulation 37 in 1991 which defined the small scale enterprises by only the number of employees.

Table 6.1
Former Definition of SME

Sector	The number of jobs for each shift
Agricultural	Up to 15
Construction	Up to 40
Trade	Up to 5
Service	Up to 10
Manufacturing	Up to 50
Food industry	Up to 30
Other sectors	Up to 15

However, the definition may have to include criteria other than the number of employees such as sales revenue and asset size so that it may be used for effective promotion policies. While Regulation 37 was replaced by Regulation 92 in 1999, the definition has remained unchanged.

The promotion of SMEs is necessary for the creation of jobs and improving the standard of living. Promoting SMEs could also improve efficiency and equity in distribution of goods and balance supply and demand in some markets. Furthermore, it would create an environment for fair competition in the market and encourage innovative businesses. Effective promotion policies could also give incentives for businesses of informal sector to shift to the formal sector; thus expanding the tax base and create an environment which will make it easier for a more accurate analysis of the economy.

For the above mentioned reasons, the Government is implementing measures to develop and implement promotion programmes. In addition, various international institutions are launching various projects in several areas of possible SME promotion such as providing funds, organising training, workshops, seminars, and offering consulting. However, without an official definition, it would be difficult to identify the target group. The definition of SMEs vary from country to country, and may even be different for different agents and institutions. It is also difficult to draw the line between SMEs and big companies. In other words, if a unified and agreed definition of a SME is unavailable, it would be uncertain if any SME promotion measure would be able to reach its target.

It is therefore vital to define SMEs. A survey was conducted within the framework of this research to (i) propose possible suggestions for SME definition and (ii) determine and recommend solutions for finance related challenges and problems faced by economic entities.

The survey included the larger economic centres or cities and also the equal representation of economic situations of provinces. The survey was conducted in the Ulaanbaatar, the capital and two other main cities, Darhan and Erdenet. It also included the relatively isolated province of Bulgan; a closer province to the capital city, Tuv and border province of Selenge. Out of the total of 1154 economic entities which participated in the survey, 446 or 38.7 percent resided in Ulaanbaatar, 201 or 17.4 percent in Darhan, 186 or 16.1 percent in Erdenet, 94 or 8.2 percent in Tuv, 80 or 6.9 percent were in Bulgan, and 146 or 12.7 percent in Selenge province.

Table 6.2
Percentage of Participants, Percentage of Economic Entities by Location
(as of the end of 2003)

City and Province	The number of economic entity	Percentage in total economic entity	The number of participating entities	Percentage in total participating entities
Ulaanbaatar	18975	60.3%	446	38.7%
Darhan	1215	3.9%	201	17.4%
Erdenet	1139	3.6%	186	16.1%
Tuv	760	2.4%	94	8.2%
Bulgan	491	1.6%	80	6.9%
Selenge	1301	4.1%	146	12.7%
Total	23881	75.9%	1153	100.0%

As was mentioned earlier, the survey consists of 2 parts and in this section, a possible definition for SMEs will be proposed based on the results of the survey. The responses by participants to each question in Part I will be reviewed first.

Table 6.3
Business Sectors of Survey Participants

Sector	The number of participants	As percentage of total participants
Construction	52	4.9%
Education	24	2.2%
Manufacturing	53	5.0%
Health and social service	40	3.7%
Whole and retail sale	416	38.9%
Hotel, motel, restaurants	135	12.6%
Service	132	12.3%
Financial	77	7.2%
Agricultural	91	8.5%
Communication	22	2.1%
Mining and quarrying	18	1.7%
Other	9	0.8%
Total	1069	100%

The majority of the survey participants or 63.8 percents are operating in such sectors as whole and retail sale, hotel, motel and restaurants, and service. Statistics show that 13339 out of a total of 31478 economic entities are operating in the whole and retail sales, repair of motor vehicles, motorcycle and personal and household goods, and hotel and restaurant sectors. Such sectors are very conducive as a start up for micro and small businesses as they require little initial investments, have low operating costs, and are not labour intensive. From the survey, it was revealed that the majority of participants who run hotel and restaurant businesses actually own small cafés, diners and fast food restaurants and are mostly located in the country side or own very small motels of 3-5 rooms.

As for the whole and retail trade, it covers all types of goods ranging from clothing to food stuff. Beginning from 1990's, because of the Mongolia's location, trading has been carried out between China and Russia. Today, many bigger and medium businesses started their businesses as "spivs", trading in China (mostly to Erlian, border city of China and Mongolia, and sometimes to Beijing). In fact, a large portion of SME sector are very small, micro businesses comprising of such traders. Their turnover is usually small, being around USD 5000 but their risks are limited as well. Usually this type of business employs 2-3 family members and is sufficient to sustain a family of 10 or more.

In order to draw up an efficient definition for the SMEs, it is necessary to carefully consider the similarities and differences between the sectors. While whole and retail sale and service businesses employ a few people who are mostly family members, the mining and manufacturing sector usually require the owner to hire skilled and experienced employees. As for the businesses that are capital intensive, higher initial investments are inevitable.

Table 6.4
The Number of Employees

The number of employees	The number of participants	Percentage in total participants
1	210	19.0%
2 to 4	453	41.1%
5 to 9	187	17.0%
10 to 19	160	14.5%
20 to 49	64	5.8%
50 to 100	20	1.8%
101-250	9	0.8%
More than 250	10	0.9%
Total	1103	100.0%

One of the most common criteria of SME used is the number of employees. As seen from the Table above, 77 percent of the participating enterprises have less than 10 employees, 97.4 percent have less than 50, and 99.2 percent, less than 100 employees.

Another widely used criterion is sales revenue while participants' income before tax can also be one possible criterion. Although countries also use the amount of initial investments when defining SMEs, it may not be very efficient indicator in Mongolia's case. In the early years of the transition, Mongolia had high inflation rates like other transitional economies. However, due to appropriate economic and effective monetary policies, inflation was brought down to single digit levels by 1998 and has been under 10 percent since then. However, initial investments for businesses set up 5 or more years ago vary vastly from the same types of businesses being established today. Moreover, as technology advances and Mongolia becomes more open to the world, new technology and machinery are becoming cheaper and more accessible. For such and other reasons, it is quite difficult to obtain a general trend in required initial investments. The following graphs and table are results to the survey on monthly sales revenue, annual income before tax and initial investments.

Figure 6.1

Monthly Sales Revenue

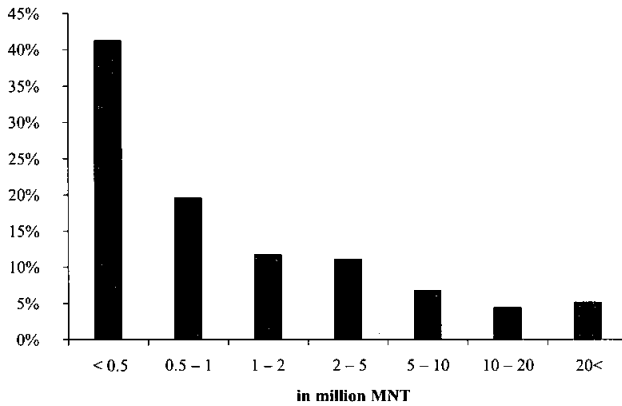


Figure 6.2

Annual Income Before Tax

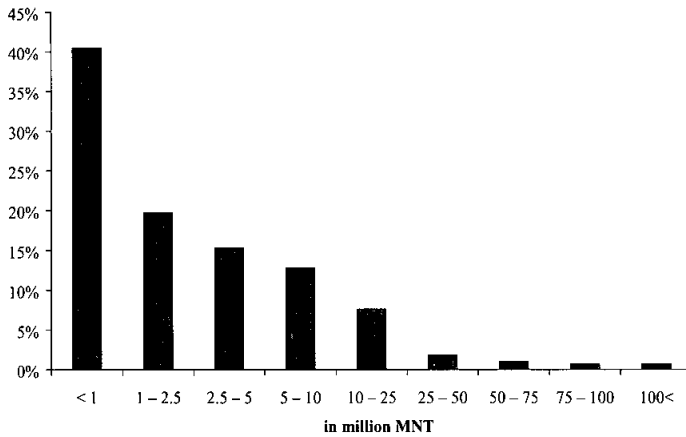


Table 6.5
Amount of Initial Investment (in million MNT)

Initial investment	The number of participants	Percentage of total participants
<0.5	427	38.7%
0.5 - 1	211	19.1%
1 - 2	170	15.4%
2 - 5	115	10.4%
5 - 10	91	8.3%
10<	89	8.1%
Total	1103	100.0%

As mentioned previously, it is necessary to break the answers into each sector to differentiate in terms of labour or capital intensiveness. The tables below show the breakdown of the number of employees, monthly sales revenue, and income before tax by various sectors.

Table 6.6
Employment by Sector

Sector Employee	Construction (%)	Education (%)	Manufacturing (%)	Whole and retail trade (%)	Hotel, motel, restaurant (%)	Service (%)	Financial (%)	Agricultural (%)	Communication (%)	Mining (%)	Health and social service (%)
1	7.7	4.3	7.8	30.7	5.3	23.5	9.1	18.0	9.5	0.0	5.0
2 - 4	19.2	30.4	35.3	49.5	27.8	47.0	32.5	41.6	47.6	5.6	42.5
5 - 9	13.5	21.7	23.5	8.9	29.3	14.4	26.0	19.1	23.8	16.7	25.0
10 - 19	34.6	13.0	15.7	6.4	24.8	10.6	23.4	12.4	4.8	44.4	20.0
20 - 49	15.4	17.4	7.8	3.5	8.3	2.3	7.8	7.9	9.5	5.6	0.0
50 - 100	9.6	8.7	7.8	0.2	3.0	1.5	1.3	0.0	0.0	0.0	0.0
101-250	0.0	0.0	2.0	0.5	0.8	0.0	0.0	1.1	4.8	5.6	2.5
250<	0.0	4.3	0.0	0.2	0.8	0.8	0.0	0.0	0.0	22.2	5.0

Table 6.7
Income before Tax (in million MNT, by Sector)

Sector Income before tax	Const- ruction (%)	Educa- tion (%)	Manufac- turing (%)	Whole and retail trade (%)	Hotel, motel, restaurant (%)	Service (%)	Financial (%)	Agricul- tural (%)	Communi- cation (%)	Mining (%)	Health and social service (%)
<1	21.2	41.2	33.3	47.7	30.1	46.2	38.0	43.0	27.8	36.8	27.8
1-2.5	11.5	35.3	17.6	18.4	22.0	21.0	23.9	19.8	16.7	5.3	16.7
2.5-5	17.3	0.0	17.6	16.5	17.9	13.4	7.0	19.8	11.1	31.6	16.7
5-10	21.2	11.8	9.8	8.7	21.1	14.3	18.3	7.0	5.6	15.8	11.1
10-25	13.5	11.8	9.8	5.7	7.3	5.0	4.2	7.0	27.8	10.5	22.2
25-50	7.7	0.0	9.8	1.6	0.0	0.0	2.8	1.2	0.0	0.0	0.0
50-75	1.9	0.0	0.0	0.5	1.6	0.0	1.4	1.2	5.6	0.0	0.0
75-100	3.8	0.0	2.0	0.0	0.0	0.0	2.8	1.2	0.0	0.0	0.0
100<	1.9	0.0	0.0	0.8	0.0	0.0	1.4	0.0	5.6	0.0	5.6

Table 6.8
Sales Revenue (in million MNT, by Sector)

Sector Sales revenue	Const- ruction (%)	Educa- tion (%)	Manufac- turing (%)	Whole and retail trade (%)	Hotel, motel, restaurant (%)	Service (%)	Financial (%)	Agricul- tural (%)	Communi- cation (%)	Mining (%)	Health and social service (%)
<0.5	24.5	47.4	36.0	45.3	29.1	52.8	42.9	45.2	33.3	35.3	39.5
0.5 - 1	10.2	26.3	18.0	20.7	26.0	20.3	14.3	20.2	9.5	5.9	15.8
1 - 2	4.1	10.5	14.0	11.7	11.8	8.1	12.9	11.9	19.0	17.6	5.3
2 - 5	12.2	5.3	8.0	8.0	19.7	8.9	11.4	9.5	14.3	17.6	18.4
5 - 10	12.2	10.5	6.0	6.5	6.3	6.5	7.1	6.0	4.8	5.9	15.8
10 - 20	20.4	0.0	12.0	3.1	3.1	0.0	4.3	7.1	14.3	0.0	2.6
20<	16.3	0.0	6.0	4.7	3.9	3.3	7.1	1.2	4.8	17.6	2.6

The survey attempted to break the businesses of participants into 11 different economic sectors in order to garner more precise information. However, as it will not be necessary to draw up SME definitions for all those sectors; the 4 main sectors of agricultural, manufacturing, services and trade will be considered. The agricultural sector contains all related activities such as livestock, harvesting, hunting, fishing, forestry and so on. Service would include hotel, motel, restaurants, household services, repair, health and social service activities. Manufacturing includes mining and quarrying, construction, factories and other labour intensive activities.

In Mongolia, micro lending and micro economic activities are very well spread. In a recent speech given by the Minister of Industry and Trade, it was stated that about 96 percent of the total operating enterprises are SMEs and make up

60 percent of the GDP. Although it was not specified in his speech, a large portion of the SMEs are micro enterprises. There have been specific programmes and projects aimed at developing micro enterprises. Micro entrepreneurs are usually people who are trying to finance their most basic needs for themselves and their families. They almost never can accumulate savings to be able to further expand their businesses. The majority of them are not registered as they operate in the informal sector. Although the minimum standard of living vary for urban and rural population, the average is around 20,000 MNT for a household. From the survey responses, the reported average household income is very close or a bit higher than the minimum average. In the urban areas, economic activities include retail sales and services that not labour or capital intensive while in the rural areas, they include livestock, hunting, and other agricultural activities.

The main purpose of defining SME is to distinguish them from bigger competitors so that development policies will reach the intended target. With that in mind, there is a need to separate definitions for micro enterprises and SME. Providing specific and separate definition for micro enterprises will enable the government, agencies, and other related national and international institutions to have a clear target when implementing policies and projects. Furthermore, it will expose the myriads of micro enterprises which are currently operating in the informal sector.

Table 6.9 presents the proposed definitions for micro and SM enterprises. From the results of the survey, the number of employee and the amount of annual sales are the most appropriate criteria for definition. While income before tax would not be included in the definition, it could also be used as an additional criterion and is presented in Table 6.10.

Table 6.9
Definitions for Micro and SM Enterprises.

Type	Sector	Description	Number of Employee	Annual Sales Revenue (in million MNT)
Micro Enterprise	Trade	Whole and retail sales	Up to 2	Up to 6
	Service	Repair, household and personal services, transportation, motel, small restaurants	Up to 5	Up to 5
	Agricultural	Livestock, harvesting, hunting, forestry, fishing	Up to 5	Up to 5
Small and Medium Enterprise	Trade	Whole and retail sales of all types of goods imported and domestically produced	Up to 10	6 – 24
	Service	Repair, hotel, motel, restaurant, storage, financial, transportation, educational activities, household, personal, social and health services	Up to 20	6 – 48
	Manufacturing	Mining and quarrying, factories, construction, electricity, gas and water supply	Up to 30	Up to 120
	Agricultural	Livestock, harvesting, hunting, forestry, fishing	Up to 20	4 – 48
	Construction	Construction, road	Up to 50	Up to 240

Table 6.10
Income before Tax

Type	Micro Enterprise			Small and Medium Enterprises				
Sector	Trade	Service	Agricultural	Trade	Service	Manufacturing	Agricultural	Construction
Income before tax (in million MNT)	Up to 1	Up to 1	Up to 1	1 – 10	1 – 20	Up to 50	1 – 25	Up to 75

3. Challenges and Problems of SME Sector

The goal of promoting SME development has always been part of Government policies. In February 1999, the Government passed Regulation 10 to support SME development by initiating a programme, the aim of which is as follows:

- Improve managerial structure, human resources, and information environment;
- Establish a favourable environment in rural areas for SMEs to operate;
- Advance techniques and technologies used by SMEs so as to reduce negative externalities and improve their competitiveness;
- Support cooperation among SMEs; and
- Promote all types of domestic and international investments in developing SMEs and expand international cooperation.

The project implemented from 1999 to 2004 and as stated in the Regulation, was to ensure an economic growth which is higher by 3.5%, higher supply of goods, lower unemployment rate, induce innovative businesses, decentralise economic activity and provide conditions for equal development in both urban and rural areas. Every Ministry and related government agencies have roles to play in the implementation of the programme as well as various non-government organisations. Within the framework of the programme, 45 sums (villages and towns) of 14 provinces were provided with centralised electricity supply and better infrastructure such as communication and roads with financing from the state and international organisations.

In addition to the government implemented projects, various other projects were financed by international organisations such as "Employment Generation Project" by ADB and "Developing SMEs and Strengthening of the Financial Sector" by KfW. The main objective of the former project is to generate employment and income opportunities by providing loans to micro and small enterprises. In the first stage of the project (1994-2001), total loans of USD 3.0 million from ADB's Special Funds resources were disbursed to the participating commercial banks. The second stage of the project started in May 2001 and at the end of 2004, funds amounting to USD 2.5 million were distributed to participating banks. During the implementation of the second stage, 1336 jobs were created. The latter project was to provide medium and long-term loans to private SMEs to facilitate economic growth through strengthening private sector, generating jobs and expanding the export base. The loans were also distributed by selected commercial banks which were supported by international experts on small and medium loan activities. The maturity of the loans were up to 10 years with grace period of up to 3 years and for euro denominated loans, the annual interest rate was fixed throughout the life of the loan at 7.75 percent.

Even as the economic situation improved with the development of better infrastructure and stabilisation of the financial sector, there are many problems and challenges faced by SMEs. One of the main challenges is the access to funds for financing SME activities. In this section, several possible policy recommendations to remedy the situation are discussed based on the survey results.

To date, there are 17 commercial banks, 98 non-bank financial institutions and about 300 savings and loan associations providing loans to private enterprises and households. In recent years, activities of the private sector have expanded

as a result of increased public confidence in the financial sector. At the end of 2004, banks' total national currency denominated loans to private sector was 118.6 billion MNT and foreign currency denominated was 201.4 billion as compared to 100.4 billion and 133.9 billion MNT as of the end of 2003 respectively. If we consider the percentage breakdown of the total loans as of 2004, 58.6 percent were to private enterprises and 35.9 percent were to individuals. Loans to individuals consist of small business loans, consumption loans, salary or pension loans, etc., with small business loans taking the biggest share in this category.

A total of 595 branches and settlement units of banks are operating out of which 470 are in the rural area. In most of the cases, there is only one bank offering its services in a rural area and the financial services are limited to basic transactions. Banks are not willing to establish branches or units in the rural areas because of the high set-up costs, low population density, under developed infrastructure and limited business activities. In the case of other financial institutions, less than 10 percent of the NBFIs are operating in the country side and while S and L associations are more active, they are not wide spread. Pawnshops, relatives, families, friends, and individuals are still main sources of lending. SMEs usually have a hard time obtaining loans from financial institutions while they require them the most. Participants of the survey were requested to respond to queries on a loan demand, loan supply and the main financing sources for initiating and continuing their businesses.

Table 6.11
Source of Initial Investment

Source	The number of participants	Percentage of participants
Bank	337	30.2%
Non bank financial institution	59	5.3%
Other entities	53	4.7%
Pawn shop	38	3.4%
Individual	351	31.4%
Self financed	230	20.6%
More than 2 sources	49	4.4%
Total	1117	100.0%

30 percent of the participants sourced their initial investments from bank loans while about 50 percent started their businesses on their own or with personal loans from relatives, family or friends. Pawn shops or individuals usually lend at a higher rate of interest with short maturities but they are popular with borrowers who are not able to meet requirements of banks. Only 5.3 percent of respondents obtained funds for their initial investment from NBFIs. In, light of this, there is still a lot of room for NBFIs and other financial institutions to expand their activities especially in the rural areas.

Table 6.12
Source of Funding

Source	The number of participants	Percentage of participants
Banks	688	58.9%
Non bank financial institutions	105	8.9%
Other business entities	52	4.4%
Pawn shops	41	3.5%
Friends or relatives	222	19.1%
Other	61	5.2%
Total	1169	100%

For borrowers who have up and running businesses, almost 60 percent of them obtained loans from commercial banks and 9 percent from NBFIs but nevertheless, friends or relatives are still favourite lenders. In order to promote the establishment of NBFIs in the rural areas, The Bank of Mongolia has set a different paid-in capital requirement of 10 million MNT for the NBFIs if they are established to operate in the country side as against 100 million MNT in the city. However, NBFIs and other formal financial institutions continue to be very inactive outside the Ulaanbaatar mostly due to the lack of development in the business environment, underdeveloped infrastructure and communication and the widely spread and low population. Because the capital market is not developed, it is almost impossible to use bonds and securities as source of additional funding. Loans from individuals and pawnshops are mostly for small amounts and have high interest rates and short maturities and as the amount of loans increases, so

do the risks. In addition, it is doubtful if there are pawnshops that could grant loans higher than 50 million togrogs to borrowers, being risky for both lender and borrower. In light of this, the main sources of borrowing for these borrowers are the domestic banks, foreign banks and financial institutions.

Table 6.13 Demand for Loan

Demand for loan	The number of participants	Percentage of participants
High	396	35.3%
Medium	484	43.2%
Low	171	15.3%
None	70	6.2%
Total	1121	100%

On the demand for loans, about 80 percent of the respondents stated their demand for loans to be high or medium. If the loan demand is classified according to location, the percentage of rural borrowers who stated that their loan demand is higher than medium level is 79.0%, which is bit higher compared to the percentage of the urban borrowers at 77.6%. From the survey, it was also revealed that there is a segment of entrepreneurs who are what is termed "discouraged borrowers" who are not eligible to borrow from financial institutions and have never applied for bank loans.

**Table 6.14
Supply of Loan**

Supply of loan	The number of participants	Percentage of participants
Well supplied	437	40.3%
Supplied at medium level	440	40.6%
Not adequately supplied	207	19.1%
Total	1084	100%

The majority of the respondents or 80 percent stated that they are able to source for loans. 79.8 percent of respondents from the capital city are able to source for funding while 85.1 percent from the rural provinces are also able to do so. This encouraging figures could be due to the revival of the activities of the Agricultural Bank which has the widest network of branches in Mongolia, and the expansion of the XAC Bank, which specialises in micro lending in the city and in rural provinces. Rural borrowings are usually for micro businesses and many of them finance their businesses with consumption or pension loans which are extended by the above mentioned institutions and other banks. Compared to the end of 1990, loan availability and the number of banks offering banking services has grown significantly in provinces. Interestingly, the borrower who answered that loan is being supplied at certain level, turns around and says that loan availability is not satisfactory and demand for loans is high. Those borrowers might have understood that demand for loans and needs are the same thing, and if they are inclined to have any need for loan, they define it as a demand for loans. Otherwise, as they do initial turnover using loans, their business circulation grows bigger; therefore, it causes an increase in need for loans.

The second part of the survey is aimed at diagnosing the problems with financing from the banks and majority of the respondents are people who have already obtained bank loans. On major problem identified is the lack of assets of collaterals required by banks while another problem relates to the difficulty in compiling the necessary documentation for the loans required by the banks. Unfavourable loan contract terms is also another obstacle faced, stated by 12.3 percent of the respondents.

Table 6.15
Obstacles of Loan Acquisition

Obstacles of Loan Acquisition	The number of participants	Percentage of participants
Lack of assets for pledge	493	36.2%
Compilation of loan documents	431	31.4%
Unfavourable loan contract terms	169	12.3%
Bureaucracy of loan officers	111	8.1%
Corruption of loan officers	42	3.1%
Own fault	31	2.6%
Other	86	6.3%
Total	1363	100%

Other problems also include bureaucracy or corruption of loan officers, and borrowers own fault.

Assets for collateral are the main problem for borrowers especially in the case of rural borrowers who are just starting their business while in the cities, collateral is less of a problem because real estate or property are often used as collateral. However, in the country side, most households do not own real estate but live in "ger" which is the most suitable for their nomadic life style which revolves around herding or harvesting. Livestock is not acceptable collateral as they are vulnerable to natural disasters and diseases. Although the Law on Land Ownership was passed and is in effect, the implementation of the Law is still in the administrative stage. Therefore, the rural people have use of their lands for a temporary period of time and for directed purposes only for the time being. While they could use their possessions as collateral, banks and financial institutions are reluctant to accept these due to the risks associated. When insurance of livestock becomes common practice among the herders in rural provinces and the above mentioned law is fully in effect, it is expected that the collateral problem could be resolved in a certain sense. Looking at the examples of other developing countries, banks and other financial institutions practice mutual trust with borrowers who have assets or collateral. Banks could first try lending at a lower amount than requested and provide counseling on business activities and upon repayment of the initial loan, the loan could be increased. In this way, the bank could build up the borrower's ability to repay the loan and at the same time develop business skills.

The compilation of documents for application for loans is also problematic for borrowers. Currently, documents which need to be submitted for loan applications include the business plan, certificate from the Department of Real Estate Registration and The Bank of Mongolia's certification of the validity of the asset for pledge and borrower's current financial condition in that there are no other obligations of unpaid loans, and other documents depending on the application. The bureaucracy and high fee charged by the Department of Real Estate for the verification of the real estate certificate are obstacles for borrowers applying for bank loans.

To help resolve some of these obstacles, The Bank of Mongolia created the Credit Information Bureau (CIB) with the purpose of providing the banks with relevant information. The CIB obtains its information from various institutions and is shared with banks and NBFIs to smoothen and promote the lending activities

However, the information is confidential and is used solely for the purpose of lending activities but could be made available to customers for relevant information.

The business plan is an important document for loan application, identifying the prospective borrower's intended business, planned turnover, economic return estimations and explains how the borrower would repay the loan. However, as micro businesses in Mongolia can quite similar, there are cases where pre-written business plans are drawn up for a fee. The lack of knowledge and information are a major problem that SME entrepreneurs encounter. Therefore, special workshops or training sessions for SMEs to gather updated information on the market, business opportunities, risks and measures against risks, marketing, and so on should be organised.

On the repayment of loans, it is encouraging to note that the percentage share of non-performing loans of total loans has been on decreasing trend. However, even as NPL has been on a decreasing trend from 1999 to mid-2001, it has recently started to increase, albeit marginally and is currently at 10 percent.

Figure 6.3
Ratio of Non-performing Loans of Total Outstanding Loans

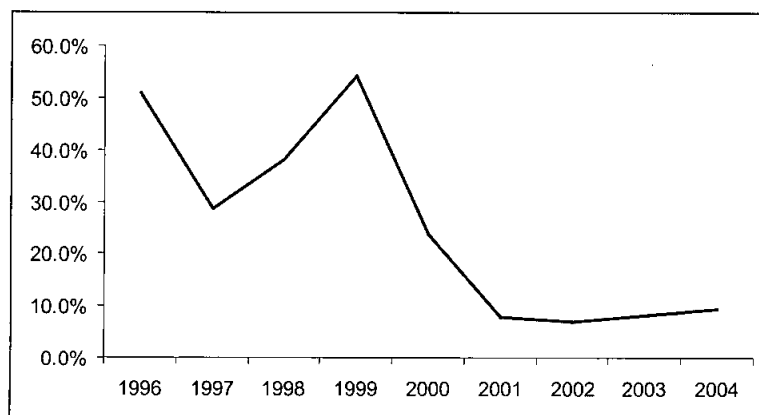


Table 6.16
Loan Repayment Problems

Problems	The number of participants	Percentage of participants
High interest rate	406	23.2%
Short maturity	519	29.7%
Business risk	269	15.4%
Domestic economy	113	6.5%
World economy	28	1.6%
Tax burden	226	13.0%
Fluctuations	140	8.0%
Other	46	2.6%
Total	1747	100%

According to the survey respondents, the main problem for loan repayment are the high interest rates charged and short maturities or in short the terms of the bank loan. Currently, weighted average rate of loans offered by the banks is 31.8 for MNT denominated loans and 18.5 percent for foreign currency loan and loans are usually short term loan, i.e. up to a year.

High interest rates are charged because of the high demand and high processing cost. In light of this, the capital market and the stock exchange need to be developed so that bigger corporations can finance their activities through issuing bonds or stocks. Small lenders on the other hand are turning to sources which charge even higher interest rates than banks because of their inaccessibility to credit from financial institutions. The short loan maturity is also a problem for small borrowers. 55.7 percent of the respondents stated that the interest rates charged are too high. However, less than 50 percent of the respondents actually seriously consider the rate of interest rate when applying for loans. 51.9 percent of the respondents revealed that loan maturity is not sufficiently long enough for repayment and the majority or 78.1 percent considered that loans with a maturity of up to 3 years would be the most appropriate. The majority of the respondents would prefer that banks be more flexible with the repayment schedule.

4. Conclusion

The most important step for development of SMEs is to have an official definition. This would help focus policies and international and national projects on the targeted group. In addition, when more programmes are implemented to promote SMEs, it would bring businesses in the informal sector into the real economy. This would widen the tax base and increase government revenue. Another measure would be to decrease the loan processing cost. Presently, the bureaucracy and high fees charged for processing documentation for loan applications discourage borrowings from the financial institutions. One way to overcome this obstacle is with the creation of a database network of all related institutions. It may be an on-line database pool made available to customers for their relevant needs and verifications. The Credit Information Bureau or CIB established at The Bank of Mongolia is a good start and has proven to be very efficient. The major conclusions from the survey are summarised as follows:

- Only up and running businesses are able to repay the loans considering the high interest rates, short maturity, and inflexible loan terms. Changes in interest rate levels and loan maturity would encourage the shift of loan sources from trading to the industrial sector and promote innovation which is currently lacking;
- Although financial intermediation in rural aimags has significantly recovered as compared to 1996-1999 crisis period, demand for micro loans is still high;
- Urban small and medium borrowers still have high demands for loans because of the inaccessibility to credit from financial institutions;
- High interest rates and loan maturities are the major difficulties for loan repayment;
- Businesses make up their capital shortage by bank loans most of the times. However, loans from individuals is another major source showing that NBFIs have vast opportunities to expand their services in the micro loan market.
- As a result of effective monetary policy, inflation has been stable around 8 percent lately, and is on a decreasing trend. In light of this, commercial banks must consider lowering the loan interest rate. By keeping the interest rate high, banks are increasing credit risk and may actually reduce profitability instead of increasing it;
- Because of short maturities of loan, the majority of borrowers go into trade and service businesses with fast turnovers. Ironically, this type of businesses face difficulties in obtaining loans from the formal sector and often rely on the informal sector, taking high risks.

Table 1
Percentage of Participants, Percentage of Economic Entities by Location
(As of the end of 2003)

City and Province	The number of economic entity	Percentage in total economic entity	The number of participating entities	Percentage in total participating entities
Ulaanbaatar	18975	60.3%	446	38.7%
Darhan	1215	3.9%	201	17.4%
Erdenet	1139	3.6%	186	16.1%
Tuv	760	2.4%	94	8.2%
Bulgan	491	1.6%	80	6.9%
Selenge	1301	4.1%	146	12.7%

Table 2
Business Sectors of Survey Respondents

Sector	The number of participants	As percentage of total participants
Construction	52	4.9%
Education	24	2.2%
Manufacturing	53	5.0%
Health and social service	40	3.7%
Whole and retail sale	416	38.9%
Hotel, motel, restaurants	135	12.6%
Service	132	12.3%
Financial	77	7.2%
Agricultural	91	8.5%
Communication	22	2.1%
Mining and quarrying	18	1.7%
Other	9	0.8%
Total	1069	100%

Table 3
Business Age of Survey Respondents

Age	The number of participants	Percentage of total participants
Up to 1 year	214	19.2%
1-3 years	268	24.1%
3-5 years	332	29.9%
More than 5 years	298	26.8%
Total	1112	100.0%

Table 4
The Number of Employees

The number of employees	The number of participants	Percentage in total participants
1	210	19.0%
2 to 4	453	41.1%
5 to 9	187	17.0%
10 to 19	160	14.5%
20 to 49	64	5.8%
50 to 100	20	1.8%
101-250	9	0.8%
More than 250	10	0.9%
Total	1103	100.0%

Table 5
Amount of Initial Investment (MNT)

Initial investment	The number of participants	Percentage of total participants
Up to 500,000	427	38.7%
500,001-1,000,000	211	19.1%
1,000,001-2,000,000	170	15.4%
2,000,001-5,000,000	115	10.4%
5,000,001-10,000,000	91	8.3%
Higher than 10,000,000	89	8.1%
Total	1103	100.0%

Table 6
Source of Initial Investment

Source	The number of participants	Percentage of participants
Bank	337	30.2%
Non bank financial institution	59	5.3%
Other entities	53	4.7%
Pawn shop	38	3.4%
Individual	351	31.4%
Self financed	230	20.6%
More than 2 sources	49	4.4%
Total	1117	100.0%

Table 7
Monthly Sales Revenue (MNT)

Monthly sales revenue	The number of participants	Percentage of participants
Up to 500,000	436	41.2%
500,001-1,000,000	207	19.6%
1,000,001-2,000,000	124	11.7%
2,000,001-5,000,000	117	11.1%
5,000,001-10,000,000	72	6.8%
10,000,001-20,000,000	47	4.4%
More than 20,000,000	54	5.1%
Total	1057	100.0%

Table 8
Annual Income Before Tax (MNT)

Annual income before tax	The number of participants	Percentage of participants
Up to 1,000,000	419	40.5%
1,000,001-2,500,000	204	19.7%
2,500,001-5,000,000	158	15.3%
5,000,001-10,000,000	132	12.8%
10,000,001-25,000,000	79	7.6%
25,000,001-50,000,000	19	1.8%
50,000,001-75,000,000	10	1.0%
75,000,001-100,000,000	7	0.7%
More than 100,000,000	7	0.7%
Total	1035	100.0%

Table 9
Demand for Loan

Demand for loan	The number of participants	Percentage of participants
High	396	35.3%
Medium	484	43.2%
Low	171	15.3%
none	70	6.2%
Total	1121	100%

Table 10
Supply of Loan

Supply of loan	The number of participants	Percentage of participants
well supplied	437	40.3%
supplied at medium level	440	40.6%
not adequately supplied	207	19.1%
Total	1084	100%

Table 11
Source of Funding

Funding sources	The number of participants	Percentage of participants
banks	688	58.9%
non bank financial institutions	105	8.9%
Other business entities	52	4.4%
Pawn shops	41	3.5%
Friends or relatives	222	19.1%
other	61	5.2%
Total	1169	100%

Table 12
Difficulties of Getting Loan

Difficulties by getting loan	The number of participants	Percentage of participants
Lack of assets for pledge, or guarantee	493	36.2%
Compilation of loan documents	431	31.4%
Too unfavorable loan contract	169	12.3%
Bureaucracy of loan officers	111	8.1%
Corruption of loan officers	42	3.1%
Own fault	31	2.6%
Other	86	6.3%
Total	1363	100%

Table 13
Level of Lending Rate

Lending rate	The number of participants	Percentage of participants
Too high	606	55.7%
Acceptable	470	43.2%
Low	12	1.1%
Total	1088	100%

Table 14
Effect of Lending Rate Level on the Decision of Getting Loan

Effect of lending rate level	The number of participants	Percentage of participants
very much	517	48.7%
in certain length	469	44.2%
not much	64	6.0%
Other	12	1.1%
Total	1062	100%

Table 15
Sufficiency of Loan Maturity

Is loan maturity sufficient enough?	The number of participants	Percentage of participants
Yes	551	51.9%
No	511	48.1%
Total	1062	100%

Table 16
Appropriate Loan Maturity

Appropriate loan maturity	The number of participants	Percentage of participants
3 months	14	1.3%
3-6 months	50	4.5%
6-12 months	282	25.3%
1-3 years	523	47.0%
More than 3 years	244	21.9%
Total	1113	100%

Table 17
Occurring Problems of Loan Repayment

Occurring Problems of Loan Repayment	The number of participants	Percentage of participants
high interest rate	406	23.2%
short maturity	519	29.7%
business risk	269	15.4%
domestic economy	113	6.5%
world economy	28	1.6%
tax burden	226	13.0%
Fluctuations	140	8.0%
other	46	2.6%
Total	1747	100%

Table 18
Necessity to Extend the Loan Maturity

Necessity to extend the loan maturity	The number of participants	Percentage of participants
all the time	248	23.2%
sometimes	695	64.8%
never	129	12.0%
Total	1072	100%

Table 19
Possibility to Extend the Loan Maturity

Possibility to extend the loan maturity	The number of participants	Percentage of participants
yes	311	29.6%
no	278	26.5%
some cases	461	43.9%
Total	1050	100%

CHAPTER 7

ROLE OF NEPAL RASTRA BANK IN PROMOTING SMALL AND MEDIUM ENTERPRISES DEVELOPMENT

by
Ram Bahadur Manandhar¹

1. Introduction

The process of industrialisation plays an important role in accelerating economic growth as it helps to increase per capita income (PCI) of the country. The difference in the level of industrialisation explains the income level differential between developed and developing countries. An increase in PCI helps to reduce the poverty levels in the developing countries, likewise an increased level of industrialisation helps to absorb rising labour force from the agriculture sector. Among the industries, SMEs are important in developing countries because compared to large industries, they require less capital and can provide more jobs, thereby helping reduce poverty. Central banks should therefore introduce policy measures to promote SMEs as there is also a close relationship between monetary policy and the promotion of SMEs. For example, when tight monetary policy is adopted, the quantum (availability) of credit declines. In such an instance, SMEs are likely to suffer more because unlike large industries, they cannot raise funds from the capital market due to their lower level of credibility. This therefore emphasises the importance of central bank's significant role in promoting the SME sector.

Small and Medium Enterprises (SMEs) have emerged as one of the most effective devices to foster economic growth because of the distinct characteristics they possess:

- SMEs are comparatively easier to promote and manage;
- They are relatively more flexible;
- They are more appropriate where resources are scarce;
- They have greater potentiality to create employment opportunities;
- They offer high potential and opportunities for specialisation and skills development;

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- They provide a vehicle for introducing a more equitable income distribution;
- They help the regional dispersal of industrial development, and utilisation of indigenous raw materials for manufacturing of value-added product;
- They provide impetus to innovation and modernisation;
- They are more suited to situations where the market size is restrictive; and
- They represent the backbone of all economic activities.

2. General Overview: Growing Importance of SMEs

The past 15 years have witnessed several changes in the world economic system: consolidating trend of globalisation and liberalisation of economies, crumbling barriers to international trade and free movement of capital due to the establishment of the World Trade Organization (WTO) in 1995; shifting towards market economy by earlier centrally planned economies.

Beginning in the 1970s, however, large manufacturing firms in key industries began to lose competitiveness and a number of important empirical studies began to document the critical role of SMEs. For example, Acs (1984) argued that newer and smaller firms entered sectors as “agents of change”. Studies using direct measures of innovative activity - such as measure of new products and processes - replaced older measures (such as R&D) and showed that innovative activity was introduced by small firms and not the larger incumbents (Klapper and et.al. 2002).

In general, the SME sector comprises relatively younger, more leveraged, and more profitable firms. This suggests that a new type of firm is emerging in transition economies that is more market-and profit-oriented. These SMEs are, however, only borrowing short-term debt, which appears to be the only type of financing that these firms can access.

Once considered a relatively unimportant aspect of the economy, SMEs are increasingly viewed by the government and international donors alike as a critical sector for generating economic growth.

Several countries have encouraged the growth and development of SMEs through stipulation and enforcement of policies and measures, which provide incentives and assistance to SMEs. Regional as well as international level attempts have also been directed at helping the SMEs grow and develop within the national frontiers and at the global level. With the rising trends of globalisation in recent times, the national economies are being increasingly harmonised with global

economies. At present, no nation can afford, in pragmatic sense, to remain isolated and insular from the world nor can it even afford redundancy in technology, management and marketing.

The earlier pre-occupations with the 'big is beautiful' concept that stressed the economies of scale common to large firms has lost much of its original ground. Experience has proved that large-firm economies of scale are not possible in all forms and scales of industrial production. SMEs comprise an important scale of production, which the large firms may not be able to operate. The burden of large firms is shared by SMEs to a considerable extent. It stands to reason that the success of large companies depends, in varying degrees, on the assistance they receive from small firms (Shrestha, 2001).

3. Entrepreneurs: The Key Factor in Economic Development

The French economists Cantillon first introduced the term entrepreneur and defined him as the agent who purchased the means of production for combination into marketable products. J.B. Say expanded Cantillon's idea and conceptualised the entrepreneur as the organiser of the business firm, central to distributive and production functions. Classical economists like Adam Smith treated the entrepreneur as the firm itself for the purpose of theoretical analysis and were not concerned with the entrepreneur as a human entity.

Joseph Schumpeter differentiated entrepreneurs from all heads of firms or managers who merely operated an established business. To him, entrepreneurs innovate by introducing new products and technology, opening new markets, finding new source of raw materials and carrying out a new organisation of any industry. With the passage of time there has been a substantial change in entrepreneurial types, and in the entrepreneur's function. Yet Joseph Schumpeter's contribution to the literature on entrepreneurs is well regarded even today (K.C., 2001).

The skills and resources provided by nature can only be transformed into efficient production units through the creative ideas and efforts of entrepreneurs. Efficient and dynamic enterprises, whether private or public, entrepreneurial initiatives are crucial to economic development. The critical point is that entrepreneurs disrupt the status quo, putting economic development and society on a new course. Entrepreneurs are undoubtedly, the most important change agents in modern society. The engine of development is the entrepreneur, who conceives a new combination of factors of production that is more effective than current ones and may bring large products.

A major actor in SME development is the entrepreneur. There are different definitions of the entrepreneur. Summing up some definitions, the attributes of an entrepreneur are as follows:

A person characterised by initiative, flexibility, leadership and hard work; an innovator; a catalyst of economic and social change; a person adept in undertaking new combinations of productive factors; a risk taker; a person able and willing to project an idea or scheme into the future and to back his judgment with innovative action to convert the idea into a marketable or profitable reality (Maskay, 1999).

4. SME Definition

There is no single definition for the SME and it depends on the country and on the business environment. A small business in Turkey might be a big business in Bosnia (Rosen, H. in http://www2.ifc/sme/html/welcome_to_sme.html).

4.1 World Bank Definition

The World Bank defines micro-enterprise as consisting of up to 10 employees, with total assets of up to \$ 100,000 and total annual sales of up to \$100,000; small enterprise, of up to 50 employees, total assets of up to \$ 3 million and total sales of up to \$ 3 million; medium enterprise—up to 300 employees, total assets of up to \$15 million, and total annual sales of up to \$15 million. While these definitions are admittedly subjective and still under review, they are broadly consistent with those used by most other international financial institutions. Still, it should be noted that the numbers shown above depend heavily on choice of this (or any other) definition (Boldbaatar, 2004).

4.2 OECD Definition

	Micro	Small	Medium
Maximum number of Employees	< 10	<50	<250
Maximum total turnover in millions of Euros	N.A.	7	40
Maximum total assets in millions of Euros	N.A.	5	27
Maximum capital/voting rights held non SME enterprises	N.A.	25%	25%

Source: Boldbaatar, 2004

4.3 India

According to the official definition adopted in India since 1998, the investment limit up to Rs.10 million in plant and machinery is treated as SSI sector. However, with respect to certain specified items such as hosiery, hand tools, drugs & pharmaceuticals and stationary items above investment limit in plant and machinery has been increased up to Rs.50 million. Since 1967, there is a policy of reserving selected products in the manufacturing sector for exclusive production in the SSI sector. The list of reserved items has been revised from time-to-time (Kamesam, 2003).

4.4 Malaysia

The Small and Medium Industry Development Corporation, Malaysia defines SMEs as enterprises with annual sales turnover not exceeding RM 25 million and full time employees not exceeding 150. The International Cooperative Alliance defines SMEs as enterprises with full time employees of less than 75 and shareholders funds of less than RM 2.5 million. For Bank Negara Malaysia, SMEs are defined as enterprises with shareholders funds of less than RM 10 million.

4.5 Germany

Germany does not have a standard definition of SMEs. The definition of the SMEs may vary, on a case-to-case basis, according to the development programmes implemented and the identified target groups. The Federal Ministry of Economy and Technology (MET) however, has adopted the following definition of SMEs.

Size	Number of Employees	Turnover (million Euros)
Small Enterprises Medium Enterprises	9 or less 10-499	Upto 0.5 million Euros 0.5 million<50 million Euros

4.6 Japan

All efforts to support and promote SMEs in Japan are governed by the SME Basic Law. The Law also prescribes the standard definition of SMEs that is adopted by all government agencies and private institutions.

Definition of SMEs		
Industry	Number of Employees	Capital Size (million Yen)
Manufacturing and Others	300 or less	300 or less
Wholesale	100 or less	100 or less
Retail	50 or less	50 or less
Services	100 or less	50 or less
Definition of Small Scale Enterprises		
Industry	Number of Employees	Capital Size (million Yen)
Manufacturing and Others	300 or less	100 or less
Wholesale	100 or less	30 or less
Retail and Services	50 or less	10 or less

4.7 Taiwan

The official definition SMEs was revised in 1995 and contained in the "Standard for Identifying Small or Medium Enterprises" as follows:

Sectors	Definitions
Manufacturing, Construction, Mining and Quarrying	200 employees or less paid-up capital of NT \$ 60 million or less
Forestry, Agriculture, Fishing, Animal Raising, Plumbing, Electrical, Gas and Fuel, Commerce, Transportation, Warehousing, Communication, Finance, Insurance, Real Estate, Industrial and Commercial Service, Personal Service Enterprises	50 employees or less, annual sales value of NT \$ 80 million or less

Source : (Bank Negara Malaysia, 2003)

4.8 Definition of SMEs/SMIs in the Nepalese Context

Table 7.A
Definition of Small and Medium Industries in Nepal

Policy	Small Industries	Medium Industries
Industrial Enterprise Act 1961	Capital investment of Rs. 50 thousand	Investment between Rs thousand and Rs. 0.5 million
Industrial Enterprise Act 1974	Fixed capital investment between Rs. 0.2 million to Rs. 1.0 million	Fixed capital investment between Rs. 1.0 million to Rs. 5.0 million
Industrial Policy 1981	Fixed capital investment up to Rs. 2 million	Fixed capital investment between Rs. 2 million and Rs. 10 million
Industrial Policy 1992	Fixed capital investment not exceeding Rs. 10 million	Fixed capital investment between Rs. 10 million and Rs. 50 million
Industrial Policy 1997 (Amended)	Fixed assets not exceeding Rs. 30 million	Fixed assets between Rs. 30 million and Rs. 100 million

Source: Maskay, 1999

From 1961 to 1997, the definition of SMIs in Nepal has undergone revision on four different occasions. On each occasion the fixed assets parameter, not the employment parameter, has been used to classify industries as large, medium and small.

In Nepal there is an official definition of SMIs instead of SMEs. SMEs indicate business as well as industrial enterprises, whereas SMIs cover small and medium industries. The two terms, SMI and SME, are used interchangeably hereafter in this report. The definition of SMIs has varied over the years as indicated in Table 7.A.

5. SMEs/SMIs in Nepal

During the regime of His late Majesty King Tribhuvan Bir Bikram Shah Dev and under the rule of Rana Prime Minister Juddha Shamsher, an institution named "UDYOG PARISAD" was created in B.S. 1992. It was the first government agency to look after the industrial activities and promote the industrial environment in the Kingdom of Nepal (<http://www.scdp.org.np/wssd/industry.pdf>).

As a step towards laying the foundation of industries in Nepal, a jute mill was set up in Biratnagar under the 'Company Act, 1937'. The Udyog Parishad helped in opening new avenues for the advent of banking, industry and commerce in Nepal and thus helped to enhance the economic status of the country (NRB, 1996).

5.1 Summary Profile of SMIs

As shown by the latest data published by the Department of Cottage and Small Industries, there were altogether 157,458 cottage and small-scale industries registered as at the end of fiscal year 2002/03 (Table 7.9). According to another official publication of the Department of Industries, there were 3191 industries registered by the end of FY 2002/03 (Table 7.11).

The study made a comparative analysis on the basis of the Census of Manufacturing Establishments carried out by Central Bureau of Statistics in 1991/92, 1996/97 and 2001/02. The following is a summary profile of SMIs in terms of number of establishments, census input, census output, persons engaged, employment and census value added.

The total number of manufacturing establishments declined by 9.67 percent in 2001/02 over 1996/97. During the same period, the total number of persons engaged and total number of employees also declined by 2.47 percent and 2.87 percent respectively. In the 1996/97 Census, the total number of manufacturing establishments, total number of persons engaged and total number of employees declined by 16.72 percent, 11.97 percent and 12.33 percent respectively (Table 7.1).

So far as census input and census output during the reference period is concerned, both have shown increasing trend. According to the Census results, census input increased by 70.83 percent and 88.21 percent in 1996/97 and 2001/02 whereas census output increased by 66.46 percent and 72.61 percent in 1996/97 and 2001/02 respectively (Table 7.1).

In case of census value addition for 1996/97, it increased by 60.26 percent over the previous Census whereas the increment for 2001/02 was 49.04 percent over previous Census. The average output/input ratio for the Census years of 1991/92, 1996/97 and 2001/02 remained as 1.71, 1.66 and 1.52 respectively (Table 7.1).

The Census results showed that the average number of employees per establishment has an increasing trend over the years at 50.02, 52.66 and 56.6 persons for 1991/92, 1996/97 and 2001/02 Census respectively (Table 7.1).

5.2 Size and Structure of Manufacturing Establishment

5.2.1 Fixed Assets

The latest Census of manufacturing establishment (2001/02) showed that out of total establishments, 96.2 percent of establishment (SMIs) were found to be in operation with Rs.10-50 million fixed assets investment and the rest were the establishments with more than Rs.50 million as fixed assets investment. The percentage share of small and medium industries for 1996/97 and 1991/92 Censuses remained as 97.98 percent and 98.77 percent respectively. It is noteworthy that the establishments operating with fixed capital investment less than 10 million contributed 86.37 percent, 90.05 percent and 95.59 percent to total establishments in 2001/02, 1996/97 and 1991/92 respectively (Table 7.2).

By definition, establishments with less than Rs.30 million and Rs.30-100 million as fixed assets are respectively considered to be small and medium industries in Nepal (Table 7.A). Thus, the above analysis does not represent the actual scenario of SMEs (SMIs) for, in the absence of separate database for establishments with fixed assets between the range of Rs. 50-100 million, the establishments lying in this range could not be incorporated.

5.2.2 Employment

By size of the persons employed in the establishments, 73.17 percent of total establishments employed less than 50 employees and only 15.25 percent of total establishments employed more than 100 employees in the 2001/02 Census. In 1996/97, the percent share remained as 72.73 percent of establishments employing less than 50 and 12.87 percent of establishments were found to be employing more than 100 employees whereas in 1991/92, the percent share was 73.59 percent and 12.59 percent respectively (Table 7.3).

5.2.3 Ownership

For the 1991/92, 1996/97 and 2001/02 Censuses, privately owned establishments held the major share at 97.05 percent, 97.55 percent and 97.04 percent of the total establishments (Table 7.4).

5.2.4 Legal Status

With regard to legal status, the number of personal establishments held the major share in all the three Census as mentioned above. However, it has declined slightly over the years. In 2001/02, personal establishments made up 66.91 percent of total establishments while its share in 1996/97 and 1991/92 remained at 67.55 percent and 69.23 percent respectively (Table 7.5).

5.2.5 Capacity Utilisation

In both Census carried out in 1996/97 and 2001/02, the majority of establishments were found to be operating in the range of 40-60 percent of capacity utilisation. In the 1996/97 Census, 40.93 percent of total establishments were found to be operating in this range. In the 2001/02 Census, 40.43 percent of establishments were found operating in the range of 40-60 percent of capacity utilisation (Table 7.6).

In FY 2002/03, industries were found to be operating from a low of 3 percent of their capacity utilisation for stainless steel utensils industry to a high of 95 percent of capacity utilisation for tea industry (Table 7.12).

5.2.6 Rural/Urban Structure

The Census of Manufacturing Establishment conducted in 1991/92, 1996/97 and 2001/02 revealed that out of total industries, 38.4 percent, 44.8 percent and 50.3 percent were found to be established in Village Development Committees- i.e. in rural areas (Table 7.7).

5.3 Contribution of SMEs/SMIs in Nepal

5.3.1 Gross Fixed Assets

As SMIs are more labour-intensive and hence use less capital, 29.9 percent of total gross fixed assets belonged to SMIs with fixed assets investment up to Rs 50 million in 2001/02. The share of SMIs in 1996/97 and 1991/92 was 40.0 percent and 31.2 percent respectively (Table 7.8).

5.3.2 Employment

With regard to total employment, SMIs with fixed assets up to Rs. 50 million, accounted for 76.7 percent in 2001/02. In 1996/97 and 1991/92 Census, the share of SMIs was 86.6 percent and 91.1 percent respectively (Table 7.8).

5.3.3 Census Output

In the 2001/02 Census, SMIs with fixed assets up to Rs. 50 million made up 52.2 percent of total census output whereas the contribution of SMIs for the Census carried out in 1996/97 and 1991/92 stood at 67.0 percent and 78.0 percent respectively (Table 7.8).

5.3.4 Census Value Added

SMIs with fixed assets up to Rs.50 million contributed 55.8 percent of total census value addition in 2001/02. The contribution of SMIs during the Census 1996/97 and 1991/92 stood at 63.5 percent and 73.2 percent respectively (Table 7.8).

5.3.5 Wages and Salaries

In view of total wages and salaries distributed to the employees, the SMIs with fixed assets up to Rs.50 million contributed 86.0 percent in Census year 2001/02. The percentage share of SMIs in 1996/97 and 1991/92 stood at 79.0 percent and 83.8 percent respectively (Table 7.8).

The contribution of the manufacturing sector to total GDP in FY 2003/04 was estimated to be 8.8 percent whereas its share to non-agriculture GDP stood at 14.4 percent. In FY 1992/93, the share of manufacturing sector to total GDP and non-agriculture GDP was 9.0 percent and 15.6 percent respectively (Table 7.13).

6. Major Problems Faced by SMEs/SMIs in Nepal

In general, SMEs in Nepal are managed traditionally with underdeveloped entrepreneurial culture, low capital base, outdated and inefficient production process and technology, and poor knowledge and information about business strategy. Since the late 1980s, Nepal has shifted from a protectionist regime to

an open market regime. As a result in this shift, barriers to international trade have been removed or substantially reduced. The Nepalese SMEs have been affected by this change and find it increasingly difficult to compete with international products both in the domestic as well as international markets. Nepal's development plans and other commerce related policies include various incentives for SMEs but the lack of awareness, lapses in policy declaration and obstacles in actual implementation of the policies have largely prevented SMEs from getting any significant benefits.

6.1 Policy and Legal Framework

In Nepal, national policies do not define SMEs by way of enterprises but rather on the basis of industrial enterprises. Moreover, poor implementation of policies resulting from cumbersome processes and bureaucratic delays have created unfavourable environment for growth and development of the industrial sector including the SMIs/SMEs. There is a huge gap between the intention of the government reflected in policy formulations and actual practices. Therefore, SMEs which should serve as a safety valve for the poor and marginalised against uncertainties of market economy, suffer from setbacks due to the lack of official vision, policies and strategies and Nepalese SMEs are essentially confined to small and medium industries (SMIS) rather than embracing the whole gamut of SMEs (Maskay, 2001).

6.2 Financial Service

Production units in the urban industrial sector generally have easier access to bank or formal financial services while the rural and relatively more deprived sectors severely lack access to financial resources. In this context, rural financing is very important for developing economies where the majority of people reside in rural areas (86 percent in Nepal).

In spite of the rapid growth of financial institutions in Nepal, the rural population has not been able to reap the benefits from the open and liberalised policies of the government. Although the bank and financial institutions have grown in number, they are still lacking competitively and innovatively and the quality of services they provide warrants improvements (Rawal, 2003).

In the last one and half decades, while the financial sector in Nepal has grown rapidly, this has not helped entrepreneurship development in the country

to the extent it should have. Most of the joint venture banks target large customers and are reluctant to provide financial resources to small entrepreneurs due to high transaction and maintenance costs.

An important finding is that the proportion of rural households borrowing from formal (institutional) sources during 1991/92 is estimated at 8 percent only on the average, ranging from four to nine percent across regions. Further, only 20 percent of rural households on average, have borrowed from the financial sector (ranging from 9 percent in the case of landless to 38 percent in the case of large size class (NRB, 1994)).

6.3 Inadequate Infrastructure

The industrial advancement of the country has also been obstructed due to the negligible market volume and the country's land-locked situation. Poor availability and quality of electricity service is another principal infrastructure problem that has thwarted the operations of manufacturing industries. Insufficient physical infrastructure such as roads, power, telecommunications, support services for marketing etc. are major constraints to development. These constraints continue to increase the costs and the risk and discourage investment in the SME sector.

Moreover, Nepal is currently experiencing a complex socio-political situation, which has intensified over the past few years. It has created considerable insecurity in many parts of the country, making it difficult for the government agencies and development partners to carry out development activities in such areas (NPC, 2003).

6.4 Entrepreneurship/Management

In today's world of rapid change and innovation, entrepreneurial competence is key for a business's success. The business world is rapidly transforming, and the management thinking is racing to keep pace. Management today is a great deal more complex and demanding but is also more creative and exciting. New problems are require new solutions that often involve fundamental transformation of business thinking and practice (Shrestha, 2001).

The absence of an entrepreneurial class willing to take risks and to undertake new ventures is yet another reason for the slow economic development. The development of indigenous entrepreneurship especially among the rural population

is imperative for a country embarking on socio-economic development programmes.

The inadequacy of entrepreneurs is an inhibiting factor in the development of Nepal. In a developing country like Nepal, growing unemployment had led to a serious economic, social and political crisis, confined not only to a few urban centres but also in almost all parts of rural Nepal.

6.5 Transfer of Technology

Technology is becoming an issue of strategic importance to the development of industries, whether large, medium or small. The larger firms have resources to manage the transfer of technology through various means but the same cannot said of the SMEs. It is only through appropriate government policies and measures that the problem of technological orientation of SMEs can be solved.

There are no proper arrangements to acquire improved, updated and new technologies for upgrading the production techniques of cottage, small and medium industries to raise productivity and quality in Nepal. There is also a lack of institutional arrangements for acquiring technological information, examining suitability of different technologies, disseminating information to the existing and potential users and developing capability to secure most favourable terms of technology.

6.6 Human Resource

The lack of awareness about manpower need and absence of coordination and interface between occupational skill providers and SMIs has adversely affected supply of skilled manpower and had forced SMEs to hire foreign labour.

One of the major challenges for entrepreneurship in the SME sector is how to cope with growing challenges of innovations in production, sales and management techniques. The entrepreneurs cannot play active roles in the promotion and development of SMEs due to shortage of educated, skilled, trained and technically qualified personnel (Maskay, 2001).

Technology development alone will not be able to attain the objectives of competitiveness if it is not assisted by human resource development. The education needs of the enterprises tend to be different at different stages of growth. There is lack of such education and training in Nepal.

In most developing countries, there exists a serious shortage of entrepreneurs, partly because the education systems do not support the promotion of entrepreneurial manpower. Overall, the teaching-learning styles do not inculcate innovation and experimentation which is necessary in the world of business.

6.7 Information Technology

The lack of awareness or lack of technical know-how poses various challenges to the quality and standard of many Nepalese products (Pandey, 2004). In fact the need to adapt new technological advancement especially with regards to information and communication is fast becoming an economic imperative rather than a mere question of choices and options.

The need to develop coherent policies and sound strategies vis-a-vis information economy and e-commerce is also more relevant given membership of Nepal in the WTO and subsequent participation in multilateral trade negotiations of which e-commerce would be an important component

Many challenges exist on creating a conducive environment for the proliferation of IT in general and e-commerce in particular to further augment national and international trade prospects. There is an invariable need to address the issues involved from international, national and business enterprise perspectives.

6.8 Marketing Technology

The major input in the process of modernisation stems from knowledge about domestic and international markets for SME products. Competitiveness must take into account marketing activity, a crucial factor in the success of any industrial unit. Ultimately, it is the ability to sell, even more than the capacity to produce that will distinguish a successful organisation from an indifferent one.

It is quite obvious that the survival and growth of business and enterprises in the future depends largely upon their ability to meet the demands and challenges posed by the new order.

Marketing constraints are one of the obstacles faced by Nepalese SMEs. In addition, given their size and limited access to resources, their production capacity is limited and they are unable to execute large orders. The lack of knowledge on markets is another major deterrent to the entrepreneurship

development in Nepal. Due to limited resources and know-how, entrepreneurs find it difficult to gain access to market. Exploring overseas markets and undertaking market research on a large scale is often not possible for these entrepreneurs.

The SMEs in Nepal face many marketing problems either because they neglect this aspect or are incapable of following a proper marketing strategy as they are still very traditional in nature and not well informed.

6.9 Networking/Partnership/Strategic Alliance

Most SMEs interact with their larger counterparts and the supportive value of small firms in most countries is considerable. The burden of large firms is shared by SMEs to a considerable extent. It stands to reason that the success of large companies depends, in varying degrees, on the assistance they receive from small firms.

There is a lack of strategic alliance and collaboration among SMEs and with other large enterprises in areas like research and development, gaining access to market, attaining economies of scale etc.

6.10 International Cooperation/Collaboration

Since the collaboration and cooperation with multinationals offer considerable scope and potential for improved technology, new markets and financing opportunities, there is a need for exploration of the promotion of linkages between multinational companies and local SMEs in the areas of joint venture and sub-contracting arrangements.

There is a lack of networking with international, regional and national SME development institutions for SME development. Due to shortcomings of the markets and the lack of experience of SMEs, both national and outside support is required. Nepalese SMEs are also lacking the institutional mechanism for improving the coordination of funding agencies both at the global and country levels.

6.11 Information and Dissemination

The total cumulative and updated information about the number of SME units in existence and in operation is not available. Informal sources maintain

that more than 60 percent of the registered units are not in operation and more than 50 percent of those in operation are characterised by underutilisation of capacity (Pandey, 2004).

The available statistics on SMEs (SMIs) are not reliable and has greatly hindered the policy formulation process. In the absence of reliable information on SMEs, the assessments are based on surmises and “guess-timates”. The varying definitions of SMEs and the inconsistency of sources of SME information have also made it difficult to properly assess and compare SME sector performance both at the macro and micro level (Maskay and et.al., 2001).

7. A Case Study of Major Three Export Industries

7.1 Readymade Garments

The garment industry in Nepal started about one and half decades ago. In the earlier days, traditional Nepalese garments were exported to a limited number of countries in limited quantities. The readymade garment sector has since grown to be the largest exporting sector in terms of foreign exchange earnings and contributing to employment opportunities to the rural population along with reducing trade deficit to some extent. The major export markets of Nepalese garments are USA, Canada, Germany, France, Netherlands, United Kingdom, Switzerland, Spain, Italy, Australia etc.

Rs 5,139.3 million of readymade garment was exported in FY 1994/95 with its contribution share of 29.1 percent to total exports. In FY 1999/00, its contribution was as high as 27.9 percent of total exports of the country. However, for FY 2003/04, with the estimated negative annual growth rate of 19.7 percent, the contribution to total exports was estimated to be 18.1 percent.

In FY 1999/00, the annual growth rate was as high as 43.7 percent over previous year. However in FY 2002/03, it increased by 51.8 percent as against a negative growth of 40.3 percent in FY 2001/02 (Table 7.14).

7.2 Woolen Carpet

The art of weaving of carpet is an old tradition in the kingdom of Nepal, especially in the mountain region of the country. The development of an export quality carpet was initiated with the influx of the Tibetan refugees in the early

sixties. In the beginning, it was launched as a source of livelihood for the Tibetan refugees and marketing was limited to tourists visiting the kingdom. Later, it was transformed into a national commercial commodity and has remained the most important exportable product of Nepal. The woolen carpet has become the second largest export item to Germany, USA, Austria, Netherlands, United Kingdom, Switzerland, Spain, Belgium, Sweden, Korea and Russia.

The share of woolen carpet to total exports was 43.8 percent in FY 1994/95, which showed a gradual decline over the years and remained at 10.6 percent in the last two fiscal years of 2002/03 and 2003/04.

The industry showed the highest growth of 15.5 percent in FY 1998/99 whereas for the three fiscal years of 2000/01, 2001/02 and 2002/03, it experienced negative growths of 12.7 percent, 27.7 percent and 14.4 percent respectively. However, in the FY 2003/04, it was projected to grow by 5.1 percent as against 14.4 percent of negative growth in the previous years (Table 7.14).

7.3 Pashmina

Pashmina is Nepal's third largest overseas export product after readymade garments and woolen carpets. Pashmina is the inner-coat of the hair of the mountain goat. USA is the largest overseas importer of Nepalese pashmina. Other major markets of pashmina include Japan, United Kingdom, France, Germany, Republic of Korea, Italy, Canada and Switzerland.

The contribution of pashmina to the share of total exports was 7.4 percent in FY 2000/01. The share gradually declined to 2.0 percent for FY 2003/04. Exports increased significantly in FY 2000/01 with 54.6 percent whereas in the following fiscal years it showed continuous negative growth of up to 69.8 percent in FY 2001/02 (Table 7.14).

7.4 The Problems

The above-mentioned major export industries of Nepal face various obstacles. Some of them are, in one way or other, common to all industries while some of them are considered to be unique to the individual industry:

- There is a lack for quality maintenance. The industries have been badly affected due to the increase use of low quality raw materials which has reduced their competitiveness in the global market.

- Lack of administrative mechanism to control unauthorised border trade and unfair competition with imitation goods of inferior quality.
- One of the main problems is production without any assessment of the market needs and demands. In case of carpet, for example, the taste of the European markets and the US markets are quite different. The Americans prefer extremes of light and dark colours whereas the Europeans prefer softness in colour. Any marketing effort done without taking this into account is likely to flounder.
- The Nepalese export industries are found to depend heavily on a limited segment of the market. The lack of market is due to Nepalese firms' inability to penetrate and diversify the market. In case of garment, Nepal is found to be almost fully dependent on the US market. The same has been shown for the carpet industry, having been able to capture only a limited segment of the German market.
- Another major problem is the lack of collaboration and cooperation with multinational companies and as a result, Nepalese industries lose considerable scope and potential for improved technologies, new markets and financing opportunities.
- Although e-commerce has significantly reduced the barriers of distance, cost of intermediaries and transaction cost, the Nepalese export industries is still lacking infrastructural support and access to information technology (IT) and knowledge-based activities.
- There have been debates on the certification of standard in exportd as well as in the use of goods within the country even when they have been certified by standardisation institutions registered in the country. The Bureau of Standard and other quality certifying agencies need to refocus their services on the export industries.
- At times, Nepalese suppliers are not to be able to meet the demand of large quantity orders due to capacity problems.
- Nepalese exporters for garments have lost the competitive power in comparison to exporters of Sub-Sahara African countries which enjoy duty-free access to US market. Further, coupled with the phasing out of the Multi Fibre Arrangement (MFA) at end of December 31, 2004, the Nepalese garment industry will lose even more grounds.
- Being landlocked country, Nepalese products bear comparatively higher transaction cost thereby making the product price relatively higher in international markets.

- In the Nepalese trade and industrial sector, it has been noted that there is a 'herd tendency' meaning that there is concentration in an industry which have shown to be profitable. However, this concentration will gradually increase competition and consequently devastate the whole industry in the absence of viable markets.
- Another possible threat to the export industry is membership to WTO. Nepal being a new entrant should be given due consideration that there is a world's product competitive map, a map showing the real flows of financial and industrial activity, where people want to buy the best and cheapest products – no matter where in the world they are produced.

8. The Way Ahead

The development of SMEs in the present scenario needs to be seen not merely from the perspective of balanced economic development and for the elimination of poverty but also from the perspective of maintaining peace and tranquility, social harmony and environment protection.

Competitive and resilient SMEs are important for the growth and development of the economy and they need to be dynamic, innovative, growth – oriented and embrace best practices in their operations and management to meet the highest performance.

8.1 Policy and Legal Framework

At the very outset, instead of Small and Medium Industries (SMIs) the concept of SME should be developed so that all kind of business activities could be incorporated. Further, a separate agency within the government should be established to monitor SMEs.

Formulation of ambitious industrial plans, programmes and policies does not by itself guarantee fruitful results, as shown by experience. Plans must be supported by a well-coordinated implementation strategy. The strategy for the nation's industrialisation should be framed on the correlation between the existing needs and the resources at the country's disposal. In addition, continuing attention should be given to organise and improve basic support services helping industrialisation (Thapa, 1993).

The first task in developing a strategy for modernising SMEs would be to determine the role to be played by different partners in different aspects of modernisation. Formulation and implementation of appropriate fiscal, legal and regulatory policies for stimulating the development of SMEs should be reviewed in this context. Laws such as the Labour Act, Company Act, Industrial Enterprises Act, Foreign Exchange Act and Taxation Policies should be more relevant and pragmatic to cater for the requirements of SMEs.

Policies and programmes should be able to create an environment for better co-operation between SMEs and academic research institutions so that better innovation and technology upgrading could take place in Nepal. Considering the country's thrust on decentralisation policies and programmes, there is also a need to decentralise SME functions and activities at the district level office. Moreover, the SME policy framework should give due priority to establish venture business in areas of IT and biotechnology.

8.2 Financial Service

A responsive financial system is widely regarded as critical for expansion of the SMEs. Importance should be placed for streamlining and simplifying the system and procedures related to credit extension by commercial banks and other financial intermediaries to provide financial services and resources to SMEs in both urban and rural areas.

Financial sector development may help in the alleviation of poverty directly by spreading deposit and credit facilities with innovative instruments for the poorer sections of the population and promoting investments in rural areas, where most of the poor live, and by participating in various anti-poverty credit schemes. Indirectly, monetary policy and financial sector development may help the poor by facilitating employment intensive productive investment in the economy, controlling inflation and providing employment.

Policies assuring easy financial access at appropriate interest rates will go a long way in improving the financial health of SMEs. In view of market and resources, SMEs are the only viable sectors and therefore, policies must be geared towards or improved upon to meet their requirements. This will make SMEs the foundation for faster and equitable growth in Nepal.

8.3 Infrastructure Development

Successful development requires that states complement markets, not substitute them. States should focus on providing a good business environment in which contracts are enforced, markets function, basic infrastructure provided, and people (especially poor people) are empowered to participate.

Government institutions can support the development of markets in many ways by providing information, fostering competition, enforcing contracts, and helping to make credit available to entrepreneurs.

There is a need for a predictable environment in which people, ideas, and money can work together productively and efficiently. In the context of a sound macroeconomic framework, a good investment climate strengthens governance and overcomes bureaucratic inefficiencies, improves access to key financial and infrastructure services, and provides a sound legal and regulatory framework for enterprises that promotes competition.

8.4 Entrepreneurship/Management Development

The absence of entrepreneurship has proved to be a major obstacle for the promotion of industrial activities and creation of national capital. SME entrepreneurs should be equipped with necessary knowledge and skills to counter the threats posed by the country's WTO membership and take advantage of the benefit offered.

Assistance, facilities and incentives should be provided to private institutions for devising innovative strategies to promote entrepreneurship. It is also time to increase the exposures of staff and entrepreneurs to international standards and practices so that innovation and entrepreneurial actions can be harnessed as basic inputs to SME functioning and development.

By bringing in suitable management practices including proper cost control to meet the basic requirement of global market, there is a need for SMEs to revolutionise their quality culture. Development of appropriate institutional framework for providing consultancy services on productivity and quality improvement of SMEs is important

There should be substantial investment in training and retraining of human resources on a continuous basis. Further, there is a need for programmes that promote pro-enterprise environment with venture capital support, complemented further by entrepreneurship and human resource development.

8.5 Technology Transfer

Appropriate government policies are a must for facilitating technology transfer to SMEs, a proper networking and linkage with domestic and foreign investors, as well as multinational companies, is also necessary.

The receptiveness of SMEs to modern technologies depends heavily on their willingness to and practice in employing technological staff. The human factor is critical in the transfer and dissemination of knowledge. The technological personnel are the bearers of knowledge and play an important role in firms by involving themselves in scientific/technological management of their firms, either doing their own development work or by contracting it out.

8.6 Human Resource Development

Skill formation is a consequence of industrial education and training acquired at educational institutions and within firms. Different types of skills are required at different levels of industrial development. Moving from one level or pattern of industrial development to another requires changing the skill creation system and its utilisation by industries.

There is need a for national skills development policy to guide the training programmes of various agencies. To help produce entrepreneurs, educational policies, curricula and teaching strategies, at all levels, need to be thoroughly improved and upgraded. To equip manpower with the desired level of knowledge and skills and also to vocationalise the educational system, there is the need for establishing close linkages between the leading educational institutions and SMEs.

The entrepreneurial and human resource development programmes must be affordable to the SMEs. Emphasis should be given to the demand driven training programmes and be made cost effective. Educational policies, curricula and teaching strategies at all levels need to be thoroughly improved and upgraded to help foster experimentation.

The vitality of companies depends on the use of human resources, and SMEs have the prospects of enhancing the capacity of its human resources, and attracting and retaining the talented ones. Making people responsible for the results and involving them in decision-making process tend to spur their cognitive capabilities. SMEs can introduce such a system more effectively.

8.7 Information Technology

SMEs must keep abreast of the changes in the technology relevant to their area of operation. Adoption of such technology helps SMEs to operate efficiently and gain competitive edge over its rivals. This requires SMEs to improve their operations, management and introduce Total Quality Management (TQM).

Even though the recent years have seen remarkable growth in terms of awareness and application of IT resources in a number of activities, Nepal as a whole has yet to see a satisfactory pace of application of IT in education, government and corporate sectors. Private business, banks and financial institutions, NGOs, INGOs and international agencies operating within Nepal are on the forefront as far as using IT resources compared to the government and small business sector.

There is a need to take a more proactive approach, which would include:

- Creating awareness on benefits and challenges of e-commerce and e-trade.
- Promoting incubator programmes to promote e-commerce initiatives.
- Embarking on specialised training and capacity building initiatives.
- Dissemination and promotion of information on best and effective practices in e-commerce.
- Direct support in joining Internet-based business-to-business "exchange" (Bhattarai, 2001).

8.8 Marketing

SMEs should be aware competitors' situation, changing buyer behaviour, market trends, and similar marketing information. The development of marketing skills is an important ingredient in the modernisation process of SMEs. It is also necessary to create separate institutions for marketing so that entrepreneurs can concentrate on their particular function and develop expertise in that area. Establishment of institutions that specialise in marketing and distribution helps entrepreneurs to market their product effectively at lower cost. The advent of

Internet marketing has made it possible for SMEs in recent years to market their products efficiently by eliminating middlemen.

Government should support and initiate special mechanisms like strategic alliance and networking between SMEs and large firms, and promotion and establishment of export trading houses and free trade and export processing zones.

8.9 Networking/Partnership/Strategic Alliance

In order to build better cooperation and collaboration between SMEs and large enterprises and also amongst SMEs, the following points should be taken into consideration:

- Build effective interaction and coordination among R & D institutions and SMEs;
- SMEs to follow economies of speed, scope and networking rather than economics of scale;
- For collective cooperation and cluster approach to harness individual strengths and to build up necessary capabilities;
- To encourage the development of partnership or alliances between SMEs to take advantage of their individual technical powers and avail gains from technology and training; and
- To encourage the establishment of linkages between small and large-scale enterprises for enhancing SMEs growth prospect. The linkage can take the form of sub-contracting, product complementation arrangements or the provision of services in the areas of repair and maintenance, technology services, computer software services, etc. (Maskay, 2001).

8.10 International Cooperation and Collaboration

Since the collaboration and co-operation with multinationals offer considerable scope and potential for improved technology, new markets and financing opportunities, due consideration should be given to the need for exploration of the promotion of linkages between multinational companies and local SMEs in the areas of joint venture and sub-contracting arrangements. There is also the need for networking with international, regional and national SME development institutions. Due to shortcomings of the markets and the lack of experience of SMEs, both national and outside support has become necessary.

8.11 Information and Dissemination

There is a need for an institution specialising on SME data and related information to be located either within the Bureau of Statistics or within the Department of Industries (Maskay and et. al. 2001). Information about SMEs on registration, closure/termination and operation is to be continuously updated by concerned authorities so that the gap between records on register and actual position could be minimised as far as possible.

8.12 Women Empowerment

SMEs offer an immense opportunity for gender mainstreaming of national development programmes. SMEs not only provide an opportunity for women entrepreneurs to enhance their role with less capital and intensive labour, SMEs are most suitable mechanism to promote women employment and income opportunities in the country. Hence, more government involvement is necessary to encourage women to become entrepreneurs.

9. Role of Nepal Rastra Bank as a Central Bank

Nepal Rastra Bank (NRB) has played a crucial role in resource mobilisation and its efficient allocation. In fact, as a catalyst for development, it has engaged itself in the development of financial infrastructure through its participation in the establishment of various financial intermediaries for national development of the country. The Bank has facilitated the mobilisation of the small and scattered savings and their allocation to the productive channels through the development of financial institutions. The Bank has attempted to influence the flow of institutional credit away from traditional sources by providing incentives and leadership to financial institutions (NRB, 1996).

NRB has made a number of innovative attempts for developing micro-finance framework in the country. It has been involved in these programmes directly or indirectly and, in one-way or other.

9.1 Cottage and Small Industries Project

The Cottage and Small Industries (CSI) Project was launched in 1982 with the World Bank's (IDA) assistance of US \$ 6.5 million in two zones (three districts in Kathmandu valley and six districts in Gandaki zone) and offering an

opportunity to apply innovative approaches to credit delivery, product and skills development and commercial services for cottage industries. Nepal Rastra Bank as an apex institution, administered the project based on the lending approach and induced all the three participating banks of NBL, RBB and ADB/N to promote, appraise and supervise CSI sub-projects, which were responsible for channeling the term-loans to CSIs, related market agents and inputs supply companies.

As a follow-up operation to the first cottage and small industries project (CSI-I), the second cottage and small industries project amounting to US \$ 10 million was approved by IDA on May 13, 1986; and became effective on July 31, 1987. The scope and scale of CSI-II was increased from 9 to 27 districts. Soon after the project was launched in 1987, it was agreed to halt the activities prematurely as of June 30, 1992 some three year prior to the closing date because of its poor repayment rate and high number of defaulters.

The greatest achievement under the CSI Project was that it created greater awareness and created a favourable environment to establish cottage and small industries in the project areas in general and a remarkable growth in the export-oriented woolen carpet industry in particular besides financing over five thousand industrial projects to the tune of Rs 364.41 million (NRB, 1996).

9.2 Agricultural Projects Services Centre

The Agricultural Projects Services Centre (APROSC) was set up in 1974 at the initiative of Nepal Rastra Bank for supplying techno-feasibility surveys to the commercial banks in the field of agricultural and rural sector. The Centre helps both individual and institutions interested in investing in the agricultural and rural sectors through the identification and formulation of economically sound and financially viable projects besides providing consultancy services. The Centre also assists the national and international organisations in evaluating agricultural and rural development programmes and projects and suggests improvements for effective implementation (NRB, 1996).

9.3 National Productivity and Economic Development Centre

The National Productivity and Economic Development Centre Limited (NPEDC) was established in September 1993 by converting the then Economic Services Centre Ltd. which was operating since June 1988 and prior to it, the Industrial Service Centre since 1974. The main objectives of NPEDC are

productivity promotion, productivity research and consultancy services. With a view to further strengthening the activities of the Centre, NRB has made investments in the equity capital of the Centre. NPEDC's main areas of emphasis will be developing the capability to undertake project engineering services, providing consultancy services to industries for enhancing productivity, increasing bilateral co-operation between national productivity organisations, undertaking subsectoral policy and planning studies and establishing an industrial information system (Ibid).

9.4 Banking Promotion Board

In order to develop banking system in the country, NRB set up a Banking Promotion Board in July 1968 with the representatives of the banks, the government and the trading communities. The main objective of the Board is to promote banking activities in the country through creating awareness among the general public about the services provided by banks both in terms of deposit mobilisation and credit extension for productive as well as consumption activities. In this context, the Board studies and analyses the existing policies and programmes related to banking promotion and disseminates necessary information through various forms of publicity. The Board set up a banking publicity sub-committee, which broadcasts a banking programme from the Radio Nepal, twice weekly to date (Ibid).

9.5 Priority Sector Lending

Priority sector lending was introduced in 1974 when two major commercial banks, the Nepal Bank Ltd. and Rastriya Banijya Bank were entrusted to provide credit to agriculture, cottage industry and services (Mathema, 2002). Under this programme, commercial banks were directed to lend 5 percent of their total liabilities to "small sector" at preferential rate of interests. This "small sector" lending was renamed "Priority Sector Credit" in 1976 and the lending ratio was also raised to 7 percent of total deposit liabilities. Since 1981, the main vehicle for the implementation of the priority sector credit policy has been through the Intensive Banking Program (IBP) (NRB, 1996). IBP is relatively more comprehensive and target oriented and is based on the principle of area approach, viability of the project and regular monitoring and supervision. Since 1990, all commercial banks are directed to finance at least 12 percent of their total loans and advances. After the termination of the World Bank assisted cottage and small industries project in mid-July 1992, it has been brought under the priority sector programme. At present 3 banks (NBL, RBB and ADB/N) are financing

priority sector credit under the Intensive Banking Program (IBP) while other commercial banks are financing the priority sector under their separate individual credit programme (Mathema, 2002). The total loans extended to the priority sector during FY 2002/03 amounted Rs.22.6 billion which was 20.9 percent of their total outstanding loans of the previous six months (NRB, 1996).

From the Table 7.10, it is clear that as of mid January, 2004, out of total priority sector loans, 82.6 percent consist of direct investment and 17.4 indirect. On the contrary, 74.1 percent of total deprived sector loan was disbursed indirectly as against only 25.9 percent as direct investment. This shows that commercial banks are reluctant to provide credit to the rural population and priority lending to the deprived sectors have been made mainly because of directives from the central bank. It is interesting to note that for the review period, six out of 15 reporting commercial banks have divested their total deprived sector loans through indirect channels.

9.6 Small Farmer Development Program

To fulfill the demand of micro-finance for the rural-poor, ADB/N launched a special targeted oriented credit programme called Small Farmers Development Program in 1976 (Mathema, 2002). The number of farmers benefiting from the programme stood at 83093 as at mid-July 2003. ADB/N has been handing over the SFDP gradually to local groups since in recent years (NRB, 2002/03).

9.7 Production Credit for Rural Women

In 1992, a credit programme geared especially for facilitating credit to the rural women was introduced by HMG/N as a socio-economic programme in coordination with UNICEF and NRB. NBL, RBB and ADB/N were the three participating banking institution and NRB's role as a responsible fund management agency. The programme was initially started in 5 districts, which increased to 67 districts by the end of 1998 and has disbursed loans amounting Rs 369 million to 46 thousand beneficiaries (Mathema, 2002). The principal objectives of the programme are to improve the social and economic status of poor rural women through training community development and provision of credit for women groups to engage in income generating activities. The project is executed directly by the Women Development Division of the Ministry of Local Development with the credit channeled by NRB through three participating banks of NBL, RBB and ADB/N (NRB, 1996).

As the implementation period of this project is over, the loan recovery process of the participating banks is going on and as of mid-July 2003, the NRB has repaid HMG the principal and interests amounting to Rs.57.7 million and Rs.31.5 million respectively. As of mid-July 2003, the disbursed loan amounting to Rs. 171.2 million was recovered from the participating banks (NRB, 2002/03).

9.8 Micro Credit Project for Women

The Micro-credit project for women was initiated in 1994 by the Ministry of Local Development of HMG/N in close coordination with NRB, NBL and RBB and financial assistance of ADB/Manila. It is also regarded as the improved extension of the PCRW as beneficiaries of this programme are solely women. A loan amount per borrower not exceeding, Rs. 30,000 for agriculture, Rs. 40000 for micro-enterprise and Rs.250,000 for urban-based small business was disbursed under this programme (Mathema, 2002). This project was executed by the Women Development Division of the Ministry of Local Development. NRB channeled the credit through three participating banks of NBL, RBB and ADB/N (NRB, 1996). The implementation period of this project was phased out in 2002. The NRB paid interest and principal amounting to Rs.23.1 million to HMG/N as of mid-July 2003 (NRB, 2002/03).

9.9 Rural Self-Reliance Fund

Realising the growing entry of the non-governmental organisations and/or self-help groups in rural community development including rural lending, HMG/N established a corpus fund of Rs. 20 million in 1991 to extend credit to NGOs or Savings and Credit Co-operatives for on-lending to the rural poor for assisting them to improve their standard of living through income generating activities (Mathema, 2002). As of mid-July 2003, it disbursed loans equivalent to Rs.60.4 million through 49 non-government organisations in 26 districts and 141 cooperatives in 37 districts (NRB, 2002/03).

9.10 Deprived Sector Credit

This programme was launched by NRB in 1991 to direct commercial banks to utilise specified share of priority sector credit to the rural poor and deprived sector. The share specified was fixed at different levels for different commercial banks depending upon their experiences, branches in rural areas and amount of funds available for rural lending (Mathema, 2002). The loans extended by

commercial banks aggregated Rs.3.7 billion as at mid-July 2003 (NRB, 2002/03).

9.11 Rural Development Banks

A concept following the Grameen Bank Replication was started in 1992 when the HMG/N felt the need for the establishment of a separate organisation which would take sole responsibility for financing the rural poor and supplement to some extent, the rural micro finance activities of the previously established institutions. The Rural Development Banks (five were established during the period 1992–1996) targeted poor rural women and established an appropriate credit delivery mechanism on a group liability basis (Mathema, 2002). As of mid-July 2003, the RDBs operating in five development regions disbursed loans amounting to Rs.7.7 billion to 169572 rural women and recovered Rs.6.6 billion. (NRB, 2002/03)

9.12 Rural Micro-Finance Development Centre

On February 21, 1999, a loan agreement of US\$ 20 million was signed between HMG/N and ADB/Manila to implement a rural finance project in 26 districts. For this, the Rural Micro-Finance Development Centre (RMDC), the apex Developing Banking Institution was established with the equity participation of the NRB, commercial banks and few other financial institutions. The RMDC operated as the wholesale financial institution and will disburse the ADB/Manila loan to all the Grameen Bikas Bank replicators, small credit cooperatives and financial intermediary NGOs which fulfil the eligibility criteria for funding (Mathema, 2002).

9.13 Third Livestock Development Project

The Project started on December 23, 1996 under a loan agreement between HMG/N and ADB/Manila with the primary objective raising livestock productivity and consequently improve the living standard of the people involved in this business. There were 19 participating financial institutions that signed an agreement with the NRB including 2 commercial banks, 3 development banks, 4 rural banks, 8 co-operative enterprises and 2 non government enterprises. As of mid-July 2003, the NRB had already refunded Rs. 150.9 million to 17 financial institutions. Although the tenure of the project was only up to July 2003, it was extended for one-year up to July 2004 (NRB, 2002/03).

9.14 Poverty Alleviation Project in Western Teri

Under the agreement between HMG/N and IFAD signed on December 12 1997, this project has been operating since fiscal year 1998/99. As of mid-July 2003, credit has been provided to about 20000 deprived families as against the target of 28833 families (NRB, 2002/03).

9.15 Community Ground Water Irrigation Sector Project

Priority has been accorded by the 20-year long-term Agriculture Plan on increasing agricultural productivity to raise the income of small and marginal farmers. After a loan agreement between HMG/N and ADB/Manila signed in November 17, 1998 this project was conducted in 12 Terai districts of eastern and central development regions of the kingdom. As of mid-July 2003, Rs.23 million has been disbursed for building 954 shallow tubewells comprising 950 on a GroupWise basis and 4 on an individual basis through the participating institutions (NRB, 2002/03).

9.16 Revolving Line of Credit Facility to Rural Development Banks

Under the refinance/revolving line of credit facility provided by the NRB to banks and financial institutions, the NRB has made available, without increasing the limit set under the facility under which the banks could withdraw or deposit at one time or at different times. As of mid-July 2003, Rs.20 million, Rs. 5 million and Rs.15 million was to be recovered from Eastern Regional Rural Development Bank, Mid-western Regional Rural Development Bank and Far-western Regional Rural Development Bank, respectively (NRB, 2002/03).

9.17 Refinance to ADB/N and NIDC

With a view to supporting commercial farming, refinance facility was provided by the Agriculture Development Bank (ADB/N) from FY 1996/97 to FY 2002/03 for the commercial production of export-oriented agricultural products such as tea, apple, raw cotton, cardamom, dried ginger, herbs, cut flowers, tissue culture etc. However Rs. 246.3 million has yet to be recovered.

The NRB also rescheduled the repayment period of the refinance provided to Nepal Industrial Development Corporation (NIDC) and extended it to FY2009/10. As of mid-July 2003 the NRB had yet to recover refinance amounting to Rs.773.3 million (NRB, 2002/03).

10. Monetary Policy for FY 2004/05

In addition to the involvement of NRB in above-mentioned programmes, some relevant monetary policy measures announced for FY 2004/05 include the following:

- The positive efforts and contributions of the NRB alone will not be sufficient to overcome the problems relating to structural, institutional and comparative benefits of industrial sector. However, taking into consideration the slackness of the industrial sector, the provision of refinance for sick industries will be continued in order to support and facilitate the rehabilitation of these industries. Since FY 2001/02, refinancing of Rs. 2.25 billion was made available for commercial banks and development banks for the rehabilitation of sick industries. Furthermore, Rs. 1.0 billion has been set aside for this facility for FY 2004/05 and refinance rate has been revised downwards to 1.5 percent from the existing 2.0 percent.
- The refinance rate for rural development banks and export credit in domestic currency including agricultural credit has been revised downwards to 3.0 percent from 4.5 percent. The refinance rate for export credit in foreign currency is kept as low as 2.0 percent (unchanged) with a provision that the commercial banks charge not more than 4.0 percent to the borrowers of this facility
- The Cash Reserve Ratio (CRR) has been reduced from 6.0 percent to 5.0 percent for FY 2004/05. This policy change will release additional resources of Rs. 2.0 billion which will help to reduce the financial intermediation cost to some extent
- Arrangements have been made for the regulation, inspection and supervision of the small farmers cooperatives, previously under the supervisory purview of the NRB, through the Small Farmers Development Bank (SFDB). For the remaining cooperatives and licensed non-bank financial institutions, presently inspected and supervised by the NRB, an arrangement will be made to establish a separate, second-tier institution responsible for the supervision of these institutions.

11. Conclusion

A creative partnership between the state, market and all the intermediary institutions is imperative to garner political will and to ensure that national and local development policies are legislated into action. Two facts, however, become a matter of crucial consideration. The first is the public participation/ownership over the policies made for them as internal stakeholders and the second is the enlargement of choices for the people on the vision of development for their own benefits (Maskay, 2000).

A broad-based consensus between the state, the market, the private sector, NGOs, civil society and the international regime facilitate the overarching vision of transformation, thereby contributing to the collective strength of majority of the people for realising development synergy (Dahal, 1999).

More generally, by putting broad interests ahead of specific or vested interests, national authorities will be able to address poor governance in its various forms such as inefficient management of public resources, reduced accountability and unresponsiveness to the public expectations and needs. As there is increasing evidence that poor governance dampens investment and growth, tackling governance problems will, in turn, help sustain economic development. What is needed is vigilance and firm policies to make the economies robust and more dynamic, shifting the focus from short-term considerations to tackling the underlying problems. Maintaining financial stability, restoring the momentum of economic growth and reinvigorating the fight against poverty are the most basic issues today (Basyal, 2004).

In many respects, the seven steps listed below, are familiar and, in part, duplicate the standard components of “policy matrices” attached to policy framework papers since the late 1980s or poverty reduction strategy papers since the late 1990s (Beaugrand, 2004).

Table 7.B: Key Steps to Promote Entrepreneurship and Growth

S. N.	Areas	Objectives
1.	Peace and Stability	Establish a credible political system than ensures legitimacy continuity (civil strife and war are not conducive to economic development).
2.	Governance and the rule of law	Maintain law and order, enforce property rights; avoid capricious changes in the legal and regulatory framework; promote accountability; set up credible judiciary system; weed out corruption.
3.	Mentality	Drum up support for economic and social reforms, encourage innovation, and place economic success at the forefront of the political discourse.
4.	Economic Incentives	Adopt sound economic policies, including hard budget constraints, open competition, a neutral tax system, no non-tariff barriers and low tariffs, basic protection for FDI, etc.
5.	Basic infrastructure	Ensure the provision of a minimum array of public services, especially as regards the transportation network and utilities.
6.	Access to capital	Develop efficient financial intermediation systems; mobilize external savings, but with prudent debt management.
7.	Education	Build up human capital - raise literacy and gain access to up-to-date knowledge (promote adaptability and inventiveness).

Table 7.1
Principal Indicators of Manufacturing Establishments ⁺

	1991/92	1996/97	% Change	2001/02	% Change
Total number of establishments	4271	3557	-16.72	3213	-9.67
Total number of persons engaged	223463	196708	-11.97	191853	-2.47
Total number of employees	213653	187316	-12.33	181943	-2.87
Total wages, salaries and facilities (in '000 Rs.)	3348493	4,05,80,69	21.19	6389661	57.45
Census input during the reference period (in '000 Rs.)	19347452	33051777	70.83	62206455	88.21
Census output during the reference period (in '000 Rs.)	32997374	54927092	66.46	94811061	72.61
Census value-added of the reference period (in '000 Rs.)	13649922	21875315	60.26	32604606	49.04
Average output-input ratio	1.71	1.66	-2.92	1.524	-8.43
Average number of employees in the establishments	50.02	52.66	5.27	56.6	7.54

Table 7.2
Manufacturing Establishment by Fixed Assets⁺

Fixed Assets (Rs. in Million)	Number of Establishments					
	1991/92	% to total	1996/97	% to total	2001/02	% to total
Less than 10	4083	95.59	3203	90.05	2775	86.37
10-50	136	3.18	282	7.93	316	9.83
50 and above	52	1.22	72	2.02	122	3.79
Total	4271	100	3557	100	3213	100

Table 7.3
Manufacturing Establishments by Size of Persons⁺

Size of Persons	Number of Establishments					
	1991/92	% to total	1996/97	% to total	2001/02	% to total
10-19	1966	46.03	1753	49.28	1635	50.89
20-49	1173	27.46	834	23.45	716	22.28
50-99	594	13.91	512	14.39	372	11.58
100-199	332	7.77	284	7.98	317	9.87
200 and above	206	4.82	174	4.89	173	5.38
Total	4271	100	3557	100	3213	100

Table 7.4
Manufacturing Establishments by Ownership⁺

Ownership	Number of Establishments					
	1991/92	% to total	1996/97	% to total	2001/02	% to total
Private	4145	97.05	3470	97.55	3118	97.04
Foreign and Private	23	0.54	30	0.84	28	0.87
Foreign	2	0.05	5	0.14	24	0.75
Government	65	1052	36	1.01	17	0.53
Joint with Government	23	0.54	9	0.25	17	0.53
Others	13	0.30	7	0.19	9	0.28
Total	4271	100	3557	100	3213	100

Table 7.5
Manufacturing Establishments by Legal Status⁺

	1991/92	% to total	1996/97	% to total	2001/02	% to total
Personal	2957	69.23	2403	67.55	2150	66.91
Partnership	600	14.04	324	9.11	243	7.56
Private Limited	604	14.14	743	20.88	752	23.40
Public Limited	83	1.94	63	1.77	48	1.49
Others	27	0.63	24	0.67	20	0.62
Total	4271	100	3557	100	3213	100

Table 7.6
Manufacturing Establishments by Capacity Utilisation⁺

Capacity Utilisation (percent)	Number of Establishments			
	1996/97	% to total	2001/02	% to total
Less than 20	198	5.57	202	6.29
20-40	787	22.12	709	22.07
40-60	1456	40.93	1299	40.43
60-80	799	22.46	786	24.46
Above 80	317	8.91	217	6.75
Total	3557	100	3213	100

Table 7.7
Manufacturing Establishments By Rural Urban Structure⁺

Manufacturing Establishments	1991/92		1996/97		2001/02	
	No.	Percent	No.	Percent	No.	Percent
In VDC	1638	38.4	1594	44.8	1615	50.3
In Municipality	2633	61.6	1963	55.2	1598	49.7
Total	4271	100	3557	100	3213	100

⁺ Source : *Census of Manufacturing Establishments, 1991/92, 1996/97, 2001/02*
HMG/Nepal, Central Bureau of Statistics.

Table 7. 8
Contribution of Small Scale Manufacturing Establishments⁺

Enterprises with Fixed Assets (in Rs. million) ↓	Percentage Share in				
	Gross Fixed Assets	Employees (in Number)	Census Output	Census Value Added	Wages & Salaries
1991/92 Census					
Less than 10	17.4	82.4	59.1	57.5	72.2
Between 10-50	13.8	8.7	18.9	15.7	11.6
Less than 50	31.2	91.1	78.0	73.2	83.8
50 and above	68.8	8.9	22.0	26.8	16.2
Total	100	100	100	100	100
Amount (Rs.'000)	20067126	213653	32997374	13649922	3348493
1996/97 Census					
Less than 10	17.2	65.3	36.3	33.6	54.7
Between 10-50	22.8	21.3	30.7	29.9	24.3
Less than 50	40.0	86.6	67.0	63.5	79.0
50 and above	60.0	13.4	33.0	36.5	21.0
Total	100	100	100	100	100
Amount (Rs.'000)	26491045	187316	54927092	21875312	4058069
2001/02 Census					
Less than 10	11.8	55.6	22.4	20.9	36.8
Between 10-50	18.1	21.1	28.8	24.9	27.2
Less than 50	29.9	76.7	52.2	55.8	86.0
50 and above	70.1	23.3	48.8	54.2	36.0
Total	100	100	100	100	100
Amount (Rs.'000)	40371381	181943	94811061	32604606	6389661

⁺ Source: *Census of Manufacturing Establishments, 1991/92, 1996/97, 2001/02*
HMG/Nepal, Central Bureau of Statistics.

Table 7.9
Number of Registered Cottage and Small Scale Industries By Classification,
Investment and Employment

Fiscal Years	Private	Partnership	Private Ltd.	Total	Capital Investment (Rs.in million)	Employment
Up to 1989/90	42467	2827	2132	47426	9742	440940
1990/91	4822	273	108	5203	1130	37095
1991/92	4968	465	242	5675	1400	85125
1992/93	6087	398	296	6781	3150	82176
1993/94	8535	630	321	9489	5720	153000
1994/95	7833	439	247	8519	5376	75091
1995/96	8638	468	544	9650	7220	92581
1996/97	7404	446	346	8196	6040	85540
1997/98	8669	471	481	9621	8810	93094
1998/99	8789	684	533	10006	9620	88973
1999/00	8889	549	685	10123	10350	79618
2000/01	8368	407	542	9317	7320	67975
2001/02	8851	526	513	9890	7720	65374
2002/03	6768	454	340	7562	5910	47455
Total	141091	9037	7330	157458	89508	1494037

Source: Audhyogik Prabardhan Tathyank(in Nepali), 2003/04
HMG, Ministry of Industry, Commerce and Supply,
Department of Cottage and Small Industries.

Table 7.10
Priority and Deprived Sector Loan Statement of Commercial Banks
Mid-January, 2004

Rs. in million

Priority Sector		Deprived Sector	
Total	7756.4	Total	2393.7
<i>Direct Investment</i>	<i>6404.7</i>	<i>Direct Investment</i>	<i>619.4</i>
Agriculture	655.6	Agriculture	244.1
Domestic Industries	1690.8	Domestic Industries	21.7
Services	3430.4	Services	353.6
Power Sector	606.7		
Machine and Import of Raw Materials	21.2		
<i>Indirect Investment</i>	<i>1351.7</i>	<i>Indirect Investment</i>	<i>1743.3</i>

Source: NRB, Banking and Financial Statistics, No. 42, Mid-January 2004.

Table 7.11
Year wise Registration of Industries as Per Category[⊕]

F.Y.	Manufacturing	Service	Tourism	Construction	Agro-Based	Energy	Mineral	Total	Total Capital Investment (Rs.in mln.)	Employment
Up to 1993/94	629	812	121	-	27	7	4	1600	32240	110330
1994/95	86	56	37	5	28	-	1	213	13999	20655
1995/96	111	194	42	11	14	-	-	372	18838	35045
1996/97	128	52	42	6	15	-	1	244	13908	24799
1997/98	35	38	24	3	5	2	1	108	9997	11468
1998/99	39	27	27	2	5	7	-	107	13958	8902
1999/00	69	33	37	4	4	7	-	154	24969	13032
2000/01	66	42	31	-	3	2	-	144	10767	9165
2001/02	62	42	17	1	11	6	-	139	22373	11741
2002/03	64	25	16	-	3	2	-	110	13208	12904
Total	1289	1321	394	32	115	33	7	3191	174257	258041

[⊕] Source : Industrial Statistics, 2003/04

Ministry of Industry, Commerce and Supplies
Department of Industries.

Table 7.12
Capacity Utilisation of Selected Medium and Large Scale Industries

Highest Five in Descending Order		Lowest Five in Ascending Order	
Product	Capacity Utilisation	Product	Capacity Utilisation
Tea	95	Stainless Steel Utensils	3
G.I./H.B. Wire	94	Leather/Sport Shoes	25
Cigarette	90	Slipper	27
Soap	71	Detergent Powder	31
Dry Cell Battery	69	Bricks	36

Source : Industrial Statistics, 2003/04,

HMG/Nepal, Ministry of Industry, Commerce and Supply,
Department of Industries.

Table 7.13
Sector wise Contribution to GDP

(Rs. in million)

	1992/93	2002/03+	2003/04++
Real GDP at Factor Cost (at 1994/95 price)	188782	286480	296459
Agriculture Sector	79631	111471	115629
Non-Agriculture Sector	109151	175009	180830
Manufacturing	17075	23584	26014
Agriculture Sector/GDP (Percent)	42.2	38.9	39.0
Non-Agriculture Sector/GDP (Percent)	57.8	61.1	61.0
Manufacturing/GDP (Percent)	9.0	8.9	8.8
Manufacturing/ Non-Agriculture Sector (Percent)	15.6	14.5	14.4

+ Revised Estimate ++ Preliminary Estimate

Source : Economic Survey, 2003/04, HMG/Nepal, Ministry of Finance.

Table 7.14
Major Exportable Commodities

(Rs in Million)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03R	2003/04P
Total Exports	17639.2	19881.1	22636.5	27513.5	35676.3	49822.7	55654.1	46944.8	49930.6	52723.7
Readymade Garments	5139.3	5374.8	5955.0	7015.4	9701.9	13942.4	13124.7	7833.0	11890.0	9544.8
Woolen Carpets	7718.1	8163.9	8880	8485.3	9802.0	9842.1	8592.3	6212.5	5320.0	5588.8
Pashmina						2665.0	4121.2	1245	1157.6	1061.2
Percent to Total Export										
Readymade Garments	29.1	27.0	26.3	25.5	27.2	27.9	23.6	16.7	23.8	18.1
Woolen Carpets	43.8	41.1	39.2	30.8	27.5	19.7	15.4	13.2	10.6	10.6
Pashmina						5.3	7.4	2.6	2.3	2.0
Annual Growth Rate										
Garment	-	4.6	10.8	17.8	38.3	43.7	(5.8)	(40.3)	51.8	(19.7)
Carpet	-	5.8	8.8	(4.4)	15.5	0.4	(12.7)	(27.7)	(14.4)	5.1
Pashmina	-	-	-	-	-	-	54.6	(69.8)	(7.0)	(8.3)

P Provisional

R Revised

Figures in parentheses indicate negative growth.

Source: Nepal Rastra Bank.

Acronyms

ADB/N	-	Agriculture Development Bank/Nepal
APROSC	-	Agricultural Projects Services Center
CBS	-	Central Bureau of Statistics
CDG	-	Centre for Development and Governance
CSI	-	Cottage and Small Industries
FDI	-	Foreign Direct Investment
FNCCI	-	Federation of Nepalese Chambers of Commerce and Industries
F/Y	-	Fiscal Year
GDP	-	Gross Domestic Product
GNP	-	Gross National Product
HMG/N	-	His Majesty's Government/ Nepal
IT	-	Information and Technology
IDA	-	International Development Agency.
NA	-	Not available
NBL	-	Nepal Bank Limited
NEFAS	-	Nepal Foundation for Advanced Studies
NIDC	-	Nepal Industrial Development Corporation
NRB	-	Nepal Rastra Bank
NPEDC	-	National Productivity and Economic Development Centre
NPC	-	National Planning Commission
OECD	-	Organization for Economic Co-operation & Development
PCI	-	Per Capita Income
RBB	-	Rastriya Banijya Bank
R&D	-	Research and Development
RDBs	-	Rural Development Banks
SAWTEE	-	South Asia Watch on Trade, Economics and Environment
SMEDP	-	Small and Medium Enterprise Development Project
SMEs	-	Small and Medium Enterprises
SMIs	-	Small and Medium Industries
SSI	-	Small Scale Industry
TQM	-	Total Quality Management
WTO	-	World Trade Organization

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CHAPTER 8

THE ROLE OF THE BANGKO SENTRAL NG PILIPINAS IN PROMOTING SMALL AND MEDIUM SCALE ENTERPRISES¹

by

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1. Introduction

The changing business and regulatory environment brought about by globalisation has spawned new challenges and opportunities for small and medium enterprises (SMEs). Contrary to dire predictions that globalisation would weaken SMEs, a number of them, particularly in China and Indonesia, have found ways to thrive in the more competitive business environment. Even without the advantage of scale economies and resources to undertake research and development, SMEs have enhanced their position in global markets through innovation. The shift from traditional factors of production, such as land, labour and capital, towards knowledge-based activities has opened opportunities for SMEs to capitalise on creating and commercialising knowledge. The resiliency of this sector, along with its significant contribution to innovation-led growth and employment generation, has given new impetus to economic planners to review their SME strategy.

In the Philippines, efforts to boost the SME sector have been intensified due to heightened competition in global trade. In particular, the influx of mass-produced and lower-priced goods from China has threatened the viability of domestic SMEs. To meet the challenges posed by the new business environment, the Philippine Government crafted the SME Development Plan for 2004-2010. The Government's resolve to harness the potential of the SME sector is also in line with the present Administration's 6-year mandate to reach 3 million entrepreneurs who will contribute to the generation of 6 to 10 million jobs.

In light of these developments, this paper aims to reexamine the role of central banks in promoting the growth of SMEs. The paper has 9 sections. Section

1. Prepared by Joel Victor S. Soto, Office of Supervisory Policy Development and Lucia C. Laquindanum, Department of Economic Research for the SEACEN Workshop on The Role of Central Banks in Promoting Small and Medium Scale Enterprises. The authors wish to acknowledge the valuable assistance of Msdmes. Tina Kiss, May Agcaoili and Carmi Hemedes.

1 of the paper gives a brief introduction on the challenges faced by SMEs. Section 2 gives the definition and describes the current state of Philippine SMEs. Section 3 tackles the legislative and regulatory framework. Section 4 presents the institutional settings for the development of SMEs. Part 5 lays out the SME Development Plan for 2004-2010. Section 6 looks into the issues and challenges faced by SMEs. Section 7 tackles the role of central banks, in general, in the development process. Section 8 focuses on the role of the Bangko Sentral ng Pilipinas (BSP) in the growth of SMEs, and Section 9 gives the summary, conclusions and recommendations of the paper.

2. Definition and State of the Philippine SME Sector

2.1 Definition

Small and medium enterprises are categorised based on the size of assets (excluding land) and number of employees.² In January 2003, the upper limit of the asset size of micro enterprises was raised from P1.5 million to P3 million, while that of medium enterprises from P60 million to P100 million. The definition holds for all industries (e.g., manufacturing or commerce). Efforts to review the definition are being undertaken to reflect the distinct characteristics of each category.

	<u>Asset Size :</u>	<u>Employment :</u>
Micro Enterprises	P3 million and below	1 to 9
Small Enterprises	Over P3 million to P15 million	10 to 99
Medium Enterprises ³	Over P15 to P100 million	100 to 199

2. For purposes of this study most of the discussions on SMEs include micro enterprises.

3. The definition of SMEs by asset size was amended on 16 January 2003 pursuant to the Small and Medium Enterprise Development Council Resolution No.1. From P 60 million, the maximum asset size of medium enterprises was raised to P100 million.

2.2 Profile of SMEs

The following section gives a brief description of some of the salient characteristics of the SME sector that provides the basis for the formulation of policies and regulations of the Government.

2.2.1 Number of Establishments and Employees

The total number of establishments reached 811,592 in 2001 (Table 8.1). Of this total, micro enterprises accounted for 91.6 percent; small enterprises, 7.6 percent; and medium enterprises, 0.4 percent; for a combined share of SMEs of 99.6 percent. Large enterprises comprised the remaining 0.4 percent of the total establishments.

In terms of employment, SME workers accounted for more than two-thirds (69.1 percent) of total employees (Table 8.2). The bulk of workers in the SME sector were employed in the micro and small enterprises which had shares of 38 percent and 24 percent, respectively, for a total share of 62 percent. The significant share of the two subsectors in total employment reflects their potential for employment absorption. The remaining 7.1 percent of employees were in the medium-sized enterprises.

2.2.2 Composition by Industry

Across different types of industries, microenterprises comprised more than 60 percent of total establishments, except in agriculture, utilities and construction where small-sized firms had a more significant share.

Based on employment size, microenterprises were engaged in manufacturing, commerce (wholesale and retail trade), finance, ownership of housing and real estate, private services and government service. Small enterprises were found in almost all industries with shares ranging from 14.4 percent to 38.5 percent.

Table 8.1. Number of Establishments by Sector (2001)										
										Unit: Establishment
PCIC	Establishments									
	Micro	%	Small	%	Medium	%	Large	%	Total	%
Agriculture, forestry & fishing	1,956	(46.1)	2,014	(47.4)	124	(2.9)	153	(3.6)	4,247	(100.0)
Mining	216	(62.4)	100	(28.9)	14	(4.0)	16	(4.6)	346	(100.0)
Manufacturing	108,986	(88.0)	12,627	(10.2)	988	(0.8)	1,194	(1.0)	123,795	(100.0)
Utilities	485	(41.8)	483	(41.6)	99	(8.5)	94	(8.1)	1,161	(100.0)
Construction	1,530	(55.0)	1,037	(37.3)	105	(3.8)	111	(4.0)	2,783	(100.0)
Commerce	415,924	(95.6)	18,469	(4.2)	408	(0.1)	300	(0.1)	435,101	(100.0)
Finance	17,791	(75.8)	5,477	(23.3)	84	(0.4)	109	(0.5)	23,461	(100.0)
Ownership of housing & real estate	34,527	(88.3)	3,928	(10.0)	299	(0.8)	361	(0.9)	39,115	(100.0)
Private services	92,500	(89.5)	10,237	(9.9)	318	(0.3)	244	(0.2)	103,299	(100.0)
Government service	70,034	(89.5)	7,390	(9.4)	484	(0.6)	376	(0.5)	78,284	(100.0)
Total	743,949	(91.7)	61,762	(7.6)	2,923	(0.4)	2,958	(0.4)	811,592	(100.0)
Source: National Statistics Office (NSO)										

Table 8.2. Number of Employees by Sector (2001)

										Unit: Men
PCIC	Establishments									
	Micro	%	Small	%	Medium	%	Large	%	Total	%
Agriculture, forestry & fishing	8,077	(4.9)	47,745	(29.2)	16,740	(10.2)	90,942	(55.6)	163,504	(100.0)
Mining	1,029	(4.9)	3,049	(14.4)	2,128	(10.1)	14,897	(70.6)	21,103	(100.0)
Manufacturing	353,415	(23.0)	309,952	(20.2)	136,648	(8.9)	734,088	(47.9)	1,534,103	(100.0)
Utilities	2,152	(2.8)	14,509	(18.9)	14,124	(18.4)	46,140	(60.0)	76,925	(100.0)
Construction	6,848	(4.6)	26,928	(18.2)	13,843	(9.3)	100,472	(67.8)	148,091	(100.0)
Commerce	1,109,473	(67.1)	350,368	(21.2)	55,184	(3.3)	137,925	(8.3)	1,652,950	(100.0)
Finance	74,175	(29.2)	97,782	(38.5)	11,458	(4.5)	70,469	(27.8)	253,884	(100.0)
Ownership of housing & real estate	103,153	(25.1)	92,936	(22.6)	41,199	(10.0)	173,926	(42.3)	411,214	(100.0)
Private services	307,369	(39.8)	230,866	(29.9)	41,909	(5.4)	191,602	(24.8)	771,746	(100.0)
Government service	186,194	(29.8)	183,527	(29.4)	66,125	(10.6)	188,600	(30.2)	624,446	(100.0)
Total	2,151,885	(38.0)	1,357,662	(24.0)	399,358	(7.1)	1,749,061	(30.9)	5,657,966	(100.0)

Source: NSO

2.2.3 Composition by Geographic Location

By location, 62 percent of SMEs were concentrated in the National Capital Region (NCR), Southern Luzon, Central Luzon, Central Visayas and Southern Mindanao (Table 8.3). Micro and small enterprises were more evenly distributed across all other regions while the medium and large enterprises were located mainly in NCR.

These five regions also accounted for the greater share of 76.3 percent of total employees across all sizes of establishments compared with all other regions

The Role Of The Bangko Sentral Ng Pilipinas In Promoting Small And Medium Scale Enterprises combined (Table 8.4). On the average, more than two-thirds of employees of SMEs work in these five regions.

Table 8.3. Breakdown of Business Establishments by Size and Region (2000)						
Unit: No. of Establishments						
Regional Division	Total	%	Cottage	Small	Medium	Large
National Capital Region (NCR)	196,491	23.9	167,208	26,440	1,384	1,459
Southern Tagalog (Region 4)	144,530	17.6	135,526	8,088	431	485
Central Luzon (Region 3)	87,383	10.6	81,866	5,140	190	187
Central Visayas (Region 7)	49,179	6.0	44,466	4,247	220	246
Southern Mindanao (Region 11)	35,885	4.4	32,830	2,795	127	133
Other 11 regions	307,492	37.5	285,844	20,456	718	474
Total	820,960	100.0	747,740	67,166	3,070	2,984
Share of the 5 regions	513,468	62.5	61.8	69.5	76.6	84.1
Source: NSO						

Table 8.4. Breakdown of Employment by Size and Region (2000)						
Unit: No. of Establishments						
Regional Division	Total	%	Cottage	Small	Medium	Large
National Capital Region (NCR)	2,364,533	40.1	549,796	703,159	193,801	917,777
Southern Tagalog (Region 4)	925,625	15.7	370,807	191,900	68,778	294,140
Central Luzon (Region 3)	488,644	8.3	234,451	122,236	30,675	101,282
Central Visayas (Region 7)	400,483	6.8	129,075	108,931	30,364	132,113
Southern Mindanao (Region 11)	326,376	5.5	129,867	74,909	18,670	102,930
Other 11 regions	1,396,525	23.7	751,104	321,092	74,398	249,931
Total	5,902,186	100.0	2,165,100	1,522,227	416,686	1,798,173
Share of the 5 regions	4,505,661	76.3	65.3	78.9	82.1	86.1
Source: NSO						

2.2.4 Contribution to Value Added and Sales

In terms of value added and sales, SMEs account for a significantly lower share of close to 30 percent compared to the more than 70 percent recorded by large enterprises in 1993 (Tables 8.5 and 8.6). It may be noted that the share of SMEs to total value added has grown over time from 21.1 percent in 1983

to 30.2 percent in 1998 and 32 percent in 2000. The contribution of SMEs to total sales similarly increased from 22 percent to 30.7 percent during the same period. However, the share of Philippine SMEs to total value added is lower when compared to its regional counterparts such as China (68 percent), Indonesia (63 percent), and Japan (56.7 percent) (Table 8.7). The significant difference in the percent share to value added between the Philippines and those of other Asian countries indicates the potential contribution SMEs could have on the Philippine economy.

Table 8.5. Value Added (Census) by SMEs and Size Distribution

Unit: Pesos

	1983	%	1993	%	1998	%
Micro	1,381		11,013		16,086	
Small	5,891		44,754		)	
Medium	4,687	8.3	31,283	10.1	) 669,338	
Large	44,801	78.9		71.9	)	
Total	55,379	87.2	299,148	82.1		
Share of SME	11,959	21.1	87,050	28.1		30.2

Source: NSO, Census of Establishments (Manufacturing)

Table 8.6. Sales Generated by SMEs (Census) and Size Distribution

Unit: Pesos

	1983	%	1993	%	1998	%
Micro	1,859		24,707		31,672	
Small	20,369		152,531		)	
Medium	13,630	8.4	79,006	9.6	) 1,641,583	
Large	127,092	78.0	590,665	71.8	)	
Total	161,091	86.4	822,202	100.0		
Share of SME	35,859	22.0	231,539	28.2		30.7

Source: NSO, Census of Establishments (Manufacturing)

Table 8.7. Contribution of SMEs to the Economies of Selected Asian Economies							
Unit: In percent							
	RP	South Korea	Japan	China	Malaysia	Thailand	Indonesia
No. of Establishments	99.7	99.8	99.0	99.0	94.0	98.0	99.9
Employment	69.1	86.7	88.6	75.0	40.0	55.8	99.4
Value Added	32.0	51.9	56.7	68.0	26.0	38.9	56.7

Source: SME Development Plan (2004-2010), Country papers Presented during the SEACEN Research Project on Role of Central Banks in Promoting SMEs

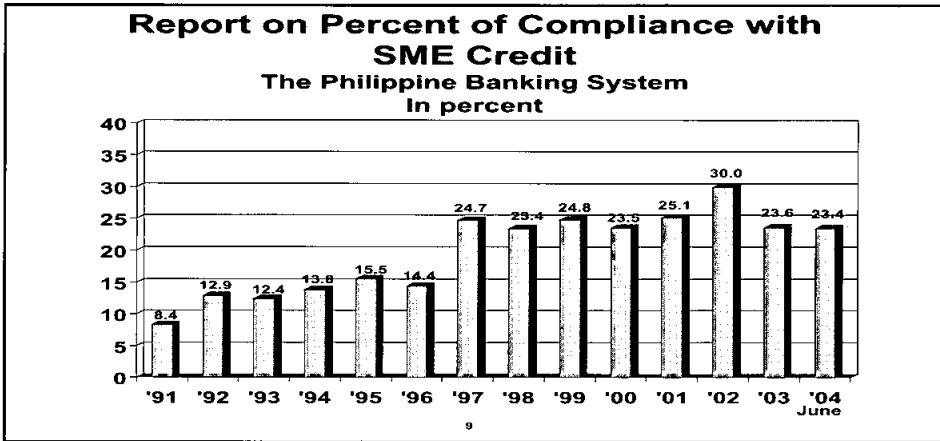
2.3 State of SME Financing

Results of a survey of SMEs conducted by the Japan for International Cooperation Agency (JICA) and the Department of Trade and Industry (DTI) indicated that 50 percent of SMEs obtain their financing from commercial banks and 34 percent from the informal sector (JICA/DTI, 2004). Other sources of funds include non-bank financial corporations.

2.3.1 Bank Lending

Banks are required by law to set aside 6 percent and 2 percent of their loan portfolio to small and medium enterprises, respectively. Loans granted by banks to SMEs have grown from P16.8 billion in 1991 to P246.5 billion as of June 2004, resulting in an increased share of SME loans to total loan portfolio of banks, from 8.37 percent to 23.4 percent during the same period. The share exceeds the combined mandated allocation of 8 percent. Commercial banks provided three-fourths of funds allocated for SMEs given their wider operating network. Commercial banks' head offices and branches reached 4,344, surpassing thrift and rural banks' 3,198 offices and branches as of June 2004. Commercial banks likewise accounted for 90 percent of the banking system's resources allowing them to have more funds available for lending to SMEs.

Chart 8.1



Although there has been a significant increase in compliance by banks to the credit allocation, SME borrowers cited difficulties in obtaining funds from banks. The JICA-DTI survey showed that insufficient mortgage/collateral remained the primary hindrance to the availment of credit from banks and corporations. Survey respondents also cited complicated procedures for documentation and the long period of loan evaluation; and the general reluctance of banks to lend to SMEs as major deterrents to easier credit access.

As earlier mentioned, JICA-DTI survey revealed that about half of SMEs rely on private and state commercial banks for their financing needs while more than one-third borrow from informal sources, such as relatives and friends. Of the firms, enterprises in the electronic industry borrowed mainly from commercial banks while those from the jewelry and metal products industries obtained their funds from the informal sector.

For their future financing requirements, a greater number of sample firms (68 percent) intend to borrow more from private and government commercial banks and less from informal sources (5 percent). Those who plan to get their financing from commercial banks opted to do so on the basis of pursuing existing lending arrangements with their banks while those who intend to borrow from government commercial banks cited favourable terms offered by these financial institutions such as reasonable interest rates and repayment period.

To reduce risks associated with lending to SMEs, the Small Business Guarantee and Finance Corporation (SBGCF or SBC) was created in 1991.

Since its operation in 1992 until June 2004, the SBGFC has extended a total of P19.9 billion in SME credit assistance with its Wholesale Lending Program amounting to P1.7 billion, Direct Lending to P9.4 billion and Credit Guarantees to P8.7 billion.

2.3.2 Equity Financing

Equity financing for SMEs, such as venture capital and private equity, is underdeveloped. Many Filipino SMEs, especially those that are family-owned, are reluctant to take in outside investors. Equity financing gained a head start in 2004 as the Equity Ventures Program of the SBC forged its first deal in pioneering equity financing for SMEs.

Equity financing can be raised through the local stock market. Venture capitals earn profits from the rise in the share value created by the company's growth. They realise profits by selling their shares at the stock market. For example the NASDAQ in the US became known as a stock market for start ups by listing a number of fast growing companies, such as high-tech ventures and innovative service providers, which have attracted risk-taking investors. As a result, the market attracted substantial funds from venture capitalists, which have been reinvested in new start-ups, resulting in increased funds re-channelled to SMEs.

The SME Board in the Philippine Stock Exchange has listed only three companies since its launch in 2001. The slow pick-up in listing was due to several factors: (1) most SMEs have a limited understanding of listing their shares, in particular, the advantages and disadvantages; (2) few know about the existence of the SME Board; (3) lack of consultants who can effectively assist companies in marking preparation for listing, including reorganisation; and (4) the listed companies are not attractive enough to investors in terms of performance and growth potentials, resulting in anemic secondary trading in the bourses after its initial public offering.

3. The Policy Environment and Regulatory Framework

Three important laws contributed to the development of SMEs in the Philippines: the Magna Carta for Small Enterprises of 1991 (Republic Act No. 6977, as amended by Republic Act No. 8289); the General Banking Law (GBL) of 2000; and the Barangay Micro Business Enterprise (BMBE) Act of 2002.

These, as well as Bangko Sentral issuances aimed at fostering a credit environment conducive to the growth of SMEs, are discussed in detail below.

3.1 Magna Carta for Small Enterprises

The Magna Carta for Small Enterprises aims to promote, develop and assist small and medium-scale enterprises through the creation of a Small and Medium Enterprise Development (SMED) Council, and provides for the rationalisation of government assistance, programmes and agencies concerned with the development of small and medium enterprises. It lays down the basic policies for SME promotion, provides for the definition of SMEs, and mandates the establishment of the institutional framework for the existing SME promotion system. The Small Business Guarantee and Finance Corporation (SBGFC) was also created under this Act.

The Magna Carta stipulates the allocation of credit resources (lending quota) for financial institutions at 6 percent of its total loanable funds to small enterprises, and 2 percent to medium enterprises for a period of 10 years until 2007.

Under the Magna Carta, four guiding principles were set as key policies for SME development:

- a. Minimal set of rules and simplification of procedures and requirements;
- b. Encouragement of private sector participation;
- c. Coordination of government efforts for coherence of objectives; and
- d. Decentralisation.

3.2 GBL

The GBL (Republic Act 8791), in particular Sections 40, 43, 44 that pertain to loans and other credit accommodations, paved the way for the issuance of BSP guidelines aimed to support the growth of micro financing within the banking sector. These guidelines, among others, helped ensure the repayment of micro-finance loans. Microfinance is the flagship programme of the BSP for poverty alleviation.

To implement Sections 40, 43 and 44, the BSP approved the following implementing guidelines: a) the maximum principal amount of micro financing loans shall not exceed P150,000; b) interest rates shall not be lower than prevailing

market rates; c) micro financing loans, which are small, unsecured loans, shall be exempted from rules and regulations governing unsecured loans, subject to certain conditions; and d) micro financing loans shall be considered compliance with the loan allocation to small and medium enterprises (Circular No. 272, 2001).

3.3 BMBE Act

Further recognising the importance of micro enterprises, Congress passed the BMBE Act of 2002 (Republic Act No. 9178). The law aims to support eligible micro enterprises as well as the informal sector by extending fiscal incentives and simplifying procedures. Incentives were granted to local government-registered barangay micro enterprises (BMBEs) through: exemption from income tax; reduction in local taxes, fees and charges; exemption from payment of the minimum wage requirement; financial support from government financial institutions; and technology assistance from concerned government agencies.

A BMBE is defined as any business entity whose total assets, exclusive of the land on which the entity's office, plant and equipment are situated, should not be more than P 3 million, and is registered with the office of the treasurer of a city or municipality.

Under Section 9 of this Act, the Land Bank of the Philippines (LBP), the Development Bank of the Philippines (DBP), the Small Business Guarantee and Finance Corporation (SBGFC) and the People's Credit and Finance Corporation (PCFC) are required to open a special credit window that will service the financing needs of duly-registered BMBEs. The Government Service Insurance System (GSIS) and Social Security System (SSS) shall likewise set up a special credit window that will serve the financing needs of their respective members who wish to establish a BMBE. The concerned financial institutions can wholesale the funds to accredited private financial institutions; including community-based organisations such as credit cooperatives, non-government organisations and people's organisations engaged in providing credit, for relending to the BMBEs.

All loans granted to BMBEs under the Act are considered as part of alternative compliance to Presidential Decree No. 717 (The Agri-Agra Law) or to Republic Act No. 6977 (The Magna Carta for Small Enterprises, as amended), and for purposes of compliance, are computed at twice the amount of the face value of the loans. Interests, commissions and discounts derived from the loans

by the LBP, DBP, SBGFC and PCFC as well as loans granted by the GSIS and SSS to their respective members under the Act are exempted from gross receipts tax (GRT).

The SBGFC and the Quedan and Rural Credit Guarantee Corporation (QUEDANCOR) under the Department of Agriculture must also provide a special guarantee window.

A BMBE Development Fund of P300 million shall also be set up and administered by the SMED Council. The Department of Trade and Industry (DTI), Department of Science and Technology (DOST), University of the Philippines Institute for Small Scale Industries (UP ISSI), Cooperative Development Authority (CDA), Technical Education and Skills Development Authority (TESDA), and the Technology and Livelihood Resource Center (TLRC) may avail of the said Fund for technology transfer, production and management training and marketing assistance to BMBEs. The DTI shall explore the possibilities of linking up BMBEs with SMEs and providing incentives.

The Philippine Information Agency (PIA), Department of Labor and Employment (DOLE), Department of Interior and Local Government (DILG), and the DTI have been tasked to disseminate the contents and benefits of said BMBE Act to the general public especially to its intended beneficiaries at the barangay level.

To facilitate the processing of loans by minimising documentary requirements, the Bangko Sentral allowed registered BMBE borrowers to be exempted from the submission of income tax returns and/or financial statements, provided reasonable measures are taken to determine that the borrower is capable of fulfilling his credit commitments (BSP Circular No. 374, 2003). Funds loaned by government financial institutions to accredited private banks and other financial institutions for re-lending to BMBEs shall also be eligible as part of alternative compliance to P.D. No. 717 or to R.A. No. 6977, at the maximum amount of 100 percent of their outstanding balance.

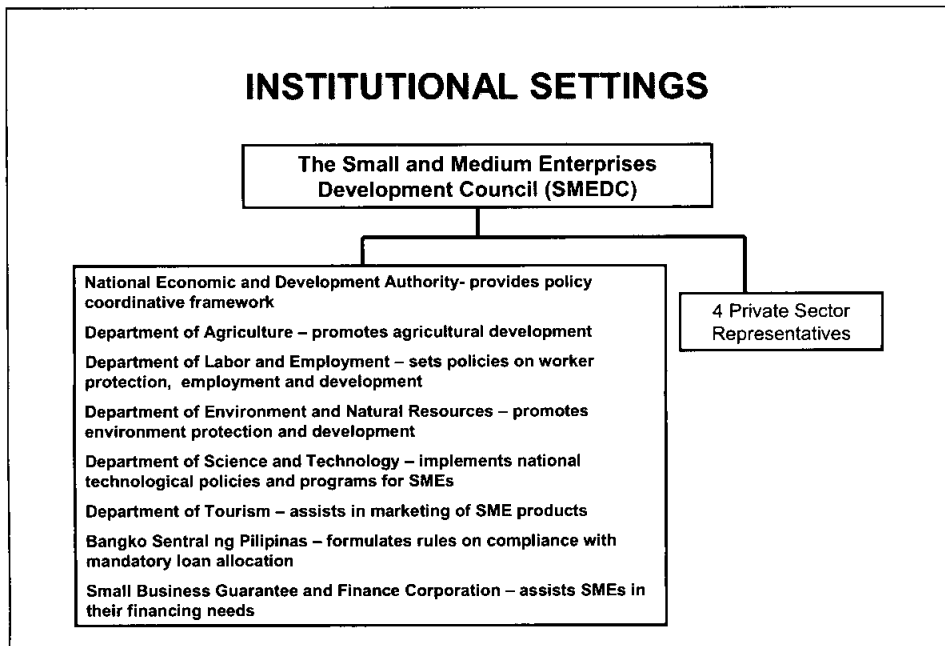
As an exemption to the general moratorium on the establishment of new banking offices, the BSP allowed the establishment of banks that will cater primarily to BMBEs, provided that at least 70 percent of the deposits generated by said branches shall be lent out to BMBEs and their outstanding loans to

BMBEs shall at all times be at least 50 percent of their gross loan portfolio (other policy initiatives of the Bangko Sentral are discussed in Section 8).

4. Institutional Settings and SBGFC Lending Programmes

4.1 Institutional Settings

A number of government agencies are involved in the implementation of the two major laws pertaining to the promotion of SMEs. Coordination among the various government agencies rests on the SMED Council which is attached to the Department of Trade and Industry (DTI). The SMED Council is the primary agency responsible for the promotion, growth and development of SMEs by facilitating and coordinating national efforts in the formulation of SME policies and implementation of SME plans and programmes. It is a multi-agency chaired by the DTI and composed of 12 members, 8 from various government agencies and 4 private sector representatives.



4.2 SBGFC Financial Assistance Programmes⁴

The SBGFC was created to source and adopt development initiatives for globally competitive SMEs in terms of finance, technology, production, management and business linkages, and to provide and develop alternative modes of financing and credit delivery systems, including direct and indirect project lending, venture capital, financial leasing, secondary mortgage and/or rediscounting. It guarantees loans to qualified SMEs, private voluntary organisations and cooperatives and may also provide second level guarantee on the credit and/or investment guarantees made by credit guarantee associations and institutions to attract lenders to finance SMEs.

The lending and guarantee programs of the SBGCF are designed to supplement market infrastructures to channel more funds to step up the development of the SME sector (Table 8.8).

Table 8.8. SBGFC Financial Assistance Programmes

Programmes	Purpose
Wholesale Lending Programmes	
SME-Funding for Investments in Regional Markets (SME FIRM)	Wholesale medium-term project funding channeled through accredited financial institutions as conduits to SMEs
SME-Funding Access for Short Term Loans (SME FAST)	Wholesale funding via rediscounting of SME loans of accredited financial institutions
SME-Financing Entry Point for Entrepreneurs in Livelihood for Micro financing (SME FEEL)	Micro financing facility that provides funds for lending activities to micro enterprises with Non-Government Organisations (NGOs), and People's Organisations (POs) as conduits.
Direct Lending Programmes	
SME-Financing Reach for Exporters through Network Development (SME-FRIEND)	Direct lending to exporters with Letters of Credit, who are endorsed by their industry associations
SME-Financing for Receivables of Suppliers Transactions (SME-FIRST)	Direct lending to suppliers of domestic firms with proven track record and management stability, where the object of credit is the supplier's sales invoice for goods and/or services delivered

4. The Appendix gives an expanded menu of financial assistance from government and private sector institutions.

Programmes	Purpose
SME-Financing for Organisationally Competent and Excellent Franchise Business (SME-FORCE) SME-Guarantee Incubation for DTI-Endorsed Projects (SME-GUIDE) – Promotes and supports the development of DTI Guarantee Programmes SME-Guarantee for Enterprises in Manufacturing and Services (SME-GEMS), SME-Guarantee Resources for Agri-Business Investment (SME-GRAIN), SME-Guarantee for Industries in Livelihood Development (SME-GUILD) and SME-Guarantee Lines for Anchor Industries (SME-GLAD) Equity Financing Programmes SME-Equity Ventures Programme (EVP)	Medium-term direct lending granted to franchisees of homegrown franchise firms that are members of industry associations intended for the start-up or expansion of a franchise outlet Initiated projects in at least 20 provinces in the country Credit guarantees on SME loans with insufficient collateral and/or no collateral, endorsed by banks Equity financing facility designed to provide capital to SME corporations with an established track record, proven technology, and great market potential as shown by a sound business plan.

5. Key Issues and Challenges

The Philippine SME sector faces a number of challenges. These may be categorised into challenges in terms of competitiveness, productivity and structural limitations, credit sources and financing and access to markets.

5.1 Competitiveness of the Sector

- Competition posed by the influx of mass-produced lower-priced goods, especially from China
- Inconsistent product quality;
- Unstable supply of quality raw materials and cheap intermediate inputs;
- Small domestic market;
- Inadequate linkages between SMEs and the leading industries;

- Lack of common research and development facilities ; and
- Poor basic management skills.

5.2 Productivity and Structural Limitations

- Low level of technology if not outmoded methods of production;
- Insufficient professional know-how; and
- Insufficient incentives and inability to meet regulatory requirements.

5.3 Credit Sources and Financing of Operations

5.3.1 Credit Sources

- Banks' tendency to shun SMEs because of a general aversion to dealing with numerous small accounts;
- Inadequate access to trade credits;
- Limited reach of credit facilities;
- Unfavourable credit terms such as the mismatch in loan maturities and gestation periods of projects; and
- Overemphasis on collateral requirements.

5.3.2 Borrowers

- Limited track record and inadequate financial statements and business plans;
- Inadequate collateral; and
- Fear of loan exposure by the entrepreneurs themselves.

5.4 Access to Markets

- Inadequate transport and communication infrastructure;
- Limited access to market information and services;
- Inability to meet volume demands due to lack of effective SME organisations;
- Inadequate or insufficiently applied outsourcing or subcontracting arrangements;
- Restrictive credit terms offered by corporate customers such as supermarkets and department stores ; and
- Inadequate complementary linkages between large enterprises and SMEs.

6. The SME Development Plan (2004 – 2010)

To meet the challenges faced by SMEs, the Philippine Government drew up a six-year SME Development Plan to strengthen and stimulate the SME sector so it can contribute significantly to the country's development. It intends to create globally competitive SMEs with built-up distinctive competencies by harnessing efficient technologies and establishing strategic relationships with market forces that would enhance their potentials. The Plan consists of three stages: a 3-year roll-out phase, assessment of interim results, and another 3-year re-programmed implementation stage. Through its various programmes, it aims to accomplish the following: (1) an increase in the SME sector's gross value added (GVA) contribution to 40 percent of aggregate by 2010; and (2) an annual growth rate of 16 percent for export-oriented SMEs.

6.1 Strategic Development Goals

The long-term development goal is to increase the contribution of SMEs as a primary engine of growth by keeping pace with the performance level of ASEAN/Asian enterprises and with the efficiency of large firms, in terms of value added, employment, number of establishments and export volume generated in line with the overall Philippine target for economic growth. In particular, the plan aims to contribute to the growth and promotion of SMEs in the following areas:

6.2 Increased Productivity

To increase productivity in terms of Gross Value Added (GVA) from 32 percent to 40 percent to be at par with the ASEAN SME sector GVA average of 40 percent. This reflects about a 25 percent increase in GVA over the three-year period or an annual average increase of 8.3 percent. Sustained growth for the six-year time frame would require a 48 percent GVA share.

6.3 Increased Production Output and Sales

To attain increased production and sales for priority sectors and lead firms within the priority sectors, target of which shall be benchmarked in the first year.

6.4 Greater Contribution to Export Growth

To be a major contributor to growth in export sales with export-oriented SMEs exceeding the Philippine Export Development Plan's average year-on-year growth forecast of 16 percent for the identified priority industries.

6.5 Encourage Establishment of New Creative Enterprises

To encourage a pool of new SMEs and progressive microenterprise entrants that will set up creative business undertakings.

6.6 Development Strategies and Its Components

The eight strategies of the SME Plan are geared towards enhancing three main areas, namely: (1) support for individual SMEs; (2) assistance to identified growth or priority industries; and (3) enhancement of operational and regulatory environment that will make it more conducive to the successful operation of SMEs. Specific activities to implement each strategy are relevant to the issues and performance targets of each category.

6.7 Support for Individual SMEs

6.7.1 Strategy 1 : Enhance Managerial and Technological Capability

- 1) Information support;
- 2) Counseling and advisory programme;
- 3) Facilitating partnerships, market and technical support;
- 4) IT-enabled SMEs through IT appreciation and application courses;
- 5) Assistance from SME industry centres;
- 6) Management advisory, technology and productivity development programmes;
- 7) Best-practice modeling from successful productivity applications;
- 8) Technology applications promotions;
- 9) Providing linkages thru SME Centers and inter-regional facilitation; and
- 10) Organising linkages for competitive support.

6.7.2 Strategy 2: Develop Business Opportunities/ Industrial Diversification

- 1) Strategic business planning, training and self-help packages to help develop strategic business plans;
- 2) Product development and design services;
- 3) Support to start-up enterprises in selected areas of industries;
- 4) Entrepreneurship training camps and enterprise development programmes;
- 5) Business opportunity development and investment promotion for innovations,
- 6) Institutionalisation of SME opportunities caravan;
- 7) Franchising seminars;
- 8) Cooperative business development programme; and
- 9) Subcontracting promotion seminars for electronics, automotive part and other foreign technology enterprises.

6.8 Assistance for the Priority Industries Sub-sector

6.8.1 Strategy 3: Support Export-oriented Growth Industries

- 1) Centre for processed food, with 3 centres initially;
- 2) Centre for furniture industry, with Pampanga and Cebu as hubs;
- 3) Centre for the craft industry, with Cebu as initial hub;
- 4) Centre for facilitating partnerships and strategic inter-regional alliance;
- 5) Centre for supplier development and linkages for supporting industries in the electronic and electrical industries, automotive parts, metal working industries and advanced manufacturing industries;
- 6) Centre for packaging development; and
- 7) Centre for agro-fisheries and marine industry development.

6.8.2 Strategy 4: Support industrial Linkages

- 1) Product development and design workshops;
- 2) Design competition;
- 3) Market intelligence support;
- 4) Packaging and labeling technology development;
- 5) Industry productivity and quality improvement programmes;
- 6) Development of SME databases and information system; and
- 7) Enhanced support for trade fairs and access to market services.

6.9 Strategies to Improve the SME Operational Environment

6.9.1 Strategy 5: Improve Access of SME to Financing

- 1) Promotion of supplementary measures to reduce the risks associated with SME financing; and
- 2) Development of personal guarantee system in place of collaterals.

6.9.2 Strategy 6: Enhance the Enabling Business Environment

- 1) Funds for start-up businesses;
- 2) Venture capital fund;
- 3) SME institutional restructuring.

6.9.3 Strategy 7: Streamline the Implementation of SME Programmes and Policies

- 1) SME development strategic planning and monitoring;
- 2) Upgrading of SME development network;
- 3) Improvement of Government procurement systems and rules from SMEs;
- 4) Mandatory allocation of bank resources;
- 5) Development of BMBE Act support programmes;
- 6) Consumer awareness programs and fair trading advocacy; and
- 7) Incentives/policy measures for business cooperatives.

6.9.4 Strategy 8: Build Institutional Capacities to Develop and Implement SME Programmes

- 1) National business registry;
- 2) Database build-up and information support on SME status/white paper;
- 3) Streamlining of registration requirements.

7. The Role of Central Banks and Monetary Policy in the Development Process

The primary role of most central banks is to pursue price stability as the overriding goal of monetary policy. Policy instruments are utilised to influence the price level and inflationary expectations toward achieving non-inflationary growth. This works on the premise that low inflation leads to a drop in interest rates and further results in increased investments and to higher economic growth.

Conversely, high inflation leads to a rise in interest rates, which curbs investments and lowers output growth.

Changes in monetary policy, whether geared towards influencing price levels or other economic variables such as exchange rates, can have consequences on economic activity. Monetary policy working through the bank lending channel will affect economic agents that rely on bank loans as long as there is no perfect substitutability of retail bank deposits with other sources of funds. SMEs that are relatively dependent on bank loans will be affected more by shifts in monetary policy than large firms that can directly access the credit market via stock and bond markets without going through banks (Gertler and Gilchrist, 1994). The more adverse effects on SMEs may be due to the possibility that tighter monetary squeeze leads to flight to quality. Banks become more selective in their lending policies, choosing customers that have established track record or those that are able to post more collateral (Domac).

Empirical results have shown that in Malaysia, monetary tightening has a larger impact on SMEs than on large manufacturing enterprises (LMEs) (Domac). The findings also showed that the effect of monetary shocks on the production of SMEs is more persistent than that of LMEs. The effects of monetary policy on interest rates are magnified by imperfections in the credit market - imperfections that widen the gap between funds raised externally (by issuing equity or debt) and funds generated internally (by retaining earnings).

While central banks' monetary policy actions have a bearing on economic growth, the question arises whether such actions are adequate to sustain the development process. While promoting price and financial stability has become the focus of central banks, those in developing countries are charged with fostering economic development, in addition to pursuing macroeconomic stabilisation objective (Sanofi). The development process promotes sustainable economic growth, creates more jobs, and ensures equitable distribution of wealth. Central banks can take a direct or indirect hand in the development process depending on their mandate, comparative advantage and to some extent on the level of maturity and development of each financial system. Central banks may take on a direct role in the absence of efficient financial markets and institutional structures necessary for attaining the overall economic goals of the nation.

The direct and indirect involvement of central banks can take the form of "developmental" and "promotional" functions, respectively. Developmental

activities include government ownership of banks (often with direct or indirect central bank involvement), participation in the capital and management of development institutions, priority sector lending, differential interest rates, preferential rediscount rates and facilities, and credit guarantees (Chandavarkar, 1996).

On the other hand, the promotional role of central banks may consist activities that generate positive externalities and reduce transaction and information costs. For microfinance, promotional efforts may comprise support for pilot projects using innovative approaches, the conduct of research, the collection and publication of data, and advocacy and training.

The creation of a regulatory environment conducive to encouraging lending to SMEs is another form of indirect involvement of central banks. Central banks may institute financial reforms that enhance the financial intermediation process and remove barriers, if not provide easier access to financing.

8. The Role of the Bangko Sentral

The Bangko Sentral's role in the development of SMEs involves primarily issuing policies that would address the issue on access to credit sources. Its charter explicitly prohibits engaging in development banking and financing, and thus enables to concentrate on purely central banking functions. It has, therefore, shifted from its supply-led approach of providing funds, to creating a conducive regulatory, market-oriented climate for the growth of the sector. In 2002, it paved the way for greater access to credit by micro entrepreneurs through a package of measures directed towards expanding the microfinance network.

8.1 Ongoing Initiatives

8.1.1 Adoption of an Accommodative Monetary Stance

Given a benign inflation environment, the BSP reduced its policy rates by 25 basis points on 2 July 2003, to 6.75 percent for the overnight borrowing rate and 9.0 percent for the overnight lending rate. Despite the increase in inflation in 2004, policy rates remained unchanged as the increase in inflation was driven more by supply-side factors, such as the hike in world oil prices rather than demand-side factors.

The BSP has also applied a lower reserve requirement for thrift and rural banks, which basically cater to SMEs, to encourage greater lending to these enterprises. Presently, the reserve requirement ratio of commercial banks is 19 percent, while that of thrift banks is lower at 8 percent, and rural banks at 6 percent on demand deposits and 2 percent on savings and time deposits. Thrift and rural banks have also been spared from an increase in reserve requirement during periods when monetary authorities managed liquidity in the financial system and the foreign exchange market. For instance, reserve requirements were raised in March 2003 and February 2004 but those for thrift and rural banks were retained at their existing levels.

8.1.2 Implementation of Financial and Capital Market Reforms

The 1980s and 1990s saw the implementation of a package of reforms to liberalise the financial sector. The push towards market-orientation started with the lifting of the ceilings on interest rates in the 1980s. In the 1990s, major reforms consisted of the creation of a new and independent central bank, privatization of the biggest state bank and relaxation of the entry of foreign banks. Rules on bank branching were eased to expand the operating network of banks for wider nationwide access to financial products and services. Reserve requirements were reduced while the minimum capitalisation of banks was raised. These reforms sought to make the banking system stronger and more efficient and competitive. A study by Llanto (1998) showed that financial liberalisation had positive effects on the investment and financial position of small-scale food manufacturing enterprises.

The Bangko Sentral likewise endorsed the passage of laws to address the unsatisfactory asset-quality of banks. To reduce the huge inventory of non-performing assets (NPAs) that has hampered the lending operations of banks, the Special Purpose Vehicle Act (SPVA) was passed in 2002 to facilitate the disposal of NPAs. The SPVA grants fiscal incentives on the sale of NPAs to cushion losses incurred by banks from the transfer of these assets to SPVs.

Meanwhile, capital market development got a boost from the passage of the Securities Regulation Code, which protects investors; and the Securitization Act, which sets the legal framework for the trading of a wide range of asset-backed securities and rationalisation of the documentary stamp tax to spur trading in the secondary market. The passage of these bills into law are expected to develop alternative modes of financing to bank credit.

8.1.3 Implementation of the Magna Carta Law

The Magna Carta for Small Enterprises, as mentioned previously, provides that for a period of 10 years up to 2007, all banks must set aside at least 6 percent of its total loanable funds for credit to small enterprises, and 2 percent for medium enterprises. The Bangko Sentral was required to implement said provision of the law as well as to set up an incentive program to boost lending to SMEs beyond the mandatory credit limits. Moreover, the Bangko Sentral must update the SMED quarterly on the banks' compliance with the loan allocation.

In this regard, the BSP has been closely monitoring banks' compliance with the ratio requirements to ensure the flow of funds to the SME sector. It has also imposed sanctions provided by law for non-compliance. Over time, several banks have been penalised for their shortfall in compliance. To address banks' inability to meet the allocation requirements, the BSP implemented the following alternative modes of compliance:

1. Unavailed committed credit lines which shall not exceed 10% of direct loans actually extended to SMEs as indicated in the report for the period;
2. Holdings of Small Business Guarantee and Finance Corporation (SBGFC) instruments that do not pay market rates;
3. Purchase of small/medium enterprises' promissory notes from lending institutions and/or NGOs;
4. Loans granted to export traders, including those not guaranteed by SBGFC and to domestic traders and import traders, subject to compliance with the total asset size requirement and that in case of import traders, the importation of raw materials form part of the raw material input to a finished product;
5. Equity investments in venture capital corporations;
6. Equity investments by member banks in, and loans to, the Bankers Association of the Philippines (BAP) Guaranty Corporation (BCGC) to the extent of the member bank's proportionate share to total outstanding loans granted by BCGC to small/medium enterprises; and
7. Loans to the microfinance sector.

These allowable alternative modes of compliance, however, should not be considered as a redirection of funds to other applications since the end beneficiaries of these transactions are also SME-related entities. Banks have generally exceeded the mandatory allocation of credit to SMEs. For the quarters ended 31 December 2003 and 2002, the excess compliance of the total banking system over the minimum amount required for both small and medium enterprises amounted to P 163 billion and P 208 billion or, compliance ratios of 24 percent and 30 percent, respectively. From end-year 2002 to end-year 2003, direct SME compliance improved from 83 percent to 90 percent.

Moreover, the levels of indirect compliance are actually minimal as compared with direct compliance. For instance, at end-June 2004, the level of direct compliance reached P222.4 billion while indirect compliance amounted to only P14.1 billion or 90 percent and 10 percent, respectively, of total compliance. This indicates that banks are not generally averse to risks associated with SME lending.

8.1.4 Participation in the SMED Council

The SMED Council is the primary agency responsible for the promotion and development of SMEs. It facilitates and coordinates national efforts and programmes and assists relevant agencies in sourcing local and foreign funds. The BSP formulates rules and regulations to ensure compliance with the mandatory allocation of credit to SMEs.

8.1.5 Other Measures to Ease and Broaden Credit Access to SMEs

1. Reduction of the risk weight applicable to qualified SMEs and microfinance loan portfolios from 100 percent to 75 percent, subject to certain conditions (Circular No. 364 dated 9 January 2003), such as diversification of SME portfolio, past due ratio not exceeding 5 percent for the immediately preceding 3 years, prudential compliance and financial soundness, and adequacy of risk management system;
2. Exemption of SME loans without latest income tax returns and/or audited financial statements from "Loans Especially Mentioned" classification, provided said loans are current, have not been restructured, and are supported by ITR and/or audited financial statement at the time they were granted;

3. Allowing for the establishment of microfinance-oriented thrift banks and rural banks as an exemption from branching moratorium (Circular No. 273 dated February 27, 2001);
4. Exemption of microfinance loans from normal documentation applicable to regular bank loans (Circular No. 273 dated February 27, 2001);
5. Opening of a rediscounting facility to refinance microfinance loan portfolio of rural and thrift banks (Circular No. 282 dated 19 April 2001);
6. Approval of the 12-point accreditation guidelines for rural and thrift banks and the lending features of short- and long-term loans for direct or retail lending by participating government financial institutions under the SME Unified Lending Opportunities for National Growth (SULONG); and
7. Monitoring the implementation of the BMBE Act of 2002.

8.2 Initiatives to Boost Further SME Lending

1. Review the present 35 percent SBL limit to give government banks more room to lend to conduit banks;
2. Provide SMEs greater access to trade financing and working capital from the financial markets;
3. Identify appropriate credit technology models for SMEs, including value formation and sound governance;
4. Participate in regional consultation and/or business fora with SME beneficiaries and banking institutions in the locality to address the issues and concerns of SME, in coordination with the Department of Trade and Industry (DTI) as lead agency;
5. Coordinate with the Public Information Agency (PIA) in producing a regular radio program as a way of intensifying public information campaign; and
6. Initiate the establishment of a credit information bureau, in coordination with the National Credit Council (NCC), that will facilitate access to credit at a lower cost.

8.3 Moves to Hasten Capital Market Development

The Philippine capital market is practically a government securities market as indicated by the 99.5 percent share of investments in Treasury bills and bonds

to total outstanding securities in 2003. Banks account for 95 percent of credit, unlike in Malaysia where more than 30 percent of credit is sourced from the capital market, either through equity or fixed income bond. To deepen and widen the market, the BSP is supporting the passage of the following reforms aimed at addressing the weaknesses of the market. The development of the capital market will give SMEs an alternative mode of financing to bank loans.

- a. The Bangko Sentral is supporting the passage of legislative measures that would nurture a sustainable capital market. Among those important bills pending in Congress include the following: 1) amendments to the Securities Regulation Code (Republic Act No. 8799), which seeks to revise certain provisions of the Code in order to promote a more vibrant capital market; 2) Revised Investment Company Act (RICA) bill, which seeks to promote the application of fiduciary principles in investments and in the management and administration of investment companies; 3) Personal Equity and Retirement Account (PERA) bill, which seeks to institutionalise retirement plans for employees who are non-members of GSIS, SSS and Pag-ibig; and, 4) the Pre-Need Code, which seeks to establish a legislative framework that will govern the pre-need industry.
- b. The BSP issued a number of directives to assist in building the necessary market infrastructure that will deepen the Philippine capital market. These measures include the following: 1) creation of the Financial Stability Forum to facilitate consultation, exchange of information and coordination of the regulatory and supervisory activities of the BSP, Securities and Exchange Commission, Insurance Commission and the Philippine Deposit Insurance Corporation; 2) issuance of guidelines on third-party custodianship, to ensure that all transactions in the market are backed by corresponding debt instruments; and 3) issuance of guidelines on the creation, administration and investments of Unit Investments Trust Funds (UITFs) by authorised trust entities, to replace the common trust funds (CTFs).

9. Conclusion and Recommendations

The Government's long-term programme for SMEs seeks to make this sector the driving force behind economic growth, contributing to the generation of 6-10 million jobs in the next six years. Philippine SMEs account for 99.7 percent of total firms in the country and employ 69.1 percent of all workers.

Although their share of the total number of enterprises and employment is substantial, Philippine SMEs contribute only 32 percent to total value added, which is much lower than that of their Asian counterparts, e.g., China (68 percent) and Indonesia (56.7 percent). Narrowing this disparity is possible because of the local SMEs' large potential for growth.

To be able to harness the SMEs' full potential and enable them to become competitive in the global market, the Government has launched the SME Development Plan 2004-2010. Various agencies of the government are involved in the implementation of the Plan, including the Bangko Sentral. The BSP, however, has not been directly involved in the development of SMEs because of the charter prohibition against engaging in development banking or financing activities. Nevertheless, it has helped foster an environment conducive to overall economic growth that has benefited SMEs. In particular, the Bangko Sentral has pursued monetary stability, which has helped maintain the low cost of funds; liberalised the financial system to bring in more players and promote competition; and has provided the regulatory incentives to encourage banks to lend more to SMEs.

The results of a study on small industries indicate that the shift to market-oriented reforms benefited the performance of SMEs. The Bangko Sentral has contributed significantly to the implementation of these reforms. Moreover, it has sustained policy support directed at easing access to credit for SMEs. This support includes, among others: lower reserve requirements for thrift and rural banks that cater mainly to SMEs; relaxation of the documentary requirements in the grant of loans; and lifting of the moratorium on the establishment of microfinance-oriented banks. The BSP continues to explore new avenues to provide SMEs greater access to credit.

9.1 Recommendations

The BSP may consider adopting certain practices of SEACEN member central banks that have further advanced the development of the SME sector. Recommendations based on these practices are as follows:

a. Facilitate linkages between commercial and rural banks

The BSP can support a linkage programme between commercial and rural banks similar to that of Bank Indonesia (BI) to augment commercial banks' lending to SMEs, considering that commercial banks lack the expertise to lend

to small businesses and are generally reluctant to deal with numerous small accounts due to administrative costs. Under this linkage programme, a Memorandum of Understanding (MOU) between a commercial bank and rural bank/s shall state the rights and obligations of each party. The commercial bank shall place funds in the rural bank/s which shall take full responsibility in extending the loans to SME borrowers. Recent research by BI showed that the linkage programme increased rural banks' capacity to provide credits to MSME.

b. Prepare SMEs for Basel 2

The BSP may take a proactive stance in ensuring SMEs' access to credit under the New Basel Accord by encouraging the SBGFC to guarantee SME loans to qualify under the new accord. House Bill No. 180, which seeks to amend the Magna Carta for Small Enterprises, proposes to grant sovereign guarantee to guarantees to be issued by SBGFC. In Taiwan, the Ministry of Finance and the Bank Association have considered setting their Small and Business Credit Guarantee Fund as the loan guarantor for SMEs' loans because under the old Accord, such measure helped SMEs to obtain loans at a risk weight of 50 percent. Under the new accord, the said risk weight declined to 35 percent.

c. Conduct Survey on Repayment Track Record of SMEs

The experience of some countries such as Indonesia has shown that SMEs are able to withstand economic shocks more than large enterprises because they are less dependent on imports and their local market has a wider reach. It has also been observed that small-scale enterprises exhibit more flexibility to differential access to credit and cost of external finance which have a significant effect on their investments. The BSP can conduct a study of the repayment record of local SMEs vis-a-vis large enterprises to lend empirical support to these observations. Positive results may convince banks that SMEs are financially viable and hence, encourage more lending to this sector. One macroeconomic implication of showing that SMEs adjust more readily to adverse changes in the economic environment is that having an SME-based economy can help smoothen out business cycles due to their resiliency to economic downturns.

d. Hold SME Fairs in BSP Regional Units

The BSP is currently participating in regional consultation and/or business fora with SME beneficiaries and banking institutions to address the issues and

concerns of SMEs, with the DTI as the lead agency. In addition, the BSP may conduct SME fairs in its regional offices where banks can present their products and services and offer free consultation for SMEs interested in applying for loans. Similar fairs or bazaars conducted by the BI resulted in wider dissemination of information and forging of credit guarantee agreements and linkages between banks on SME financing arrangements.

e. Establish Internet Linkages

The BSP can provide in its website linkages to banks' SME units to assist in the dissemination of information on SME credit facilities provided by banks. Inclusion of their products and services on the BSP website may encourage banks to pursue SME financing more aggressively as this would enhance their reputation in the area of promoting social responsibility.

f. Enhance Compliance to Mandatory Loan Allocation

To encourage compliance with the mandatory credit allocation, the BSP may require banks to disclose their SME compliance ratio in their published statement of condition to inform the public of the extent of their commitment in financing the SME sector.

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FINANCING PROGRAMMES

I. MICRO FINANCING PROGRAMMES

- a. Foundation for a Sustainable Society, Inc. (FSSI)
 - *Microfinance Eco-Enterprise Program (MEEP)*
- b. GSIS Family Bank (GFB) 8
 - *GSIS Family Bank Microfinance Lending Program*
- c. Land Bank of the Philippines (LBP)
 - *Microfinance Program*
 - *Cooperative Lending Program (CLP)*
- d. National Livelihood Support Fund (NLSF)
 - *Livelihood Credit Assistance Program (LCAP)*
 - *Youth Entrepreneurship Financing Facility Program (YEFFP)*
 - *Credit Assistance for Coconut Farmers (CACF)*
 - *Special Tie-up*
 - *Livelihood Development Program for Overseas Filipino Workers*
- e. Opportunity Microfinance Bank (OMB)
 - *Individual Micro Business Loans*
 - *Group Micro Loans*
- f. People's Credit and Finance Corporation (PCFC)
 - *Micro Finance Program*
- g. Philippine Enterprise Development Foundation (PEDF)
 - *Balikatan sa Kaunlaran (Partnership for Progress)*
- h. Small Business Corporation (SB Corporation)
 - *SME-Funding Entry Point for Entrepreneurs in Livelihood Program (SME-FEEL)*

II. SME FINANCING PROGRAMMES

a. Asiatrust Development Bank

- *Bank Carry Term Loan*
- *Short Term Loan*
- *Discounting Line / Receivables Discounting*
- *Domestic Letter of Credit / Trust Receipt*
- *Import Letter of Credit / Trust Receipt*

b. Department of Science and Technology (DOST)

- *Small Enterprises Technology - Upgrading Program (SET-UP)*

c. Development Bank of the Philippines (DBP)

- *Credit Line for Micro, Small and Medium Enterprises (CLMSME)*
- *Sustainable Logistics Development Program (SLDP)*
- *Environmental Infrastructure Support Credit Program II (EISCP II)*
- *Kreditanstalt fur Wiederaufbau - Industrial Pollution Control Loan Project (Kfw-IPCLP)*
- *Credit Line for Solid Waste Management (CLSWM)*
- *Education Sector Credit Program*

d. Foundation for a Sustainable Society, Inc. (FSSI)

- *Coconut Business Integration & Development Program (COCOBIND)*
- *Solid Waste Eco-Enterprise Program (SWEEP)*
- *Sustainable Partnership for Eco-Enterprise Development (SPEED)*
- *Fund for Sustainable Civil Society – Start-up Eco-Enterprise Development Program (FSCS-SEED)*

e. Government Service Insurance System (GSIS)

- *GSIS Special Financing Program*

f. Land Bank of the Philippines (LBP)

- *Easy Pondong Pang-Asenso (EPPA)*
- *Special Financing Assistance to Small & Medium Exporters (SFA-SMEx)*
- *SME Unified Lending Opportunities for National Growth (SULONG)*
- *Accelerating Change in the Countryside thru Equity Sharing Strategy (ACCESS)*
- *Retail Countryside Fund (RCF I and II)*
- *Countryside Loan Fund Program (CLF I, II, and III)*

g. National Livelihood Support Funds (NLSF)

- *Isang Bayan, Isang Produkto, Isang Milyong Piso (1M1)*

h. Philippine Business for Social Progress (PBSP) 59

- *Small and Medium Enterprise Credit Program (SMEC)*

i. Philippine Export-Import Credit Agency (PHILEXIM) 60

- *Special Credit Facility for Export Development (SCFED)*
- *Short Term - Direct Lending Program (ST-DLP)*
- *Medium & Long Term - Direct Lending Program (MLT-DLP)*
- *SME Unified Lending Opportunities for National Growth (SULONG)*
- *Preshipment Export Finance Guarantee (PEFG)*
- *Postshipment Export Risk Guarantee (PERG)*
- *Term Loan Guarantee Program (TLGP)*

j. Philippine National Bank (PNB)

- *Small Business Loan (SBL)*

k. Planters Development Bank

- *Revolving Credit Line*
- *Mortgage Optimizer*
- *Term Loan*
- *Contract to Sell (CTS) Purchase Facilities*

l. Quedan Corporation (Quedancor)

- *Urban and Rural Poor Program*
- *Philippine Dairy*
- *Credit and Entrepreneurship Assistance Program for Agricultural Engineering Students and Organizations*
- *Self-reliant Farmers/Fisherfolk (SRF)*
- *Swine Program*
- *Fisheries*
- *Quedancor 20-20-20 Program for Palm Oil*
- *Small Retail Enterprise (SRE)*
- *Income Augmentation and Livelihood (IAL)*
- *Women Entrepreneurs*
- *Food and Agricultural Retail Enterprises (FARE)*
- *Livestock and Poultry*
- *Quedancor-SMC Credit Program for Cassava, Corn, Sorghum & Soybean*

m. Small Business Corporation (SB Corporation)

- *SME-Financing for Receivables of Suppliers' Transactions (SME-FIRST)*
- *SME-Financing for Receivables of Suppliers' Transactions Expanded (SME-EFIRST)*
- *SME Financing Reach for Exporters thru Network Development (SME-FRIEND)*
- *SME-Financing for Organizationally Competent and Excellent Franchise Businesses (SME-FORCE)*
- *SME-Guarantee Incubation for DTI-Endorsed Projects (SME-GUIDE)*
- *SME-Guarantee for Enterprises in Manufacturing and Services (SME-GEMS)*
- *SME-Guarantee Resources for Agribusiness Investments (SME-GRAIN)*
- *SME-Guarantee Lines for Anchor Industries (SME-GLAD)*
- *Guarantee for Suppliers of Locators of PEZA/BOI*
- *SME-Guarantee Undertaking of Industries in Livelihood Development Program (SME-GUILD)*
- *SME-Funding Access for Short Term Loans (SME-FAST)*
- *SME-Funding for Investments in Regional Markets (SME-FIRM)*
- *SME-Equity Ventures Program (EVP)*

n. Social Security System (SSS)

- *SME Unified Lending Opportunities for National Growth (SULONG)*
- *The SSS Special Financing Program*
- *Industry Loan Program*
- *Financing Program for Tourism Projects*
- *Special Financing Program for Vocational & Technical Schools*
- *SSS Financing Program for Educational Institutions*

CHAPTER 9

ROLE OF CENTRAL BANK IN PROMOTING SMALL AND MEDIUM SCALE ENTERPRISES: THE CASE OF SRI LANKA

by
Sunil Lankathilake*

1. Introduction

Small and Medium Scale Enterprises (SME) are an inescapable feature of the economic and social landscape of most developing economies. In recent years, among scholars, policy-makers and donor agencies, there has been an increasing recognition of the importance of the SME sector in the development process. Indeed, many governments in Asia have explicitly included SME programmes as part of their national economic plans. However, the relative importance of SME varies significantly across the countries and within a given country, across stages of development over time. Typically, developing countries have a large number of SMEs, and these employ a substantial proportion of a country's working population. The experiences in many developing countries clearly shows that it is mainly the growth-oriented small and medium-sized enterprises among the industries that have a high propensity to apply technology and training and cater to specialised niche markets. Among the factors that have contributed to the success of such SMEs is a high incidence of inter-firm relationships, which have rendered individual firms less susceptible to risks, fostered mutual exchange of information and know-how between firms and created a pool of collective knowledge. These industries generate a substantial amount of income generating activities, both at the household and at the national level.

Recognising the significant contribution made by the SME in promoting growth and improving quality of life, the government of Sri Lanka, has offered a wide range of incentives to assist SMEs during last five decade. It has been recognised that the growth of the SMEs strengthens the linkages throughout the economy, create employment at lower investment cost, produce basic consumption goods using domestic raw materials, prevent urban migration, mobilise domestic savings,

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train the labour for future industrial expansion, provide opportunities for adopting appropriate technologies, improve backward and forward linkages, promote subcontracting, and create an environment in which large investment can flourish. Small-scale industries, being labour-intensive, is believed to be able to create more earning opportunities for unskilled workers reducing poverty and inequality. The SMEs are geographically more dispersed than larger enterprises and thus contribute to the promotion of a more regionally balance development.

The main objective of the paper is to review role of the Central Bank in promoting SME in Sri Lanka. The paper has four sections. Section two reviews the various definition for SME adopted in Sri Lanka, size and structure of SMEs, geographical concentration of SMEs, characteristics, special programmes introduced by the government to promote SMEs, major factors accounting for the failure of SME development policies and current and future plans and policies at national levels to promote SME sector. Section three of the paper analyse formal financial sector for supporting SMEs, SME financing problems and role of the Central Bank in promoting SMEs. Section four presents the major conclusion of the study and suggests several recommendations for future development of SMEs.

2. Definition, Structure and Characteristics of SMEs in Sri Lanka

2.1 Definition

Small and medium scale enterprises (SMEs) exist in all sectors of the economy and encompass a wide range of size and variety of structures. As definitions within this diversity of firms are problematic, there is no universally accepted definition for SMEs. From an economic perspective, a firm was regarded as small if it had a relatively small share of its market place, was owner managed and independent. Often, definitions vary from industry to industry, institution to institution and from country to country. Generally, SMEs are defined in terms of value of fixed assets, number of full-time employees, value of turnover or production and the nature of the enterprise, i.e. whether the industry is in the formal or informal sector. The definitions of SME also change over time because the cut-off point of size of the capital of SME needs to be revised over time in order to allow for inflation.

Sri Lanka does not have a nationally accepted definition for SME as yet. However, having considered various definitions adopted by different institutions in Sri Lanka, the Task Force for SME Sector Development Programme, appointed

Role Of Central Bank In Promoting Small And Medium Scale Enterprises: The Case Of Sri Lanka
by Minister of Enterprise Development, Industrial Policy and Industrial Promotion has suggested a definition for SME in Sri Lanka. This definition and some of the definitions adopted by various institutions in Sri Lanka are given below.

2.1.1 The Definition Adopted by the Task Force for Small and Medium Enterprise Sector Development Programme

Criteria: Assets value excluding land and buildings

- The enterprises with the assets values not exceeding Rs. 50 million excluding land and buildings are defined as SMEs. This asset value is to be adjusted for inflation every five years based on the implicit GDP deflator.
- The Task Force also agreed to give a demarcation between Small Scale and Medium Scale enterprises based on asset values i.e. asset values not exceeding Rs. 20 million for small scale enterprises and Rs.50 million for medium scale enterprises.
- At the lowest end, the required asset value for a small-scale enterprise was set at rupees one million.
- The term “enterprise” is defined to include any business activity or enterprise engaged in industry, agri-business and/or services whether single proprietorship, partnership, or corporate venture.

2.1.2 The Definition Adopted by National Development Bank and DFCC Bank in Sri Lanka

Criteria: Book value of fixed assets excluding land and buildings

The definitions of SME used by NDB and DFCC bank for the lending purposes varies from credit line to credit line.

(a) Small and Micro Industries Leader and Promotion Project I (SMILE I)

If the book value of fixed assets of an enterprise excluding land and building are below Rs.10 million, such an enterprise is considered as a SME and eligible to get SME loan under this credit scheme.

(b) Small and Micro Industries Leader and Promotion Project II (SMILE II)

If the book value of fixed assets of an enterprise excluding land and building are below Rs.15 million, such an enterprise is considered as a SME and eligible to get SME loan under this credit scheme.

(c) SAHANYA

If the book value of fixed assets of an enterprise excluding land and building is below Rs.70 million, such an enterprise is considered as a SME.

2.1.3 The Definitions Adopted by the Industrial Development Board (1994)

(a) Criteria 1: Capital investment in plant and machinery and employment

If the capital investment in plant and machinery does not exceed Rs. 4 million and total number of regular employees does not exceed 50 persons, such an enterprise is defined as a small-scale industry.

(b) Criteria 2: Employment

Micro industries	Small Scale Industries	Medium Scale Industries	Large Industries
Less than 5	Between 6 to 49	Between 50 to 100	More than 100

2.14 The Definition Adopted by the Department of Small Industries

Criteria: Capital investment and employment

The enterprises those with a capital investment of less than Rs. 5 million and employment with less than 50 are defined as SMEs

2.1.5 The Definition Adopted by the Export Development Board (EDB)

Criteria: Capital investment and annual export turnover

The EDB defines SMEs as those with a capital investment of less than Rs.20 million in plant, machinery and equipment excluding land and buildings and an annual export turnover not exceeding Rs. 40 million.

2.2 Importance, Size and Structure of SMEs in Sri Lanka.

The SMEs in Sri Lanka has provided significant contribution to the national economy in terms of value addition, job creation, income generation and reduction of poverty, equitable income distribution and balanced development in the regions. Although there is no accurate estimate on SMEs contribution to GDP in Sri Lanka, some researchers believe that its contribution to GDP is over 15 per cent. Sri Lanka does not have a complete data set for SME sector to measure its contribution to the economy. However, the approximate size of the SME sector can be estimated from published and unpublished survey information in the country. The Census and Statistics Department has conducted two major surveys on SME in 1983 and 1996. Under these surveys, the small, medium and large-scale industries are defined on the basis of number of employees in the enterprise. The enterprises with less than 30 employees were defined as small industries, employees between 30-149 as medium scale enterprises and employees over 150 as large-scale enterprises. As can be seen in many developed and developing countries in the world, SMEs in Sri Lanka account for the majority of firms and a large share of employment. However, their share in value addition is much smaller than large-scale enterprises.

As per the definition adopted by the Census and Statistic Department, over 96 per cent of industrial enterprises in Sri Lanka could be identified as SMEs and these enterprises accounted for 36 per cent of employment in the industrial sector in the country (Table 9.1). However, these enterprises accounted for only 20 per cent of value-added of the manufacturing sector in 1996. Table 9.1 further shows that although the share of the establishments in SME remained unchanged during 1983-1996 period, the employment and value addition shares of SME have declined substantially during this period. The decline has been significantly large for the small scale industries, whose contribution to employment has declined from 29 per cent to 19 per cent and the contribution to value-added has fallen from 11 per cent to just 5 per cent.

However, in terms of employment generation, small-scale enterprises still plays vital role than their counterparts of medium scale industries. In 1996, small industries alone have provided employment opportunities for nearly 19 per cent of labour force in the manufacturing sector. Many analysts argue that within the industries, SMEs are more labour intensive than large firms. Apart from labour intensity, it is often observed that SMEs are important for job creation. However, while gross job creation rates are substantially higher for small firms, job losses in SMEs also high as gross destruction rates of SME are higher than large-scale industries. This is because small firms exhibit high birth rates and high death rates and many small firms fail to grow due to several impediments peculiar to SMEs. The survey conducted by Central Bank of Sri Lanka in 1998 found that the closure rate of such firms is high in the first five years of operation. The survey findings indicated that the operational period of the half of the enterprises in the sample is below 5 years and 76 per cent had been in operation for less than 10 years. Only 14 per cent of the enterprises in the sample have been in operation for more than fifteen years and only 24 per cent had continued operation for more than 10 years period. Among other things, this information indicates that the life span of small-scale industries is relatively low or closure rate is high during first five years of operation

Table 9.1
Relative Size of SMIs: 1983 and 1996

Size group	1983			1996		
	Establish-ments	Employ-ment	Value added	Establish-ments	Employ-ment	Value added
Small	86.6	29.2	11.3	85.4	18.7	4.9
Medium	11.4	19.4	19.8	10.7	17.6	14.7
Large	2.0	51.4	68.9	3.9	63.7	80.4
All	100	100	100	100	100	100

Source: Census of Industries 1983 for 1983 and unpublished data for 1996
White Paper on National Strategy for Small and Medium Enterprises Sector
Development in Sri Lanka

2.3 Geographical Concentration of SMEs

Despite the various policies introduced by the government to minimise excessive concentration of industries in the Western Province and to encourage the setting-up of industries in less developed backward areas of the country,

Table 9.2 shows that substantial amount of SME as well as large scale industries are located in the western province of the country, particularly Colombo and Gampaha districts. However, the extent of geographical concentration is more severe for the larger scale industries than small enterprises. While 82 per cent of the large-scale establishments were located in the Western Province, the corresponding figures for the medium and small groups were 52 and 28 per cent respectively. Many SMEs in the country prefer to locate in Western Province due to various factors such as proximity to close access to product, labour and material and credit markets, and the harbour and airport. Inadequate infrastructure facilities in other provinces have discouraged the regional dispersion of industries. In recent years, the concentration of industries in urban districts have created several economic and social problems such as road congestion, environmental pollution, higher property prices, high rent/lease on factory premises and lack of accommodation for factory workers in these districts. Though successive governments have taken several measures to diversify location through fiscal incentives and providing infrastructure in the Industrial Parks, Industrial Estates and Export Processing Zones, they have had only limited success.

The survey conducted by the Central Bank of Sri Lanka in 2002 on Small Scale Business Activities also confirmed that substantial amount of small service and industrial enterprises are located in the Western province. Table 9.3 shows that, over 37 per cent of small business entities were located in Western province

Table 9.2
Geographical Concentration of Industries by Size: 1996

Province/District	Establishment (%)			Employment (%)		
	Small	Medium	Large	Small	Medium	Large
Western	27.7	52.2	82.4	25.2	55.7	84.3
Central	25.0	18.8	3.8	24.2	16.0	4.0
Southern	11.1	7.6	4.2	12.8	8.8	2.7
North Western	13.7	7.6	4.4	15.8	6.4	3.5
North Central	2.3	0.6	0.4	2.7	0.5	0.2
Uva	7.3	3.9	1.3	6.3	3.3	1.4
Sabaragamuwa	12.8	9.2	2.9	12.9	9.0	3.7
Total	100	100	100	100	100	100

Source: White Paper on National Strategy for Small and Medium Enterprises Sector Development in Sri Lanka

while 17 per cent and 13.6 per cent were in North Western and Southern province. This survey further indicated that major type of SMEs in Sri Lanka are paddy mills, furniture and carpentry works, bakeries, welding works and tailor shops.

Table 9.3
Distribution of SME by Type of Business Activity and by Provinces

Business Activity	Percentage Share								
	Central	Eastern 1/ (Ampara)	North Central	North Western	Sabaraga -muwa	Southern	Uva	Western	Total
Paddy Mills	14	34	30	15	15	13	21	3	12
Furniture & Carpentry Works	8	15	12	9	11	8	9	12	10
Bakery Products	11	9	9	6	10	11	12	6	8
Lathe Machines & Welding Works	7	6	8	8	6	8	7	8	8
Tailor Shops	9	6	7	6	10	9	7	7	8
Beauty Saloons & Barber Shops	9	8	6	4	8	8	7	6	7
Tiles, Bricks, Cement Blocks & Related Products	4	1	1	11	3	5	1	7	6
Garages & Service Stations	4	6	5	4	4	5	4	7	5
Rock Metal Products	4	2	7	6	6	4	5	3	4
Timber Mills	4	3	0	4	3	3	1	4	3
Chillies and Grinding Mills	3	1	2	2	3	4	3	2	3
Jewellery	3	2	0	1	2	3	2	3	2
Coir, Coconut Shell, Copra Related Products	0	0	0	7	0	3	0	2	2
Garments & Handlooms	0	1	2	1	3	3	3	3	2
Exercise Books & Printing Presses	2	0	1	1	1	2	1	3	2
Vulcanising & Cycle Works	1	1	0	2	1	2	2	2	2
Electric Goods Repairs	0	0	0	0	0	0	0	4	1
Tobacco & Beedi Products	4	1	0	2	0	0	0	0	1
Leather, Footwear, & Other Products	1	0	0	0	1	1	0	1	1
Tea Packeting and Related Products	2	0	0	0	1	1	2	1	1
Other (50)	10	3	8	10	11	9	12	17	12
Provincial Total	11.5	2.4	7.3	16.9	6.7	13.6	4.5	37.1	100

Note 1/ Data refer to Ampara District only and therefore it is not representative of the entire Eastern Province
Source: Central Bank of Sri Lanka

On the basis of the international classification of industries, over 53 percent of the small scale enterprises in Sri Lanka are in the industrial categories of food, beverage and tobacco products and textile, apparel and leather products. Major industrial sub sectors in this category were paddy millings, food processing, bakeries, grinding mills, tailoring shops and handloom industries. These two industrial categories accounted for nearly 62 per cent of the employment in the small-scale enterprises in the country.

Table 9.4
Distribution of SMIs by Type of Industry: 1983 and 1996

Type of Industry	Establishment (%)		Employment (%)	
	1983	1996	1983	1996
Other mining	11.6	12.5	9.0	6.9
Food, beverage and tobacco products	35.5	33.7	36.8	38.4
Textile, apparel and leather products	19.8	19.3	23.4	24.2
Wood and wood products	7.3	7.3	6.1	5.2
Paper and paper products	2.2	2.3	2.4	2.1
Chemical, petroleum, rubber & plastics	5.8	6.4	7.4	8.0
Non-metallic mineral products	12.1	12.3	8.9	9.2
Basic metal products	0.1	0.1	0.1	0.1
Fabricated metal products, etc.	4.3	4.5	4.7	4.2
Manufactures n.e.s.	1.4	1.7	1.2	1.4
Total	100	100	100	100

Source: White Paper on National Strategy for Small and Medium Enterprises Sector Development in Sri Lanka

2.4 Characteristics of SMEs in Sri Lanka

The manufacturing sector in Sri Lanka shows a distinct dual structure. At one extreme, there exist a few large modern capital- intensive, import-dependent and export oriented enterprises, while at the other extreme there are small and informal sector enterprises that use very simple and traditional technologies and

serve in the limited local market. This structural imbalance has arisen despite implementation of various SME promotion programmes for many years. The industrialisation policies pursued by Sri Lanka in the past are said to be having contributed to a bias in favour of larger scale enterprises by encouraging premature movements of resources into large capital- intensive businesses rather than promoting the gradual and organic growth of enterprises.

A sample survey conducted by the Central Bank of Sri Lanka¹ in 1998 shows that the age of more than 96 per cent of the entrepreneurs in SMEs in Sri Lanka are over 25 years. This is due to the fact that normally the school leavers spend some years in gaining experience and acquiring necessary skills by working in other enterprises before setting up their own enterprises. Therefore, the age structure indicates that the majority of entrepreneurs who set-up small scale industries are not immediate school leavers, but entrepreneurs who have either completed a vocational training in a particular field/s or have acquired some technical skills while working as apprentice in a manufacturing enterprise.

It is frequently argued that education helps individuals to gain access to new technological developments. It may also help entrepreneurs raise their marketing, personnel relations, and other relevant skills. However, this survey revealed that the educated youth have not entered the small-scale industrial activities in a big way as yet. Nearly 44 per cent of the entrepreneurs in the sample have educational qualification below G.C.E- Ordinary level and 40 per cent have G.C.E- Ordinary level qualification.

The initial capital in small-scale industries in Sri Lanka is generally low due to the difficulties in raising capital at the initial stage of the projects and higher labour intensive nature of projects. The initial investment requirement of the one fourth of the enterprises in 1998 was over Rs. 100,000 (US\$ 1,550) while investment requirement of 36 per cent of the enterprises was below Rs.25,000 (US\$ 387). Nearly 37 per cent in the food and beverages industries and 44 percent in the paper and printing industries have invested over Rs.100,000 (US\$ 1,550). In the food, beverages and tobacco product category, highest investments was absorbed by rice mills, grinding mills, and bakeries while printing presses have absorbed highest investment in the paper and paper product category. These industries require relatively higher valued machines in setting up the industry.

1. Lankathilake. S, "Can Small Scale Industries be Promoted to Large Industries?", Staff Studies, Central Bank of Sri Lanka, 2001

The average initial investment of below Rs.25,000 (US\$ 387) was reported in industries such as apparel and leather product industries, wood and wood products, and non-metallic mineral products.

As in the many other developing countries, the initial capital required by the small-scale enterprises in Sri Lanka has been raised from personnel savings or family sources by way of assistance from relatives and friends. Formal credit is rarely used as start up capital because the new entrepreneurs find it difficult to borrow from banks due to difficulty in convincing banks of credit worthiness. When the industry is established and shows some progress, demand for working capital as well as the fixed capital for expansion increases. The non-availability of adequate credit at the right time is one of the major problems faced by small industries in Sri Lanka². The uncertainties of small business and their high mortality rate as well as their vulnerability to market and ad-hoc policy changes have made them high-risk areas. The commercial banks, therefore, insist on high collateral for SME loans. In some cases, the loan officers lack experience in evaluating loan proposal of the project. Hence, in approving SME loans, they are more concerned about the security of loans rather than the future cash flow of the project. The two state banks namely Bank of Ceylon and People's Bank are the major sources of borrowing for small-scale industries. It is observed that over 50 per cent of the enterprises have obtained credit facilities from these two banks.

The majority of small-scale manufactures in Sri Lanka sell their output directly to the consumers in local markets. In the local markets, generally manufacturers receive relatively lower prices for their products. Access to markets in urban centres is constrained by the poor condition of infrastructure such as roads, transportation and communication. The major problems associated with marketing are higher competition from imported items and large scale manufacturers, inadequate financial facilities to improve product quality and marketing channels and distribution problems such as the lack of transport and storage facilities. Many small scale industrialists in Colombo, Gampaha, and Kurunegala districts have reported that marketing of their output is difficult mainly due to intensive market competition from cheap imported goods.

2. The higher risk in lending to small scale industries, bias against small borrowers by banks, higher administrative costs in lending to SME and lack of proper account of business activities in SME make banks reluctant to lend to small scale enterprises,

2.5 Special SME Promotional Programmes

Recognising the beneficial impact of SMEs in creating employment opportunities and income generation, governments since independence have attached higher importance to the SME sector in their policies for economic development. The SME sector has received considerable attention in successive development plans and important policy documents presented from time to time. The World Bank Report in 1952 suggested that governments develop numerous small or medium scale industries under State sponsorship instead of promoting large industries. In the period from 1960-1980, the SMI sector was accorded priority in the development policy agenda of successive governments with the objective of saving foreign exchange, creating new employment opportunities and distributing industries in rural areas. Even under the liberalised economic policy regime introduced in 1977, the role of this sector has been recognised in view of its export potential, ability to provide raw materials to larger firms, capability to produce under the sub-contracting system and capacity to take the production process to rural areas which are often overlooked by large investors. The government's commitment to develop the SME sector was explicitly expressed in the industrial policy documents published in 1977, 1983 and 1996. Policy direction of government during this period was to encourage domestic companies to promote small-scale export oriented industries through industrial centres located in each district. Preferential tax rates and fiscal incentives have been extended to regional based industries. All poverty alleviation programmes and employment creation schemes have identified the potential role of this sector in the creation of employment, distribution of income and diversification of industrial locations.

In addition to supportive policy direction, the successive governments have established comprehensive institutional mechanism and implemented donor supported subsidised credit schemes to develop the SME sector in the country during last four decades. Institutional support mechanism for SMEs constitutes public sector institutions, private sector institution, non-government organisation and multilateral and bilateral donor organisations. Public sector institutions, which are engaged in the promotion of SMEs provide wide spectrum supports varying from preparation of long run development policies to provision of various services such as technology, skill development, quality assurance, credits and market supports. At present over 5 ministries and over 30 government institutions are directly or indirectly evolved in providing various supports for the SME sector. Private sector institutions that are engaged in the development of SMEs facilitate in finding markets, provide credits and other logistic support. In addition, numerous

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donor-funded and NGO bodies are involved in SME promotion and support. However, the lack of coordination and communication between these various institutions has resulted in a fragmentation of efforts and ad hoc interventions, encouraged rivalry between projects and institutions. It is believed that this has led to the inefficient use of resources and a low impact, especially in terms of the sustainability of their programmes.

Major governmental institutions, which provide direct support SME development, includes the Industrial Development Board (IDB), Export Development Board (EDB), Industrial Technology Institute (ITI), Sri Lanka Export Credit Insurance Corporation, Department of Rural Development and Cottage Industries, "Laksala" Central Environment Authority, The Sri Lanka National Design Centre (NDC), Sri Lanka Standards Institute, Technical Colleges, business chambers and several non-governmental institutions. The IDB is considered to be the main industrial extension institution in the country and has regional offices and industrial extension offices. The IDB was established in 1969 with the main objectives of encouraging, promoting and developing small and medium scale industry in Sri Lanka. The IDB supports small enterprises through providing consultancy for industry, design and fabrication of machinery and equipment, establishment and development of industries, development of products and processes, industrial information, research and development, supplying materials and testing of products, entrepreneur training, trouble shooting in industry, marketing assistance and infrastructure development.

The Export Development Board (EDB) is the premier state institution dealing with the promotion and development of exports, particularly small industries. It was established in 1979 under the Sri Lanka Export Development Act No.40 of 1979. The EDB provides information to SMEs on business opportunities abroad and facilitates contacts between local and foreign businesses, including arranging of preliminary contacts with potential foreign partners. It thus helps micro, small and medium-sized enterprises to penetrate foreign markets. The EDB also provide computerised information on exports from/ imports to Sri Lanka, current world prices for selected commodities and tariffs, on-line access to international data bases TRADSTAT, MNS, COMTRADE, DATASTAR, advisory services for those requiring guidance and information, dissemination of market-related information - trends, designs, statistics, addresses of buyers and other literature of relevance and production of video documentaries on exportable products and related matters.

The Industrial Technology Institute (ITI) is also one of premier institution which provides scientific and industrial research, technical services and training for small industries in Sri Lanka since 1955. The ITC has contributed to the development and dissemination of appropriate technology to enhance the efficiency and productivity of CSSIs. Over the years, the ITC has catered to the technology requirements of cottage and small-scale industrialists especially in the areas of agro and food processing and preserving, wood and wood products, leather products, chemical products and paper and paper products. The ITI also provide services such as R&D, consultancy, calibration, design and fabrication, trouble shooting and quality assurance services for small industries.

The Department of Rural Development and Cottage Industries was set up in 1957 as the main institution responsible for promoting the cottage industrial sector. The Department was renamed the Department of Rural Development and Small Industries in 1968 and its scope of activities was expanded to include industries such as power looms, handlooms, carpentry, commercial pottery and coir fibre. The Textiles Department was created in 1976 in view of the importance of textile production as a CSSI.

“Laksala” was established in 1964 with the objective of helping to solve the marketing problems of handicraft industrialists. With a view to promoting the export orientation of the CSSI sector, the Department of Handicraft Marketing and Export Promotion was established in 1980 by amalgamating Laksala and other handicraft marketing centres. In 1982, the Sri Lanka Handicrafts Board was established in place of this Department. In 1993, the Department of Small Industries was wound-up and its duties and functions were allocated to the Provincial Councils.

Apart from this institutional mechanism, there are a large number of institutions and committees in Sri Lanka with a mandate to address industrial sickness and facilitate development of SMEs. These institutions have been able to address some of the problems in the industrial sector to a certain extent but not to the full satisfaction of the industries. This institutional structure includes the Committee of Defunct Industries, Industrial Restructuring Unit of Ministry of Industries, Presidential Task Force on SME Development, High Power Industrial Facilitating Forum and Industrialisation Commission. The Committee on Defunct Industries was appointed in 1997 on a Presidential directive with the objective of reviving several defunct industries by enlisting the support of several institutions such as Banks, Board of Investment of Sri Lanka, Ceylon Electricity Board as well as relevant technical advisory personnel in order to provide the necessary support.

The tasks of the Industrial Restructuring Unit includes identifying the incipient sick, sick and defunct industries, examining the causes for being defunct in the spheres of management, finance, labour relations, markets, etc., proposing remedial measures in the form of restructuring proposals incorporating diversification programmes, mergers, joint ventures, licensing, franchising alliances and assisting the Cabinet Sub-Committee on Sick and Defunct Industries in implementing its decisions.

The main objective of the High-powered Industrial Facilitation Forum (IFF) was to establish a continuing dialogue on difficulties encountered by the private sector in their day-to-day operations. The problems forwarded by the private sector will be solved by the full time secretariat with the help of relevant government agencies. Problems that cannot be resolved in the first instance will be referred to the forum. The problems that are not resolved expeditiously will be submitted to the cabinet.

In addition to this institutional set up, there are several commercial and development banks in the country, which provide long term and short term credit requirements for small scale enterprises. The National development Bank (NDB), DFCC Bank and Regional Development Banks are the major banks which provide long and medium term credit facilities under special loan schemes by way of direct loans and equity participation for the SMEs. The NDB has implemented special credit programme known as SMI I, SMI II, SMI III and SMI IV loans scheme especially for SMEs. The SMI lending scheme commenced in Sri Lanka in 1979. The World Bank provided \$ 110 million for this credit programme and the Asian Development Bank provided parallel financing of \$45 million for the last two projects (SMI III and IV). The National Development Bank (NDB) acted as the apex lender of this credit programme. The project aims to provide subsidised loans for manufacturing, mining, construction, agriculture industries, fish processing, industrial services, horticulture, commercial transport and animal husbandry. Initially the interest rates were fixed but later moved to adjustable nominal rates to ensure positive real interest rate. Maturity of loan for SMI I is 5-7 years and SMI II, III and IV is 10 years. At present, NDB offer various loan scheme such as SAHANYA, Small and Micro Industries Leader and Promotion Project (SMILE 2) for small industries. In addition to these major credit programmes, commercial banks, development banks and other village level organisations have granted substantial amount of credit to micro enterprises. (Table 9.5)

Table 9.5
Micro Credit Supply
(As of 30 June 2001)

Institution/Programme	Microcredit (Number of Active Loans)	Microcredit Amount Outstanding (SLRs million)	Average Microcredit Amount (SLRs)	Microcredit Amount Outstanding (US\$ million)	Average Microcredit Amount (US\$)
Bank of Ceylon	100,241	1,831	18,266	20.3	203
People's Bank	194,000	1,940	10,000	21.6	111
SBSs	326,236	2,070	6,345	23.0	71
HNB	9,237	379	41,031	4.2	456
Seylan Bank	4,500	99	22,000	1.1	244
Sanasa Dev. Bank	6,270	128	20,415	1.4	227
RDBs (12/31/2000)	80,860	3,234	40,000	35.9	444
CRBs (12/31/2000)	577,622	4,950	8,570	55.0	95
TCCSs	252,682	2,845	11,258	31.6	125
SEEDS	240,383	679	2,827	7.5	31
Janashakthi	17,654	86	4,854	1.0	54
Total	1,809,685	18,242	10,080	202.7	112

Source: Commercialization of Micro finance, Asian Development Bank

CBSL = Central Bank of Sri Lanka; CRB = cooperative rural banks; HNB = Hatton National Bank; RDB = rural development bank; SBS = Samurdhi Banking Society; SEEDS = Sarvodaya Economic Enterprise Development Services; TCCS = thrift and credit cooperative societies.

2.6 Assessments of Past Efforts

Although, the government offered a series of incentives to the private sector led industrial development during 1980s and early 1990s, most of these incentives were said to be unintentionally biased towards the large-scale industries, encouraging domestic resources to be directed to large capital-intensive businesses rather than promoting the growth of SME enterprises. Some analysts argued that this bias has rendered the SME promotion strategies largely ineffective during last two decade. Further, efforts focusing on SME development are often hampered by the absence of a favourable and consistent macroeconomic framework conducive for SME growth. Unorganised or badly conceived SME promotion strategies are equally to blame. In addition, repressive legal and regulatory regimes have imposed disproportionately high costs on SMEs, which often results in a polarisation of business size. It is often argued that the state regulations and supports should have proper balance to promote SMEs. Overly protective SME development policies have proved ineffective in promoting a robust and dynamic SME sector. The outcome of such policies in the past has resulted in SMEs having low productivity, insufficient opportunities for dynamic growth and inability to face international competitiveness.

There is broad consensus that SMEs can become effective creators of employment, innovation, income and growth. However, many of SMEs in Sri

Lanka do not realise their full potential because they lack access to markets, finance, and technology and business skills. With globalisation and liberalisation, the SMEs in Sri Lanka face new challenges. Production is now knowledge-based and competition arises from both continuous innovation and lower price. In this environment, entrepreneurs need to innovate new design, have extensive knowledge of markets and technology. The most suitable style of intervention against this background is the provision of specialised support services through a multi-layered network of service providers, whereby the government supplements or supports these activities and coordinates with specialised institutions in the provision of services to SMEs. However, almost all business services are provided by government agencies and non-governmental organisations (NGOs) and private sector involvement is minimal. In most cases, the quality and relevance of business services provided by these institutions have been found to be less than satisfactory and are often confined to urban areas with many small enterprises being ignorant of their existence. Policies towards SMEs do not adequately address the problem of insufficient linkages between large and small firms, improvement of productivity, penetration into new niche markets and reduction of cost of production and yet such linkages are an important prerequisite for competitiveness, especially in high-end markets. The training programmes offered by the government institutions seem to favour start-ups rather than expansions. NGO activities are particularly concentrated in the area of micro finance and are not catered to needs of medium scale industries.

The growth of the SMI sector, particularly during early 1970s was hampered by the lack of modern machinery, raw materials and effective competition under the protective market environment. The lack of modern machinery and technology led to high cost of production and low quality of products, which reduced competitiveness. Further, the industrial policy of the government during early 1970s emphasised the expansion of government owned large scale manufacturing enterprises for industrial development while the role of the private sector in the industrial activities received less priority. During this period, the government focused on developing import substitution industries through providing high tariff protection for domestic manufactures.

However, with the liberalisation of the economy in late 1970s, the industrial policy of the government have placed greater emphasis on private sector-led industrial development, with particular emphasis on role of small and medium industries to solve the rural unemployment problem. The government from time to time offered several credit lines for assisting the SMIs in the country. The

removal of import restrictions enabled the entrepreneurs to import modern sophisticated machinery and raw materials, thus raising the capacity of industries, employment and output. However, free imports of some goods have adversely affected certain inefficient small and medium industries.

The SMEs in Sri Lanka now face new challenges with globalisation and liberalisation of the economy in recent years. A reduction in trade barriers since 1977 has led to lower import prices and a greater availability of imports. This could have hurt SMEs in import-competing sectors but could also have been helpful to SMEs that use imported inputs. As the SMEs in Sri Lanka generally produce simple consumer goods for the domestic market, these are much less likely to be hurt by import competition than the larger industries. In the mean time, globalisation and trade liberalisation has created new opportunities to gain access to various markets and knowledge sources, which will be helpful to build lasting competitive advantage through continuous innovations. Globalisation has clearly shifted the competitive advantage of SMEs away from traditional inputs of production such as land, labour, capital toward knowledge-based resources.

2.7 Major Factors Accounting for Failure of Development Efforts of SMEs

As indicated earlier, despite the various policy measures and support offered by the public and private sector institutions during last four decades, the SMEs in Sri Lanka are less dynamic and less competitive than the large-scale industries. The SMI sector is still facing the problems of low quality of products, poor managerial skills in business management, project preparation, marketing, outdated technology and inefficient use of machinery and the lack of economies of scales in purchasing inputs as well as inability to face import competition due to high cost of production and low productivity. The various studies have found that growth in the SME sector is constraint by factors relating to both factor and product markets. Although SME support agencies have been in existence in Sri Lanka for some time, their impact on business formation and growth have generally been limited. They have been criticised for their bureaucratic nature, inability to recruit and retain competent and motivated staff, lack of coherence and coordination, insufficient geographical coverage, and their overemphasis on business start-ups with too little focus on the other stages of an enterprise growth. In addition, their programmes fail to address the underlying constraints faced by SMEs, particularly in the context of the growth of knowledge-intensive production and the intensification of competition in the global market.

A legal and regulatory system that calls for complex registration and licensing requirements and demands cumbersome and costly reporting practices has imposed heavy costs on SMEs. By contrast, larger firms benefit from economies of scale, and often pass the burden of compliance requirements down their supply chains to SMEs. In such an environment, informal sector enterprises are discouraged from entering the formal sector, and in more extreme cases, formal sector enterprises are induced to reduce their activities. As firms grow and become more visible, their options for regulatory avoidance increases, suggesting that there exists a theoretical break point in the cost of compliance. This point logically lies somewhere between very small businesses, which can avoid the rigours of regulation, and those enterprises that have reached a size that enables them to spread the administrative expenditure between a greater resource base, and to offset the costs with certain benefits of legitimacy such as the possibility to secure public contracts, access to credit, and opportunities for subcontracting work. Hence, the challenge for policy makers is not to impose dramatic break points in the form of regulatory barriers for SMEs.

The enterprise sector in Sri Lanka shows a distinct dual structure. At one extreme, there exist a few large modern capital-intensive, resource-based, import-dependent and export oriented enterprises, while at the other extreme there are small and informal sector (micro) enterprises that use very simple and traditional technologies and serve a limited local market. This structural imbalance has arisen despite implementation of SME promotion programmes for many years. The constraints that prevent the dynamism and expansion of SME are lack of policy coordination, non-focused fiscal incentives and some fundamental problems in factor, product and labour markets.

It is often found in the past that institutional financial policies in Sri Lanka were not well incorporated into the overall SME development policies in the country. It is also observed that although some fiscal incentives are extended to the SME sector, continuation of such incentives was constrained by reduction of government revenue in recent years. Revenue constraint in the public sector that directly relate to lower public investment is one major problem in the expansion in production capacity in the economy. Inadequate infrastructure causes higher costs in marketing, transportation and communication, as well as instability of energy supply. It is also argued that there is favouritism for BOI companies over non-BOI companies and exporting companies over non-exporting companies, which should be gradually remedied. However, there is a need to move from a subsidy-based investment culture to an efficiency-based investment in order to efficiently use the limited amount of resources.

In addition to the inadequate infrastructure facilities in the areas of roads and energy, frequent interruption to power supply and voltage fluctuations, absence of a proper bankruptcy legislation and its judicial enforcement remain major impediments to accelerating industrial growth. Unnecessary regulations in certain activities such as time-consuming reporting requirements and burdensome approval procedures have increased business transactions costs.

It is observed that some of the existing regulations in the country have unduly increased business transaction costs, slowed down decision making of enterprises and have made room for political interference and patronage. The unnecessary and complex regulations also have encouraged regulators to engage in rent-seeking activities leading to corruption, delays, waste of resources, inefficiencies and revenue losses to the government.

The rigid and highly distorted labour market in Sri Lanka has also been cited as an impediment to expansion of SME sector. The flexibility in the labour market is believed to be necessary not only to protect the jobs of existing workers but also to create more job opportunities in the future. In any growing economy, job creation for the future generations should receive the highest priority and a conducive environment for employers to hire workers should be created. Prohibitive labour laws prevent enterprises from initiating restructuring programmes in the face of impending difficulties and thereby put even the existing labour at risk of losing employment.

The findings of the survey conducted by the Deregulation Commission in Sri Lanka in 2001 revealed that regulatory impediments especially the factor market related state interventions, act as a serious deterrent to business progress. In particular, the study showed that the operational activities of land and labour markets are constrained by various legal and administrative regulations. A dualistic legal system and different types of public sector institutions functioning at national and provincial level regulate the economic activities of the land market. At present, the ownership of private land is subject to different legal systems operating in the country. Government intervention can be seen at every stage in the case of state lands and private lands leading to delays and corruption.

In the area of product markets licensing procedures, import duty anomalies and trade practices have been identified as key areas of regulatory interventions.

The evidence reveals that some of the licensing procedures are anti-competitive and discourage intra-industry trade. Most of the laws and administrative procedures in external trade are identified as impediments to business progress.

The commercialisation of new research findings and new innovations is essential to the continuous enhancement of productivity and competitiveness of the SME sector. However, institutional arrangements for commercialisation of research and development in Sri Lanka have not improved to the required level.

2.8 Current and Future Plans and Policy at National Level to Promote SME Sector

As stipulated in the “National Strategy for Small and Medium Enterprise Sector Development in Sri Lanka-2002”, the government policies towards SME are to develop a globally competitive SME sector with an entrepreneurial culture committed to sustainable growth. This requires the SME sector to be dynamic, robust, innovative and technologically driven. Under this policy, the government does not interfere directly in the market, but provides a favourable macroeconomic environment, institutional support and infrastructure facilities to develop SMEs. The government plays a largely coordinating and facilitating role in SME development with the provision of a business environment focusing on key strategic elements. This broadly covers access to finance, physical infrastructure, technology, regulatory framework, access to information and advice, access to markets, business development services, industrial relations and labour, linkage formations and environmental issues.

The future policy direction of the government, “Creating Our Future: Building Our Nation” published on 1 July 2004 has also given high priority for development of SMEs. Under this policy, the framework will be based on market friendly, export oriented strategies supported by a strong regulatory and legal framework. Under the new policy direction of the government, SME will be promoted through the establishment of multi-prong support mechanism that includes:

- Streamlining of bureaucratic procedures and regulations, value added tax administration, customs regulations and export procedures;
- Increasing training to SME through universities and technical institutions;
- Comprehensive technical support for quality management, productivity improvement, technical services and internet access;
- Grants subsidies to obtain ISO 9000/14000 certification;

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- Creating productivity centres and re-organising public technology institutions to better services;
- Access to venture capital funds and SME development finance at competitive interest rates;
- Programmes to foster the emergence and deepening of a few, selected industrial clusters in line with competitive advantage;
- An efficient and cost-competitive infrastructure for enterprise development with respect to air and sea cargo, telecommunications, internet, and electricity;
- An effective system of monitoring and evaluation will be formulated to ensure that SME competitiveness strategies are sustainable in the medium-term; and
- SME Zones and Townships will be developed to promote trust industries.

The Budget 2005 has also proposed a vast array of incentives for the development of SME sector in Sri Lanka.

2.8.1 The Establishment of SME Jathika Vivasayake Bank

The budget 2005 proposed the setting up of a new SME bank known as Jathika Vivasayake Bank to cater to the requirements of small enterprises. The required initial capital of Rs.5 billion for the establishment of this bank will be obtained through the unutilised fund available at various government accounts. This new bank is expected provide direct funds, credit guarantee schemes, equity and debt capital, restructuring aid etc. to the SME sector. The Bank is also expected to help small enterprises in solving marketing, technology and quality problems of industries. In addition to the SME bank, the budget also proposed the establishment of a SME authority to function as the apex body for SME development.

2.8.2 Human Resource and Skills Development

In order to improve productivity and competitiveness of the country, the Budget 2005 proposed the offering of incentives for human resource and skills development. In this regard, the government plans to increase the intake in vocational training institutes to 50,000. In order to give added value to the existing vocational training institutes, a new University of Vocational Technology will be set up to provide opportunities for middle level income groups to obtain technology degrees and the "Tharuna Aruna" programme will be reoriented into a Skills Development Fund.

2.8.3 Incentives for Advanced Technology

With a view to encourage advanced technologies, the Budget 2005 proposed to implement a new incentive scheme to encourage small and medium industries to acquire advanced technology in order to raise productivity and improve competitiveness. Under this scheme, new companies investing over Rs.5 million and existing companies investing over Rs.2 million will be granted duty free import of new machinery. The SME Bank is expected to provide necessary financial support for this venture.

2.8.4 The Establishment of Shopping Complex for Craft Products

With the intention to provide a permanent marketing infrastructure for craft product manufactures, the Budget 2005 proposed the establishment of a large shopping complex and exhibition centre in Colombo. The shopping complex is expected to be managed jointly by the Board of Investment, Export Development Board, Tourist Board, National Craft Council and Laksala using EDB and Tourist Board Cess Funds.

2.8.5 Incentives for SME Apparel Manufactures

In order to improve productivity and competitiveness of the SME apparel industry in Sri Lanka, the Budget offered several incentives including:

- Financial Assistance to Technology Improvements;
- Simplified VAT application;
- Incentives for Garment Buying Offices;
- Incentives for Productivity Improvement;
- Incentives for Product Design; and
- Incentives for Backward Linkage policies, providing capital and facilities, coordinate with donors for funding, collection and dissemination of information with a view to strengthening the SMEs

3 Central Bank Support

3.1 Formal Financial Sector

During 1970s and 1980s, the Central Bank played an active role in the development of the SME sector thorough creating an institutional structure for

the provision of credit to the SME sector. The Bank was closely associated with the establishment of financial institutions such as the Development Finance Corporation of Ceylon in 1956, the People's Bank in 1961, the National Development Bank in 1971 and the Regional Rural Development Bank in early 1980s with the view of narrowing the financial gap in the provision of credit to SME sector. The Central Bank in 1963, amended its Monetary Law Act (MLA) to enable it to encourage commercial banks to undertake medium and long term lending operations. In the early 1970s, the Bank began refinance operations to encourage commercial banks and other credit institutions to allocate a larger proportion of its credit portfolio for long-term credit for SMEs. In 1974, the MLA was further amended to enable the Central Bank to issue guarantees for loans and advances to SMEs by the commercial banks and credit institutions. Under this programme, loans given under specific schemes were guaranteed up to 75 per cent.

However, despite this institutional structure, the long-term credit granted by the commercial banks during this period was not encouraging. In many instances, commercial banks, even under subsidised credit schemes, relied heavily on collaterals instead of the viability of projects in lending to SMEs. The Central Bank observed that one of the major problems that obstructed approval of SME credit on the basis of project viability was the lack of knowledge of bank officers on project evaluation. In order to fill this knowledge gap the Bank set up a training institution in early 1980s known as the Rural Banking and Staff Training College (RB&STC) which offered a wide range of training courses for project evaluation officers in commercial banks and other institutions engaged in SME credit. The training courses lay heavy emphasis on project oriented lending, thus equipping project officers to adopt modern techniques of appraisal of projects, while encouraging them to concentrate on financial viability of projects rather than security of loans. The Bank's promotional role in SME credit also has been strengthened through the establishment of its own regional offices in the country to provide a more direct role in facilitating SME credit. Further, the Central Bank took initiatives to set up the Regional Rural Development Banks in early 1980s to divert more credit to rural sector and SMEs.

However, despite all this efforts made by the Bank, institutional sources have failed to make a substantial contribution in providing loans to SME sector. The major reasons for the slower growth of credit to SME sector were slower recovery rate, high administrative costs and low profitability of SME credit. Recognising the difficulties faced on the part of commercial banks and necessity

of maintaining the sustainability of credit programmes, the Bank adopted more market-oriented approach to extent credit for SMEs since early 1990s. Under this new approach, commercial banks were gradually allowed to adjust interest rates and refinance rates to strengthen the profitability of the commercial banks and hence the sustainability of the credit programmes. The Central Bank redefined its objectives and adopted two core objectives to achieve (a) economic and price stability and (b) financial system stability through an amendment to MLA effective in December 2002. Even with these restricted objectives, the Central Bank still plays an active role in facilitating development of SME sector through formulating SME policies, providing capital and refinance facilities, coordinating donor funded projects and collection and dissemination of information on SMEs.

At present, the Bank is providing refinance under various donor funded credit programmes, coordinates major loans schemes in commercial banks and administers the credit guarantee schemes applicable to some credit programmes. Further, through its Regional Development Department, the Bank has continued to implement various credit programmes aimed at improving SMEs in the country. These credit programmes include the Tea Development Project, Second Perennial Crop Development Project, Skills Development Project, North Central Province Rural Development Project, North Central Province Participatory Rural Development Project, Poverty Alleviation Micro –finance Project, Matale Regional Economic Advancement Project, Surathura Credit Scheme, Small Farmers and the Landless Credit Project (ISURU) and Sabaragamuwa Province Integrated Rural Development Project (SPIRDP).

The Tea Development Project (TDP) was funded by the ADB and commenced in 1999 as a follow up to the Small Holder Tea Development Project. The objectives of the Project are to increase tea small holders' income on a sustainable basis and to improve other related industries. The Central Bank functions as the executing agency of the credit component of the Project. Under the Project, credit is provided for replanting of tea, establishment of tea nurseries, rehabilitation and modernisation of tea factories, purchase of vehicles and construction of green leaf collection centres.

The Second Perennial Crop Development Project (SPCDP) was commenced in 1999 with an objective to support the development and commercialisation of the perennial crop sector and to provide credit facilities and extension services for the perennial crop sector. The Central Bank is the executing agency for the credit component. The project management office is responsible for implementing

the other components i.e., research, seed and planting materials, farm advisory, marketing and technical services and institutional strengthening, on behalf of the Ministry of Agriculture.

The Skills Development Project (SDP) funded by the ADB came into effect in 1999. The Ministry of Tertiary Education and Training is responsible for implementing the overall project over a period of six years from March 2000 to August 2006. The Central Bank undertook the responsibility of providing refinance in respect of sub loans granted to eligible borrowers, who successfully complete the Skills Development Programmes conducted by the Ministry. The maximum loan size would be Rs.250,000 per borrower. Six Regional Development Banks, Bank of Ceylon, People's Bank, Hatton National Bank and Seylan Bank are the Participating Credit Institutions (PCIs) implementing the credit component.

The International Fund for Agricultural Development (IFAD) is an integrated rural development project aimed at development of small industries with balanced regional development. The project area covers the Anuradhapura District, excluding the Mahaweli settlements. The Central Bank functions as the executing agency for the credit component of the Project

The Poverty Alleviation Micro finance Project (PAMP) was funded by the Japan Bank for International Co-operation (JBIC). The objective of the project is to provide loans for micro enterprises aimed at alleviating poverty in six other districts, namely Kalutara, Hambantota, Badulla, Nuwara Eliya, Matale, and Kurunegala. The Project aims to provide a cost effective and sustainable micro credit delivery system, high women participation, inculcating savings habits and thrift among poor, improving the literacy level of the rural community and improving self-confidence and weaning them away from the dependency mentality. Micro loans granted under the project amounted to Rs. 290.7 million as at end 2003.

The major objective of the Suratura Programme-Self Employment Promotion through Micro Enterprise Credit was to provide required capital for SMEs and micro enterprises at subsidised interest rates. The three Participatory Credit Institutions (PCI) of the Suratura Programme namely, Bank of Ceylon (BOC), People's Bank (PB) and Hatton National Bank (HNB) have extended credit under the Second Phase of the programme out of their own funds at a subsidised interest rate of 10 per cent per annum. The government continued to pay a 10 per cent interest subsidy to PCIs under this scheme. Under this scheme, loans

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are provided to the unemployed, particularly the educated youth, enabling them to commence new projects or to expand existing projects. The Central Bank was entrusted with the responsibility of operating the interest subsidy component and monitoring the recoveries.

In accordance with Section 108(1) of the Monetary Law Act, the Central Bank (CBSL) acts as the agent of the Government or acts on behalf of the Government, in guaranteeing the loans granted by banking institutions, which are qualified to receive guarantees under special loan schemes. An amendment was made to the Monetary Law Act in 1974 by which a new Section 108A was introduced to extend guarantees to loans, advances or other accommodation granted to small-scale enterprises by credit institutions operating in Sri Lanka. This provision has facilitated the CBSL to operate guarantee schemes on account of loans granted by PCIs to small enterprises and for agricultural activities. The total credit guarantee exposure of the Central Bank for small enterprises under Small and Medium Scale Enterprises (SMI & SMAP) as at 31 September 2003 is given in Table 9.6

Table 9.6
Details of Credit Guarantee Schemes and Claim Settlement
Positing as at 31/12/2003

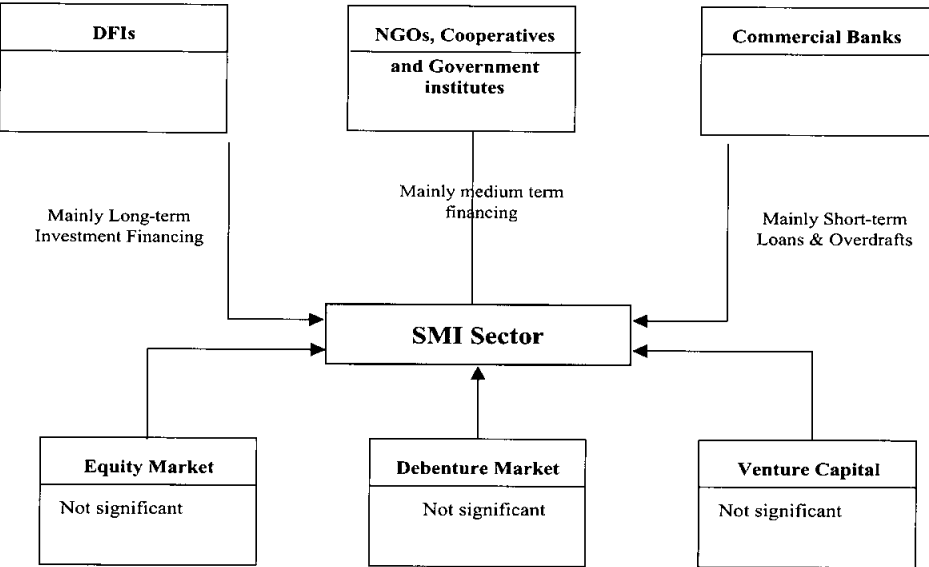
Name of the Credit Scheme	No of Loans Granted	Loan amt. (Rs. Mn)	No of claims Received	No. of Claims Settled	Amt Settled Rs.'000	Post claim Recoveries Rs.'000
MAP Credit guarantee scheme	1,894	2,742	102	16	12,483	1,732
MI Credit guarantee schemes						
SMI I	1,970	286	335	261	22,207	8,830
SMI II	2,351	1,397	228	131	29,435	18,758
SMI III	3,130	1,956	172	92	24,066	19,222
SMI IV	9,072	7,666	311	96	39,810	13,827
total	18,417	14,047	1,148	596	128,001	62,369

Source: Central Bank of Sri Lanka

3.2 SME Financing Problems: Information and Financing gaps

The major sources of credit to SME sector are development banks, commercial banks, government institutions and cooperatives. Equity markets, debenture market and venture capital markets are not significant in providing credit to SME sector as yet (Diagram 9.1).

Diagram 9.1



As in the many developing countries, commercial banks in Sri Lanka are generally reluctant to provide credit for SMEs. One of the major problems that prevent the granting of credit to the SME sector is the high risks involved. It is often argued that even if SME credit risks are correctly priced, existing law may prevent banks from charging interest rates that would cover the higher unit cost of lending to small firms. In addition, imperfect competition in the credit market may also cause banks to focus on larger, more profitable clients. The lending for SME is high-risk business because many SMEs have insufficient assets and suffer from low capitalisation. In addition, poor accounting records and the lack

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of other financial records make it difficult for banks to assess the creditworthiness of potential SME borrowers. Moreover, the relatively high cost of processing small loans means that lending to SMEs is generally not for banks.

From the banks' perspective, difficulties in lending to SMEs arise because:

- Their business plans are based on an over-optimistic vision of the market and are not well conceived;
- Market and technical surveys are weak and feasibility studies are often incomplete;
- High risks involved in SME credit;
- Their personal investments are insufficient or borrowed; and
- Their collateral is insufficient.

From the SMEs' perspective, access to finance in the banking sector is problematic because:

- Banks are interested only in well-established businesses with a solid track record;
- The banking system is very slow in reviewing a loan application; and
- Bank staff is not adequately qualified, dedicated or serious about processing SME applications.

It is often observed in many cases, the access to credit is not a major constraint for micro enterprise start-ups as the majority of donor funded and government sponsored credit schemes are focused on micro enterprises. Non-availability of medium or long-term credit particularly for medium size enterprises is a major constraint for those enterprises that wish to expand their activities. In addition to these, major development banks are located mainly in urban cities and the remote areas of the country are not well covered with respect to financial services. This has aggravated the problem of access to credit by SMES, particularly in the smaller towns and rural areas. In response, the Government, with the help of the donor agencies and various NGOs, has set up different institutional structures of funding SMEs in some areas. However, the majority of these programmes are concentrated only on providing micro finance and capital requirements of medium scale industries are still neglected.

The major constraints found in the financial system for SME credit are related to non-availability of adequate credit at right time at reasonable cost. Concessional long-term loans provided by development banks, particularly through

DFIs, are relatively scarce while commercial banks are rather short-term oriented with most of their liabilities shorter than 18 months. There are many SMEs that refrain from borrowing from banks and use the same production machinery for decades, leading to low productivity, low efficiency and weak competitiveness of the industry as a whole. The limited amount of long-term loans that commercial banks do provide to the industrial sector requires more security and cumbersome application procedures. Consequently, those enterprises which need to borrow from a commercial bank are obliged to borrow short-term loans and roll them over even in the case of financing a long-term project, resulting in bearing of the maturity risk. The capital market, both equity and debentures, is still too small to be an effective funding source for the SMI sector.

Commercial bank loans are often provided against securities including concessional loans, implying that small firms have difficulty in obtaining loans from banks. Many commercial banks also do not have well trained credit analysts and managers, leading to high non-performing loans and poor financial status of banks. The lack of such skills also makes banks dependent on securities. Meanwhile, enterprises, especially SMIs, do not employ qualified accountants and has proven to be an obstacle when obtaining financial assistance or when monitored for progress by banks. There are also many cases where small enterprises lack financial discipline.

3.3 Role of Central Bank in Facilitating SME Development

Banking activities in the past shows that major commercial banks in the country prefer not to increase their lending to smaller clients but instead prefer to lend to large borrowers because of the substantial amount of profit that can be earned and also to less competition in financial market. It is observed that larger share of the credit profile of the major commercial banks is confined to big clients and under the current environment, there is no incentive for them to lend for small enterprises. On the other hand, the lending to small enterprises by these banks is constrained by the high risks and transactions costs and lack of reliable information on borrowers. Further, difficulties in enforcing contracts due to inadequate legal frameworks particularly lack of proper bankruptcy law in the country and the lack of appropriate instruments for managing risks have discouraged SME lending. In this regard, the Central Bank could explore new measures to improve competition in the financial market to minimise risks of SME loans and remove existing impediments in the credit market. In particular, the introduction of proper bankruptcy laws would help to minimise credit risks of the commercial banks. The Central Bank also could implement measures to

encourage commercial banking activities in remote areas aimed at reducing the information gap which is believed to be a major impediment in SME credits.

The competitiveness of the credit market, an essential feature for expanding credits to SMEs, can be improved through minimising entry barriers of financial institutions and strengthening the laws governing the enforcement of contract, and collection of collateral. Measures also can be taken to develop the legal and regulatory frameworks that are essential to the development of innovative financial institutions and instruments, including venture capital, equity investments and leasing. The innovation in specialised lending technologies that reduce the administrative costs associated with credit application, monitoring and strengthening the capacity of financial institutions to evaluate SME creditworthiness in a cost-effective manner can also be promoted. The expansion of activities of credit information bureaus at the provincial level and providing information on creditworthiness of borrowers to the lending institutes in time at reasonable cost may also help to minimise the information gap of the commercial banks. The final aim of these strategies should be to reduce the risks and transactions costs associated with this segment of the market, strengthen the capacity of financial institutions to serve smaller clients and increase competitive pressure in financial markets. These measures will help to increase profitability of the lending institutions and therefore improve sustainability. The promotion of specialised banking institutions for providing credit for SMEs and cluster based or group lending programmes would also help the increase of SMEs credits.

Various analysis have found that the overall financial sector reform in Sri Lanka in recent years has contributed to the improvement of efficiency credit provision to small scale enterprises. However, experience in recent years showed that although this is a necessary condition for expanding credit to SME, it is not a sufficient condition to make available financial services to the smaller layers of the economy. Hence, further measures are needed to accelerate the provision of financial services to the low-income segment of the market through developing new delivery mechanisms suited to that segment. In this regard, the Central Bank can assist commercial banks in innovating cost-effective delivery mechanisms and enhancing loan recoveries. Measures can also be taken to build up mechanisms to encourage large scale commercial banks to provide credit to village level lenders and in turn for the village level lenders to lend money to SMEs with a reasonable profit margin. The recovery rate of such a system would be high as the village level lenders have better ability in assessing credit worthiness of borrowers as they have more information on borrowers than large-scale commercial banks.

Providing acceptable collateral is one of the major problems faced by SMIs in obtaining loans from banks. Therefore, encouraging banks to provide project oriented loans by considering the financial viability of projects rather than excessive dependence on collateral would help the future growth of the SME sector. In addition to initial capital requirement, provision of timely short-term financial assistance to meet the working capital requirements will also help to avoid business failure and collapse. In this regard, the Central Bank can provide necessary training in the areas of project lending, preparing business plans and financial projections for credit officers in the commercial and development banks at a reasonable cost.

4 Conclusion and Recommendations

The growth and expansion of all the enterprises including SMEs will be affected by the economic, political and business environment in which they operate. Therefore, the macroeconomic stability, consistent policies, governance and rule of law, peace, liberalised trade and investment regimes, well-established infrastructure and continuous improvements in human capital are the basic requirements to develop a vibrant SME sector, which can compete in the international markets. In addition to these basic requirements, some of the factors such as the removing the barriers of acquiring information, skill developments, development of backward linkages and reducing fixed costs of doing business peculiar to SMEs are also essential to develop a vibrant SME sector. Furthermore, removing entry and exist barriers, minimising expensive and time consuming regulations, minimising excessive governmental and non-governmental levies, improving legal framework including protection of business and intellectual property rights and minimising labour market rigidities will also help to expand activities of SMEs in Sri Lanka.

The trade liberalisation and intense globalisation in recent years has brought new challenges for SMES as low cost imports has increased the competitive pressure on SMEs. However, trade liberalisation and globalisation has also brought about new opportunities in the form of enhancing access to the various markets and knowledge sources, enabling SMEs to build their competitive advantage through new products, improved designs and adoption of new technologies. Hence, SME development policies of the government should focus on maximising the advantages of these new opportunities. Particularly, SME development policies should aim at developing information technologies which will improve the economies of scale of SMEs through reducing cost and improving productivity. The encouragement of sub contracting and close cooperation with larger firms to take the advantage

of knowledge externalities and access to markets, popularising clustering to gain access to new ideas and knowledge spillovers across the industries would also be helpful to develop a vibrant SME sector. The encouragement of concept of flexible specialisation will help SME improve their competitiveness. Flexible specialisation refers to the production of small series of specially designed goods of a specific quality, usually for niche markets with the high reliance of multi-purpose equipments. It is often found that the use of general-purpose equipment enhances the flexibility of SMEs to change products specifications quickly in order to meet changing customer demand in niche markets.

There is growing recognition that SMEs should be provided with assistance in the areas of technology, modern machinery, access to markets, finance and business skills in order to reap the full potential of creating employment, income and growth. Given the inherent difficulties of small enterprises, some analyst argued that external assistance is necessity to develop a dynamic SME sector. However, past experience shows that in most cases, the quality of business development services in Sri Lanka are found to be less than satisfactory and only a small number of micro and small enterprises benefit from existing institutions. In some cases, these services are often confined to urban areas, but even there, many small enterprises are unaware of their existence. It is often found that business development services provided by government organisations suffer from being supply driven with poor quality and insufficient awareness of cost control. Since both the quantity and quality of publicly provided or publicly funded services are limited by the amount of subsidies available, the programme coverage tends to be limited to urban areas. The most appropriate way of providing these services should be to develop a multi-layered network of service providers, whereby the government supplements or supports these activities rather than duplicating them, and coordinates with specialised institutions in the provision of services to SMEs. The emerging strategy for providing business services for SMEs should be demand driven, rather than on the direct provision of these by governments and donor organisations. There is also a need for micro-level approaches that address the specific problems facing small-scale entrepreneurial activity that are compatible with the general direction of industrial and macroeconomic policy of the country.

The continuous dialogue with private and public sector institutions is believed to be an appropriate platform for interaction between private and public sector players. These interactions are extremely useful in policy formulation. Given the many areas where there exists a mutual interest in cooperation between the two

sectors, including skills, technological and infrastructure development, environmental protection and the promotion of inter-firm backward and forward linkages, the ability of the government and the private sector to build an effective working relationship assumes particular importance. The proper way of implementing such a mechanism is through the establishment of business chambers or other form of business organisations at the village level and linking these chambers with relevant government organisations, banks and other institutions, which provide business services for SMEs. With this set up, problems and issues of the entrepreneurs can be discussed at chamber levels and can be forwarded to the government for incorporation in policy formulations. Such a working relationship may help to address the problems of SMEs immediately and reduce the information gap as the chambers can function as the linking arm between the government and large-scale banks.

In order to minimise risks in providing credit to SMEs, the government may consider enacting legislation to deal with the systematic restructuring of financially troubled SMEs that could be made financially viable. This legislation should provide for a moratorium on debts payable to creditors, termination of employment within a short period of time for reasons such as inefficiency and downsizing for reorganising purposes with reasonable compensation, and speedy reorganisation procedures and special provisions for systematic liquidation of non-viable business entities. The legal framework should ensure that it is fair to all parties, including competitors and tax payers and encourages entrepreneurs to take timely or early action. It should ensure that returns to creditors are maximised and businesses that are viable in the long run are not liquidated. A separate body with wide ranging powers consisting of experts from both private and public sectors should be established to administer and monitor the reorganisation of enterprises. Entrepreneurs could be charged a reasonable fee for the services provided by this body to cover its operational costs.

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CHAPTER 10

TAIWAN'S SMES AND THE ROLE OF THE CENTRAL BANK IN PROMOTING THE DEVELOPMENT OF SMEs

by
Rebecca Fu-ying Huang*

1. Introduction

During the last three decades, the R.O.C. in Taiwan has transformed from a low-income agricultural backwater into a high-income industrialised economy. Within the same period, its economic structure has transformed from predominately labour-intensive industries into capital and technology-intensive industries. Many factors contributed to this remarkable development including sustainable economic growth, low unemployment, social stability and equitable distribution of wealth. Among them, Taiwan government's effort to accelerate the development of Small- and Medium- Enterprises (SMEs) have been the major contributing factor.

What are SMEs? How did they help Taiwan to achieve an economic miracle? What was the CBC's role in assisting the development of SMEs? This paper will answer these questions by analysing data in the recent five years and using country guidelines provided by SEACEN. Section 1 introduces the SMEs. Section 2 reviews the definition and regulatory framework of SMEs in Taiwan. Section 3 analyses the roles and contributions of SMEs in Taiwan's economic development. Sections 4 to 6 discuss the roles of financial institutions, government (and its policies), and the CBC in promoting the development of SMEs. Section 7 analyses the main challenges SMEs face. Section 8 concludes this paper.

2. Definition and Regulatory Framework

2.1 Definition of SMEs

Historically, the definition of SMEs in terms of their capital and number of full-time employees had been modified six times in line with economic development

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(see Appendix 10.1). Right now, the definition of SMEs is published in the May 2000 revision of the *Standard for Determination of SME Status*. SMEs of the manufacturing sector, construction, mining and quarrying industries are those with paid-in capital of NT \$80 (US\$2.5) million or less, or those with fewer than 200 employees. SMEs of other industries are those with operating revenue of NT \$100 (US\$3.1) million or less in the preceding year, or those that have 50 or fewer employees. Micro-enterprises in contrast, are those with an extremely small number of employees. Micro-enterprises of the manufacturing sector and the construction, mining, and quarrying industries are those with less than 20 full-time employees. Micro-enterprises of the agriculture, forestry and fisheries, water, electricity and gas, commerce, transportation, warehouse, and communications, finance, insurance, real estate, and services (including business, financial, and personal) sectors are those with less than five employees. Table 10.1 summarises these guidelines.

Table 10.1: Definitions of SMEs and Micro-Enterprises in Taiwan

Sectors/ Industries	SMEs		Micro-Enterprises
	Basic	Exceptions	
Manufacturing, Construction, Mining, Quarrying	Paid-in Capital < NT\$80(US\$2.5) million	When Employees < 200 persons	Employees < 20 persons
Commerce & Services	Revenues of the preceding year < NT\$100 (US\$3.1)million	When Employees < 50 persons	Employees < 5 persons

Source: SME Administration. website <http://www.moeasmea.gov.tw/>

2.2 Regulatory Framework

2.2.1 Administrative Development of SMEs

The Taiwan government has established agencies and implemented measures to increase the competitiveness and to promote the development of SMEs. Table 10.2 summarises these establishments. In 1966, it established a SMEs guidance team to handle matters relating to meeting SMEs' working capital and other needs. In 1981, the Ministry of Economic Affairs reorganised and upgraded this

team several times into its final form—the SMEA (SME Administration), which is responsible for guiding and assisting SMEs' development. In later periods, the Taiwan government implemented the SMEA Statute, the SMEs Development Statute, and various other measures to regulate and to assist the development of SMEs.

Table 10.2: Government Assisted Development Plans

Year	Agencies established/ Regulations Implemented	Purpose
1966	SMEs Guidance Team	To handle matters relating to the provision of loans to meet SMEs' working capital and other needs
1968	SMEs Guidance Office	To conduct surveys of SMEs in Taiwan, to study the guidance methods used in advanced nations, and to promote corroborative work in the areas of technology, management, and finance.
1970	SMEs Joint Service Center	To undertake R&D work in the area of technology management, and to collaborate with the credit Guarantee Fund and the Medium Business Banks to strengthen the provision of guidance to SMEs.
1981	SMEA (SMEs Administration)	Responsible for guiding SMEs and assisting their development.
1984	SMEA Statute	To govern the SMEA.
1991	SMEs Development Statute Standards defining SMEs 2 Regulations	To govern the development of SMEs. Implemented two regulations to govern the operations of the SMEs Development Fund, and the establishment and operations of the SMEs Guidance System.
1993	Regulations	To govern the establishment and operations of SMEs Development Companies.
1994	SMEs Policy Review Committee	To review SMEs policies.
1997	An article regarding the protection of SMEs was incorporated into the Constitution of the country — paragraph 3 of Article 10 of the Constitution.	To stipulate clearly that the state should provide assistance to newly established SMEs, and to protect and develop them.

Source: SMEA website <http://www.moeasmea.gov.tw/>

2.2.2 The Small and Medium Enterprises Administration (SMEA)

SMEA is a part of the Ministry of Economic Affairs. Its main responsibility is to assist SMEs to develop. According to Article 2 of the Articles of Organization of SMEA, SMEA's main responsibilities are:

- i. Formulating plans for the development of SMEs and relevant legislations.
- ii. Providing guidance to and undertaking inspections of SMEs.
- iii. Conducting surveys and research relating to SMEs.
- iv. Assisting the SMEs to improve upon production technology, training and other related matters.
- v. Providing guidance to improve upon SMEs' operations, management, and financing etc.
- vi. Providing guidance in other areas relating to SME development.

SMEA's other responsibilities are:

- i. Providing support for entrepreneurial activity and innovation, coordinating the provision of financing for new start-ups, and coordinating incubator operation.
- ii. Helping SMEs to adopt information technology, and providing guidance with respect to computerisation.
- iii. Handling SMEs' petitions and requests for assistance, and helping to solve SMEs' problem with respect to working capital.
- iv. Promoting SMEs to implement measures specified in the 2008 National Development Plan such as the adoption of broad band Internet, the implementation of SME Online Learning Plan, the SME Knowledge Management Plan and the Enterprise Operation Service e-Network Plan, and promoting the development of industries with local characteristics and the Asia Pacific Entrepreneurial Center.
- v. Providing NT \$1 trillion to finance and strengthen Taiwan's industries.
- vi. Providing micro financing for micro-enterprises.

3. The Role and Contributions of SMEs in Taiwan

SMEs are generally regarded as the pioneers of external trade and the main driving force behind Taiwan's rapid economic growth. In addition, because SMEs account for the majority of the total number of firms, they have provided a large number of employment opportunities. The following subsections with statistics on the number of enterprises, employees, domestic sales, exports, industrial distributions, duration, ownership, and profitability demonstrate these aspects of SMEs in detail.

3.1 Overview

In line with global economic recovery, Taiwan's industry as a whole showed an improvement in 2003 from 2002. Domestic sales of SMEs, especially, grew

at an impressive rate of 20.1 percent, which is much higher than that of the 5.84 percent of large enterprises. Table 10.3 exhibits the growth of domestic sales of SMEs, among others, from 1999 to 2003.

Table 10.3: Key Facts for SMEs,

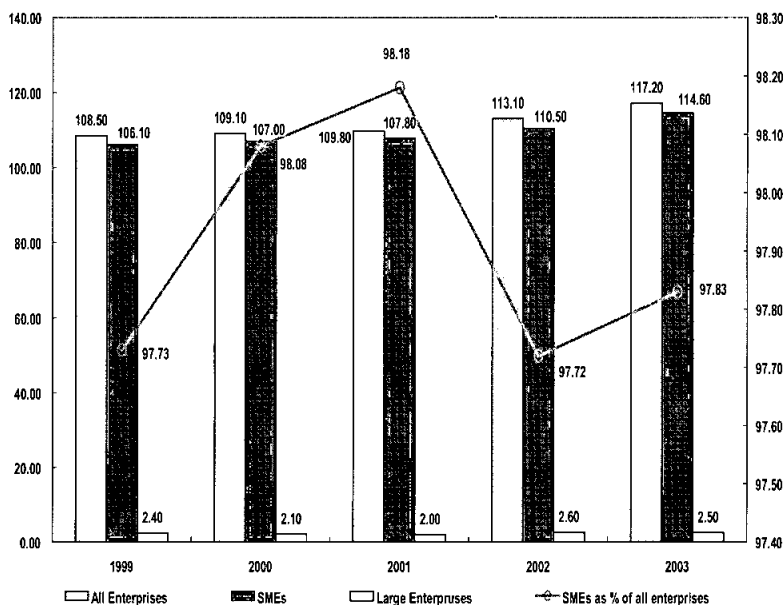
Units: number of enterprises; thousand persons; NT\$ million; %

	2003	2002	2001	2000	1999
No. of enterprises	1,146,352	1,104,706	1,078,162	1,070,310	1,060,738
Percentage of total	97.83	97.72	98.18	98.08	97.73
Annual growth rate	3.77	2.46	0.73	0.90	1.49
No. of persons employed	7,425	7,361	7,288	7,410	7,344
Percentage of total	77.56	77.86	77.67	78.06	78.25
Annual growth rate	0.87	1.00	-1.58	0.84	1.09
No. of paid employees	4,754	4,682	4,636	4,668	4,587
Percentage of total	68.93	69.15	68.93	69.19	69.25
Annual growth rate	1.54	0.99	-0.59	1.67	1.12
Total sales	8,707,060	7,495,287	6,841,565	7,566,617	6,905,112
Percentage of total	31.47	29.51	28.38	28.98	28.95
Annual growth rate	16.17	9.56	-9.58	9.58	-0.04
Domestic sales	7,379,224	6,144,404	5,541,613	6,196,680	5,707,292
Percentage of total	36.28	33.42	31.11	32.15	31.40
Annual growth rate	20.10	10.88	-10.57	8.57	0.58
Export sales	1,327,836	1,350,884	1,300,385	1,369,937	1,197,820
Percentage of total	18.11	19.28	20.65	20.03	21.11
Annual growth rate	-1.71	3.88	-5.08	14.37	-2.86

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs.

The number of SMEs as a percentage of the total number of enterprises was around 98 percent, while large enterprises account for 2 percent of the total (see Figure 10.1)

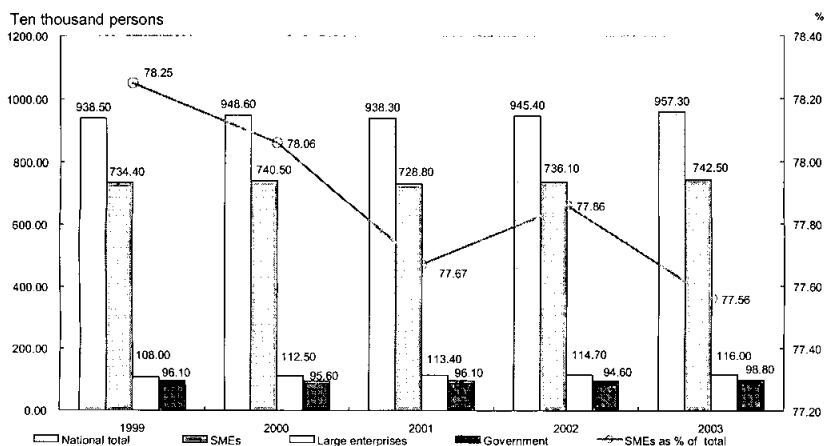
Figure 10.1: Number of Enterprises, 1999-2003



Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs

The number of persons employed by SMEs averaged 78 percent of total persons employed from 1999 to 2003 while large enterprises accounted for 22 percent of the total (see Figure 10.2).

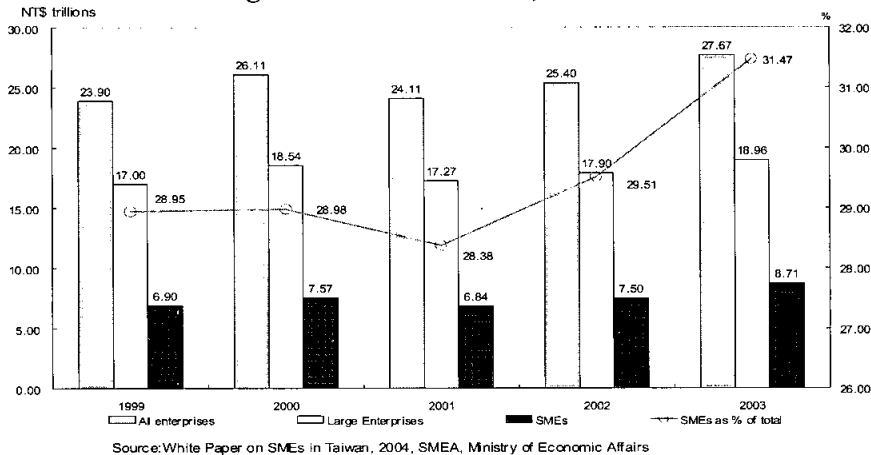
Figure 10.2: Number of Persons Employed,



Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs

Total sales of SMEs, which can be divided into exports and domestic sales, averaged 28.77 percent from 1999 to 2001. This figure then rose to 31.47 percent in 2003 (see Figure 10.3).

Figure 10.3: Total Sales, 1999-2003



The trend in domestic sales (see Figure 10.4) is similar to that of total sales while the trend in exports exhibited a decline from 21.11 percent in 1999 to 18.11 percent in 2003 (See Figure 10.5). There are many possible explanations to this decline. Export oriented SMEs growing into large enterprises, and the redefined classification of SMEs could be two of them.

Figure 10.4: Domestic Sales, 1999-2003

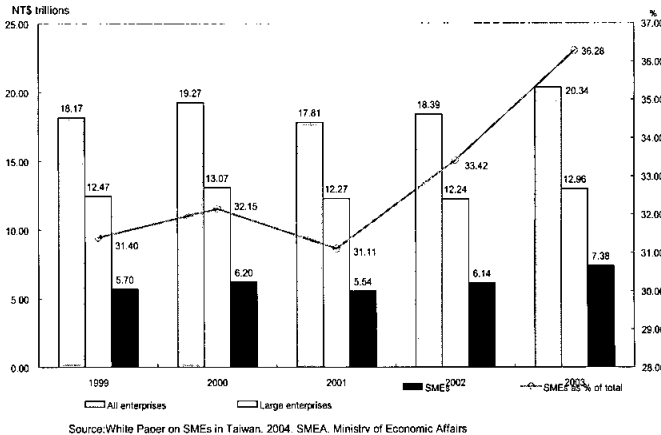
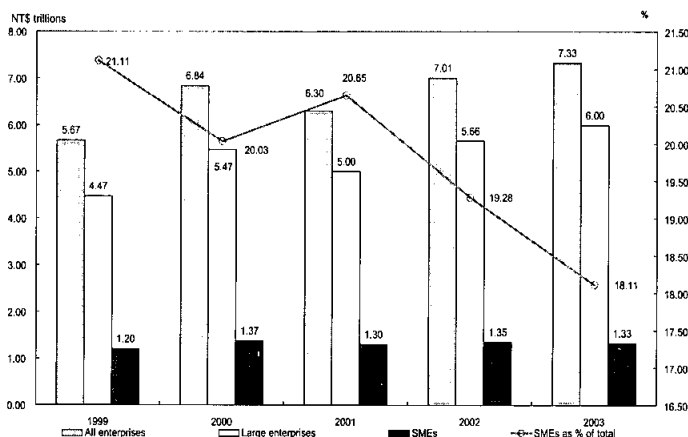


Figure 10.5: Export Sales, 1999-2003



Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs

3.2 Structure of Domestic Sales and Export Sales of SMEs

Currently, SMEs account for a large share of domestic sales. In earlier years, in contrast, they accounted for a large share of exports. In 2003, domestic sales and exports of SMEs were 84.75 percent and 15.25 percent, respectively. The same statistics for large enterprises and all enterprises were 68.33 percent and 31.67 percent, and 73.5 percent and 26.5 percent. Table 10.4 displays these statistics.

Table 10.4: Domestic Sales and Export Sales as a percentage of Total Sales

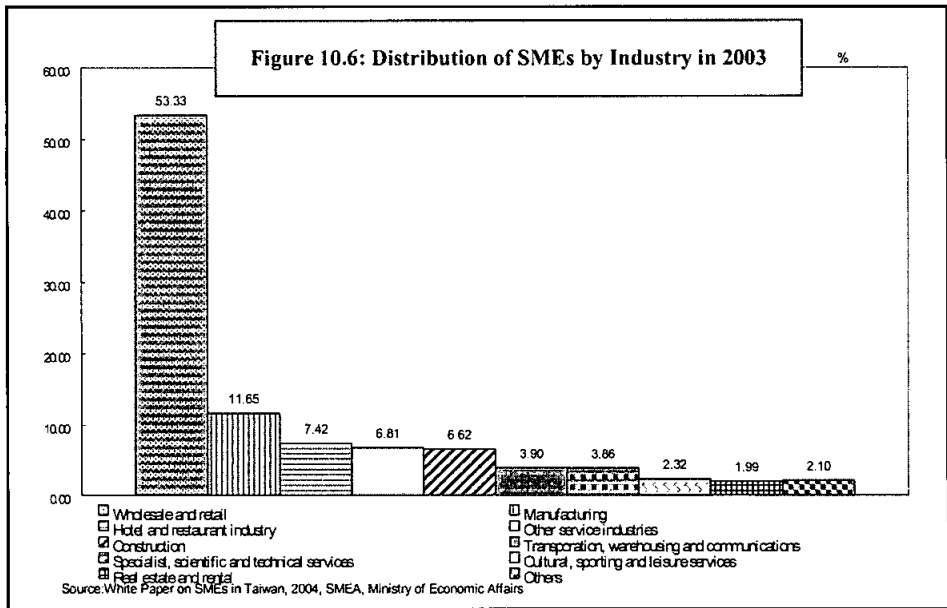
Unit: %

	All enterprises		Large enterprises		SMEs	
	Domestic sales	Export sales	Domestic sales	Export sales	Domestic sales	Export sales
1999	76.23	23.82	73.57	26.43	82.63	17.37
2000	73.81	26.19	70.51	29.49	81.90	18.10
2001	73.87	26.13	71.05	28.95	80.99	19.01
2002	72.40	27.60	68.40	31.60	81.98	18.02
2003	73.50	26.50	68.33	31.67	84.75	15.25

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs

3.3 Industrial Distributions of SMES

In 2003, the wholesale and retail industry had the largest number of SMES, accounting for 53.33 percent of the total. The manufacturing sector and the hotel and restaurant industry had the second and third largest numbers of SMES, accounting for 11.65 percent and 7.42 percent of the total, respectively. Figure 10.6 displays these statistics by industry.



3.4 Duration of Enterprises

From examining the patterns of the duration of SMES, we can see that SMES generally aim for long-term operations and are flexible enough to enter in and withdraw from the market. In 2003, SMES of 10 years or more account for 41.50 percent of the total number of SMES. Meanwhile, businesses that have been around for 10 to 20 years account for the largest groups for both large enterprises and SMES, accounting for 31.02 percent and 24.02 percent, respectively. Among SMES, 62.75 percent of enterprises have been around for at least 5 years, while the same figure for large enterprises is 76.69 percent, higher than that of SMES. Lastly, newly established SMES (those of less than

one year) account for the smallest portion at 9.73 percent of the total number of SMEs. Table 10.5 displays these statistics.

Table 10.5: Duration of Enterprises in 2003

	All enterprises	Large enterprises	SMEs
Less than 1 year	9.57	2.54	9.73
1-2 years	8.89	5.17	8.97
2-3 years	7.02	5.40	7.05
3-4 years	5.93	5.26	5.95
4-5 years	5.53	4.93	5.55
5-10 years	21.19	22.42	21.16
10-20 years	24.17	31.02	24.02
Over 20 years	17.69	23.25	17.57
	100.00	100.00	100.00

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs.

3.4.1 Ownership

In 2003, 58.74 percent of SMEs are sole proprietorships, 27.12 percent are limited companies, and 9.76 percent are corporations limited by shares. Table 10.6 displays the type and percentage of each type of ownership.

Table 10.6: SMEs by Ownership, 2002-2003

	2003		2002	
	No. of Enterprises	Share (%)	No. of Enterprises	Share (%)
Total	1,146,352	100.00	1,104,706	100.00
Corporations limited by shares	111,838	9.76	110,271	9.98
Limited companies	310,889	27.12	305,646	27.67
Unlimited liability companies	17	0.00	21	0.00
Hybrid companies	14	0.00	10	0.00
Partnerships	15,800	1.38	15,164	1.37
Sole proprietorships	673,326	58.74	643,800	58.28
Foreign companies	2,284	0.20	2,062	0.19
Taiwan representative offices of foreign companies	103	0.01	103	0.01
Subsidiaries	20,114	1.75	17,322	1.57
Others	11,967	1.04	10,307	0.93

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs.

3.4.2 New Enterprises

New enterprises refer to those that began operation in 2003. In 2003, there were 112,154 new enterprises in Taiwan, of which 647 of them were large enterprises, and 111,507 (99.42 percent of the total) were SMEs. Nevertheless, new large enterprises accounted for the lion's share on total sales, domestic sales and exports. Table 10.7 displays statistics of SMEs by size derived from business tax records for new enterprises collected by the Finance Tax Data Center of the Ministry of Finance.

In 2003, new SMEs accounted for 9.73 percent of all SMEs. The entry rate was slightly higher than those of 2002 and 2001. For total sales and domestic sales, the shares of those of new SMEs are 3.39 percent and 3.61 percent of total SMEs, higher than those of 2002 and 2001. For exports, the new SMEs account for 2.16 percent of all SMEs exports, lower than those of 2002 and 2001.

Table10.7: New SMEs by Size, 2001-2003

Units:number of enterprises; NT\$ million;%

		2003	2002	2001
No. of enterprises	All SMEs	1,146,352	1,104,706	1,078,162
	New SMEs	111,507	91,435	94,803
	New SMEs as % of all SMEs	9.73	8.28	8.79
Total sales	All SMEs	8,707,060	7,495,287	6,841,565
	New SMEs	295,370	247,292	231,363
	New SMEs as % of all SMEs	3.39	3.30	3.38
Domestic sales	All SMEs	7,379,244	6,144,404	5,541,613
	New SMEs	266,634	204,968	190,003
	New SMEs as % of all SMEs	3.61	3.34	3.43
Export sales	All SMEs	1,327,836	1,350,884	1,300,385
	New SMEs	28,736	42,324	41,384
	New SMEs as % of all SMEs	2.16	3.13	3.18

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs.

3.5 Profitability

The profitability indicator of SMEs was negative for two consecutive years in 2001 and 2002, although 2002 showed signs of improvements. This mainly reflects the weak domestic demand and the rising unemployment rate. Table 10.8 displays these figures.

4. Financing of SMEs

Because SMEs have relatively small amounts of capital, their ability to finance and financial institutions' willingness to provide additional working capital are critical to the success of their operations. To better understand SMEs' financial conditions, one needs to understand the obstacles SMEs face, the reasons for the obstacles, the structure and development of the financial system and capital market in Taiwan, and the roles of financial institutions in SMEs' financing.

Table 10.8: Profitability of Enterprises, 1999-2002

Unit: %

	Operating profit ratio	Return on Gross Assets	Return on fixed assets	Return on capital	Return on net worth
SMEs					
1999	3.45	14.23	4.08	12.85	9.20
2000	0.95	3.84	1.03	2.60	2.96
2001	-0.53	-1.96	-0.54	-1.30	-1.59
2002	-0.24	-0.87	-0.24	-0.57	-0.70
Large Enterprises					
1999	4.11	21.13	3.98	17.54	11.10
2000	1.69	9.25	1.46	8.27	6.03
2001	0.64	5.81	0.66	4.52	3.23
2002	0.41	3.69	0.44	3.07	2.30

Note: Operating profit ratio=current profit or loss/net operating income

Return on gross assets=current profit or loss/gross assets

Return on fixed assets=current profit or loss/fixed assets

Return on capital=current profit or loss/capital

Return on net worth=current profit or loss/net worth

Source: White Paper on SMEs in Taiwan, 2004, SMEA, Ministry of Economic Affairs.

4.1 Major Obstacle

The biggest obstacle that SMEs face in terms of financing in Taiwan is the lack of support from financial institutions (i.e. either refusal of loans or lending at high rates), especially during critical times in the production processes or when they are making major investment decisions. The reason for this lack of support of SMEs' financing in Taiwan may be due to the following: a lack of standardised accounting system, inadequate collaterals, a lack of guarantors, and the lack of experiences in managing the financial risk. This is not only true in Taiwan, but also around the world.

To ameliorate this situation, the Taiwan government has assisted in improving SMEs' accounting and financial management systems as well as their ability to communicate with financial institutions. For example, it has set aside the Small and Medium Business Credit Guarantee Fund for SMEs' use and also the Small Business Integrated Assistance Center, and has implemented measures to increase the availability of credit.

4.2 SMEs' Financing in Taiwan

As demonstrated above, SMEs' financing depends partly on financial institutions' willingness to extend and their ability to provide credit, and the well

being of the financial system. (Interested readers may refer to Appendix 10.2 for details on Taiwan's financial system).

Taiwan's financial system consists of financial markets and financial institutions such as domestic banks, specialised banks, etc that played important roles in SMEs' financing. The next few subsections will discuss the roles of these financial institutions in more details. More specifically, these sections will answer the questions of which type of banks provide the largest amount of loans to SMEs, what share of loans to SMEs do specialised banks account for, and what is the long-term trend of loans financial institutions extend to SMEs from various perspectives.

4.2.1 Roles of Financial Institution in SMEs' Financing

4.2.1.1 Domestic Commercial Banks

The largest creditors of SMEs include the Taiwan Cooperative Bank, the Taiwan Business Bank, the Chang Hwa Commercial Bank, the First Commercial Bank, the Hua Nan Commercial Bank, the Land Bank of Taiwan, the Bank of Taiwan, and the Hsinchu International Bank. From 1999-2003, among the 45 deposit money banks in Taiwan, credit extended by these banks and two other ones accounted for approximately 73.68 percent of total loans granted to SMEs (see Table 10.9).

Table 10.9: Major Banks Providing the Largest Amount of Loans to SMEs

Bank	Units:NT\$ million; %									
	End of 2003		End of 2002		End of 2001		End of 2000		End of 1999	
	Market share	Loans to SMEs as % of total loans	Market share	Loans to SMEs as % of total loans	Market share	Loans to SMEs as % of total loans	Market share	Loans to SMEs as % of total loans	Market share	Loans to SMEs as % of total loans
Taiwan Cooperative Bank	19.08	43.93	18.5	43.24	15.99	43.07	14.85	44.83	15.2	50.69
Taiwan Business Bank	12.15	49.87	12.22	50.88	9.07	44.35	12.12	67.81	11.53	58.09
Chang Hwa Commercial Bank	12.04	43.90	12.32	47.26	12.15	51.64	10.52	53.84	10.52	57.41
First Commercial Bank	8.84	31.99	8.96	32.32	12.59	50.78	12.41	58.96	12.17	60.41
Hua Nan Commercial Bank	6.52	22.49	6.11	22.54	11.7	49.6	10.93	52.31	9.69	49.75
Land Bank of Taiwan	3.70	8.29	3.29	8.43	2.9	8.4	2.74	8.78	2.59	9.13
Bank of Taiwan	3.45	9.54	3.63	9.08	3.58	9.38	3.63	9.71	4.01	11.07
Hsinchu International Bank	2.75	33.39	2.44	31.07	2.41	36.15	2.25	43.36	3.02	57.51
Tainan Business Bank	2.46	67.03	2.34	66.26	1.98	66.68				
Chiao Tung Bank	2.32	17.06								
Shanghai Commercial & Savings Bank			2.6	42.46	2.21	42.26	2.32	45.13		
International Bank of Taipei							2.47	42.91	2.46	44.7
Taichung Commercial Bank									2.29	59.12
Total	73.71		72.41		74.58		74.24		73.48	

Source: White Paper on SMEs in Taiwan, 2000-2004, SMEA, Ministry of Economic Affairs.

4.2.1.2 Specialised Banks

Right now, Taiwan has five medium business banks. SMEs loans account to over 50 percent of all loans extended by these five banks (see Table 10.10).

Table 10.10: The 10 Banks' Loans to SMEs as a Percentage of Total

Bank	End of 2003	End of 2002	End of 2001	End of 2000	End of 1999
Tainan Business Bank*	67.03	66.26	66.68	69.63	69.1
Hualien Business Bank*	60.37	60.98	60.36	64.96	64.22
Taitung Business Bank*	60.04	60.15	60.85	60.62	62.75
Taiwan Business Bank*	49.87	50.88	44.35	67.81	58.09
Taiwan Cooperative Bank	43.93	43.24	43.07		
Chang Hwa Commercial Bank	43.90	47.26	51.64	53.84	57.41
Kaohsiung Business Bank*	36.71	70.33	67.58	47.83	72.03
Hsinchu International Bank	33.39	31.07	36.15		
First Commercial Bank	31.99	32.32	50.78	58.96	60.41
En Tie Commercial bank	28.72				
Shanghai Commercial & Savings Bank		42.46	42.26		
Hua Nan Commercial Bank				52.31	49.75
Cathay United Bank				56.18	51.29
Taichung Commercial Bank				53.44	59.12

* Indicates the special small business bank.

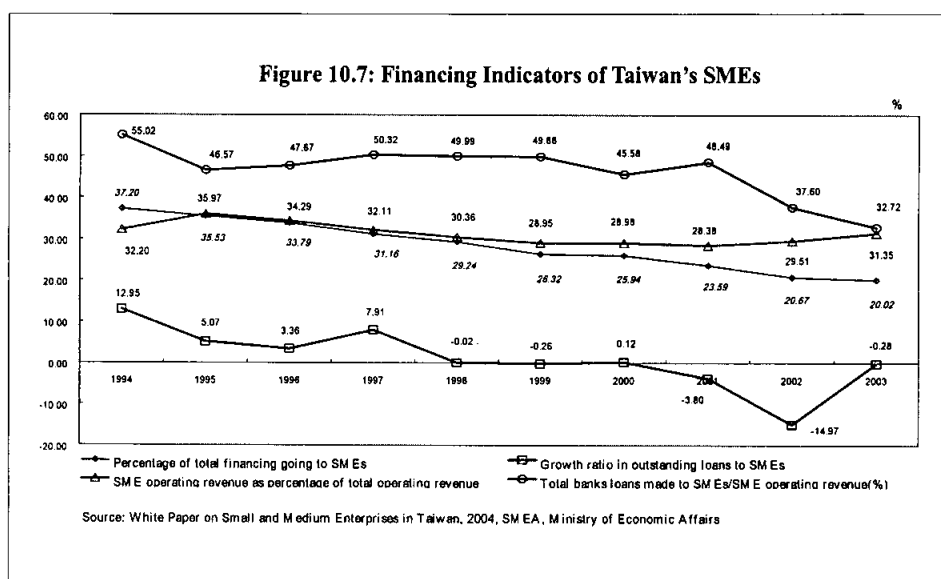
Source: White Paper on SMEs in Taiwan, 2000-2004, SMEA, Ministry of Economic Affairs.

4.2.1.3 All Financial Institutions

Loans extended to SMEs by financial institutions have declined during the last decade, especially during the last few years. In 2002, the growth rate of outstanding loans to SMEs fell to -14.97 percent. In 2003, the rate rose to -0.28 percent, up by 14.69 percent compared to that of 2002. This is a sign of economic recovery. In addition, it reflects the government's SMEs assistance measures such the setting up of the SMEs Credit Guarantee Fund. SMEs that are unable to provide adequate collaterals may use the Credit Guarantee Fund as a guarantee for obtaining loans from banks. For all loans extended to SMEs, 8 percent of them were guaranteed by this fund in 2002, 10.23 percent (known as the Credit Guarantee Utilization Rate) of total loans were guaranteed by this fund in 2003. Overall, banks' loans extended to SMEs declined in proportion to loans extended

for other purposes. For example, loans extended to SMEs accounted for 37.20 percent of total loans in 1994, and 20.2 percent in 2003.

Examining the trend of banks' loans extended to SMEs as a proportion of revenue, we can see that loans extended to SMEs accounted for 32.72 percent of SMEs' operating revenues in 2003. This means that for every NT \$100 SMEs make, loans extended to them amounted to NT \$33 in 2003, down by NT \$5 from a year ago. Compared to 1994, this figure has declined by NT \$22. Figure 10.7 displays these statistics in greater detail.



5. Government Assistance

5.1 Measures

In the past, SMEs were largely unable to access government resources. Such a lack of support in addition to SMEs' lack of experiences and inaccessibility to information led to difficulties in management. Presently, SMEs are facing increasing pressures from Taiwan's participation of the WTO and competition from Mainland China. Therefore, the Taiwan government had adopted measures

for creating an environment beneficial for SMEs' development. For example, the SMEA formulated plans to improve the business environment, to enhance mutual cooperation, and to assist the development of SMEs. To accomplish the objectives of these plans, the SMEA has built a platform for start-up and incubation of enterprises, has enhanced SMEs' abilities to apply information technology, has guided SMEs' management, and has built up the SME service network mechanism. Table 10.11 describes these measures in detail.

Table 10.11: Measures for Promoting SMEs' Development

Plans		Measures
Implementation of SME guidance and service mechanism	Strengthening the functions of SME service network	Expanding the operation of SME troubleshooting center
		Effective utilisation of SME service resources at the local level (a) Strengthening the performance of local SME service centers (b) Ongoing promotion of SME honorary instructor system
	Publicise SME success stories	Continuing the promotion of the "Industrial Upgrading Train" activities Granting the Annual Little Giant Award, Annual National Awards for SMEs, etc.
Establishment of an SME start-up and incubation platform	Aggressive establishment of an SME start-up and innovation information platform	Providing start-up information and inquiry services
		Establishing entrepreneurship and innovation colleges
		Organising entrepreneurship and innovation fairs
		Holding of the national new enterprise award competition
		Organising experience exchanges between enterprises
		Cultivation human capital for entrepreneurial activity

Plans		Measures
	Strengthening the SME incubation function	Financially sponsoring public and private incubator centres for SMEs
		Promoting the establishment of an SME incubator centre within the Tainan Science-based Industrial Park
		Promoting the development of the Nankang Software Industry Incubator Center
		Promotion of other incubator center related work. eg offer special training courses, and publish the incubator yearbook
	Helping SME start-ups to obtain working capital	More fund be invested by SME incubator trust investment account
		Helping SMEs to apply for relevant government subsidies. E.g., apply for R&D funding
	Attaching due importance to SME human resources development and training	Organising training for specialist talent
		Cultivation of SME guidance personnel
		Ongoing provision of subsidies for the SME training centers
		Ongoing promotion of the lifelong learning system
	Active participation in international SME activities	Attendance at APEC SME Ministerial Meeting
		Attendance at APEC SME Forum
		Attendance at other relevant APEC Meeting
		Attendance at other SME-related activities.
		Organising international conference and other exchange activities for SMEs
Upgrading SMEs' technology and IT capabilities	Strengthening the information management capabilities of SMEs	Continuing provision of guidance to help SMEs establish industry-specific on-line databases and e-commerce systems
		Establishment of e-enablement service teams
		Stepping up the cultivation of e-adoption talent

Plans		Measures
		Establishment of electronic marketplaces and appraisal of their effectiveness
		Promotion of on-line learning
		Promoting the adoption of broadband internet access by SMEs
		Promotion of SME information management applications
	Strengthening the provision of SME information management guidance service	For example, in 2003, the government undertook planning of shared platforms for knowledge management.
	Provision of guidance for the enhancement on SMEs' quality management capability	Expanded publication and promotion of quality concepts
		Organizing education and training, and working to improve service provision
		Implementation of consumer protection
		Promotion of ISO 9000 standards
Strengthening SME management	Improving the quality of SME management and promoting SME upgrading and transformation	For example, in 1992, the government established SME guidance system to strengthen SME managements, to help SME to upgrade their technology application capabilities, etc.
	Helping SMEs to strengthen their financial and accounting systems and to ensure them adequate financing	Using the SME financial guidance system to help SMEs secure the financing (described in greater detail in subsection 5.3)
		Provision of financing through special purpose loans (described in greater detail in subsection 5.2).
		Helping SMEs to obtain financing through the provision of loan guarantees through the SME Credit Guarantee Fund (described in greater in subsection 5.4)
	Promoting collaboration among SMEs to establish enterprise network	Provision of guidance for collaboration and exchange meetings
		Provision of guidance for practical collaboration meetings

Plans		Measures
		Industry cluster guidance
		Publicising the importance of mutual assistance and collaboration
	Expansion of government's efforts to promote the development of traditional local industries	Providing guidance for traditional local industries
		Provision of guidance to small community enterprises
Building a first-class environment for SME development	Ensuring SMEs' legal rights are protected	Research on SMEs and the law, and efforts to ensure that SMEs legal rights are protected
		Helping SMEs to establish legal affairs systems, and organising related education and training activities
		Provision of information on laws and regulations, along with related consulting services to SMEs
	Helping SMEs to secure government procurement opportunities	Provision of information relating to government procurement opportunities and provision of consulting services relating to the government procurement law
		Ongoing statistical analysis of the share of government procurement opportunities secured by SMEs
		Seminars to help SMEs to participate in government procurement

Source: White Paper on Small and Medium Enterprises in Taiwan, 2004, SMEA, Ministry of Economic Affairs

5.2 Special Purpose Loans

SMEs may obtain special purpose loans through a special purpose fund or through the banking system. In general, the interest rates for these types of loans are lower than that of regular financing. Table 10.12 lists these special purpose loans.

Table 10.12: Special Purpose Loans

Type	Remarks
1. SME loans involving the Executive Yuan Development Fund	Executive Yuan Development Fund is used as a special fund for specific purposes for promoting Taiwan's economic development. Beginning in 1989, the government has introduced the following special purpose loans for SMEs with funds from the Executive Yuan Development Fund.
SME upgrading loans (Phase 8)	Phase one began in August 1989. As of the end of 2003, a total of 26,348 loan applications had been granted, with a total value of NT\$164,913 million.
Loans for the purchase of automation equipment	The project was launched in late 2002. As of the end of 2003, a total of 5,039 loan applications had been approved, with loans totaling NT\$325.75 billion.
NT\$50 billion of reconstruction loans following the major earthquake of September 21,1999	The programme began in October 1999. As of the end of 2003, a total of 1,770 loan applications had been approved, with loans totaling NT\$14.46 billion.
Loans for the revitalisation of traditional industries	The programme began in December 1999. As of the end of 2003, a total of 2,994 loan applications had been granted, with loans totaling NT\$28.20 billion.
2. Special loans provided by the Ministry of Economic Affairs SME Development Fund	The programme began in September 1991. As of the end of 2003, a total of 3,256 loan applications had been approved, with loans totaling NT\$46.48 billion.
3. Special loans for SMEs provided by the Council for Economic Planning and Development Medium and Long-term Development Fund	The programme began in August 1996. Five phases have been implemented, with a total of 10,130 loan applications been approved, the value totaling NT\$136.78 billion.

Role Of Central Bank In Promoting SMEs In The SEACEN Countries

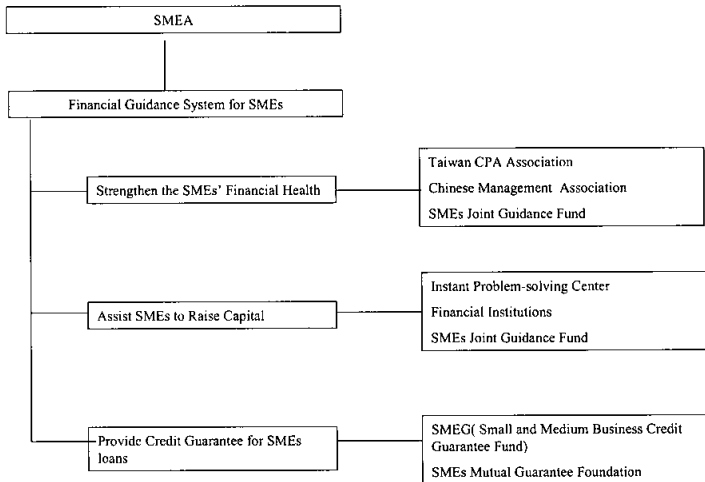
Type	Remarks
4. Convenient small loans for SMEs	The programme began in March 1999. As of the end of 2003, a total of 80,255 loan applications worth NT\$48.26 billion had been approved and granted.
5. Young entrepreneur loans provided through collaboration with the Executive Yuan Sino-American Fund	The programme began in February 1968. As of the end of 2003, a total of 16,006 loan applications had been approved, with loans totaling NT\$20.32 billion
6. Special loans to traditional industries	The programme began in October 2000. As of the end of 2003, a total of 147,754 loan applications had been approved, with loans totaling NT\$1.25 trillion.
7. Loans to micro enterprises entrepreneurs	The programme began in January 2003. As of the end of 2003, a total of 2,494 loan applications had been approved, with loans totaling NT\$2.03 billion.

Source: White Paper on Small and Medium Enterprises in Taiwan, 2004, SMEA, Ministry of Economic Affairs

5.3 Financial Guidance System

The Financial Guidance System, established in 1992 and supervised and coordinated by the SMEA, aims to strengthen the SMEs' abilities to finance, to assist SMEs to raise capital, to provide credit guarantees for loans, and to help SMEs to strengthen their financial management, internal control, accounting operations and billing systems. Figure 10.8 displays the organisation of this system.

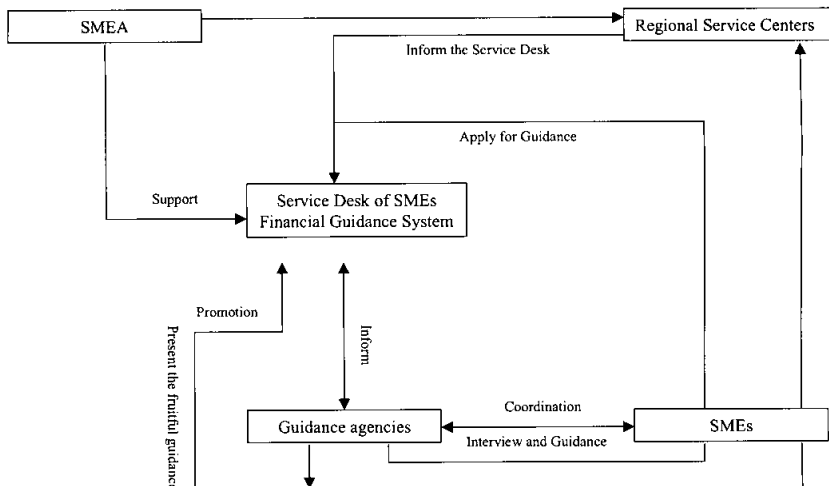
Figure 10.8
Financial Guidance for Taiwan's SMEs



Source: SMEA

In practice, the service desk of the Financial Guidance System can provide SMEs guidance directly. Alternatively, SMEs may obtain guidance indirectly through regional service centers. Figure 10.9 displays the guidance process.

Figure 10.9
The Process of SME's Financial Guidance



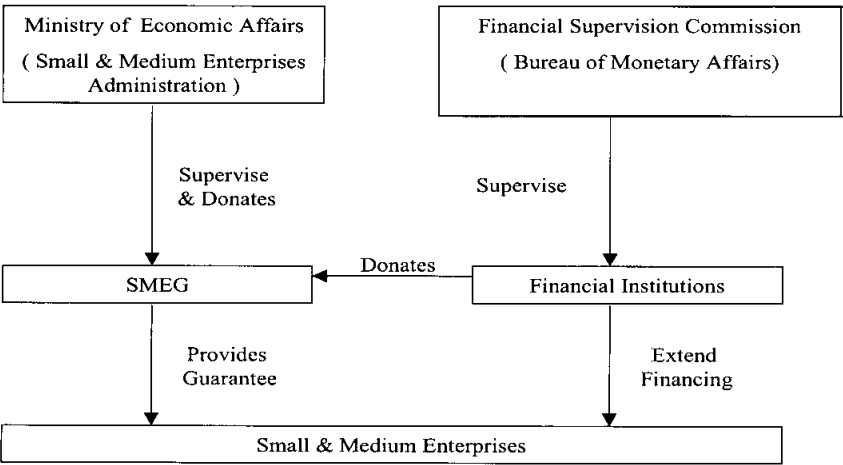
Source: SMEA

In the last few years, approximately 300 SMEs received assistance from the Financial Guidance System per year. Of these SMEs, approximately 100 of them received financing recommendations with a yearly value exceeding NT \$1 billion.

5.4 Small and Medium Business Credit Guarantee Fund (SMEG)

The SMEG, established in 1974, is a bridge between SMEs and banks. SMEG helps SMEs that are operating normally but are unable to provide guarantors or adequate collaterals to obtain loans from financial institutions via the provision of credit guarantees. The SMEG can pick from four approaches to accomplish this task. The following subsections describe these approaches in detail. Figure 10.10 shows how SMEG operates.

Figure 10.10
SMEG System



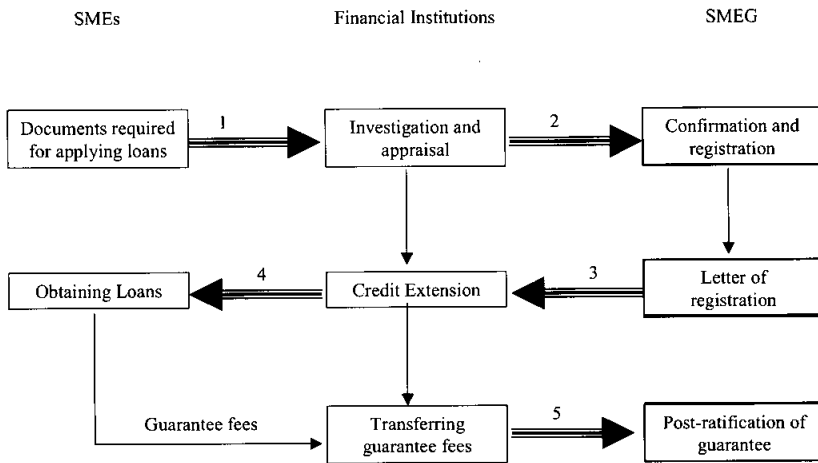
Source: SMEG

Note: Financing of the SMEG comes from donations. As of the end of 2003, donations amounted to NT\$49.3 billion (including separate funds for special guarantee programmes). Of this total, the government accounted for 80.13 percent, contracted financial institutions accounted for 15.80 percent, and other agencies accounted for 4.07 percent.

5.4.1 Authorised Approach

If SMEs apply for amounts less than the limit set for the guarantee item and meet the requirements for obtaining loans via the authorised approach, financial institutions will extend the credit before referring the application to SMEG for post-ratification. Figure 10.11 summarises the procedure where SMEs obtain loans from financial institutions via the authorised approach.

Figure 10.11
The Authorised Approach

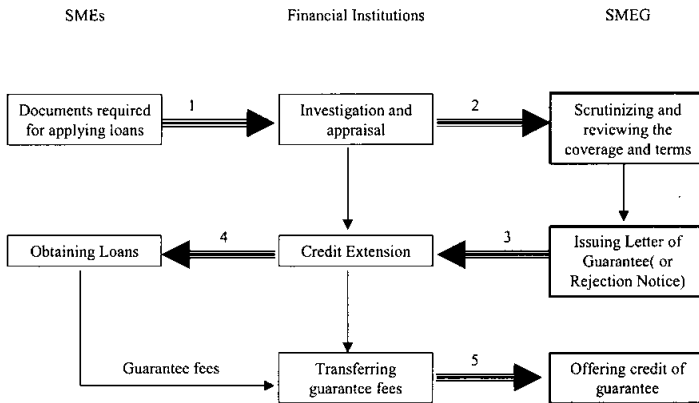


Source: SMEG

5.4.2. Normal Approach

SMEs may obtain loans from financial institutions through the normal approach upon the approval of the applications and the subsequent provision of guarantees from the SMEG. Figure 10.12 displays this process in detail.

Figure 10.12
The Normal Approach

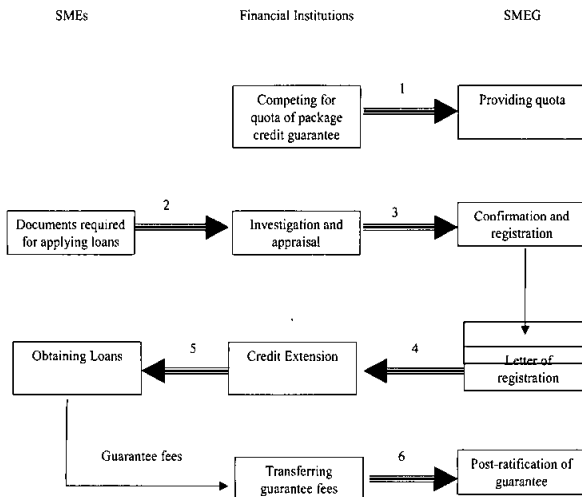


Source: SMEG

5.4.3 Package Credit Guarantee

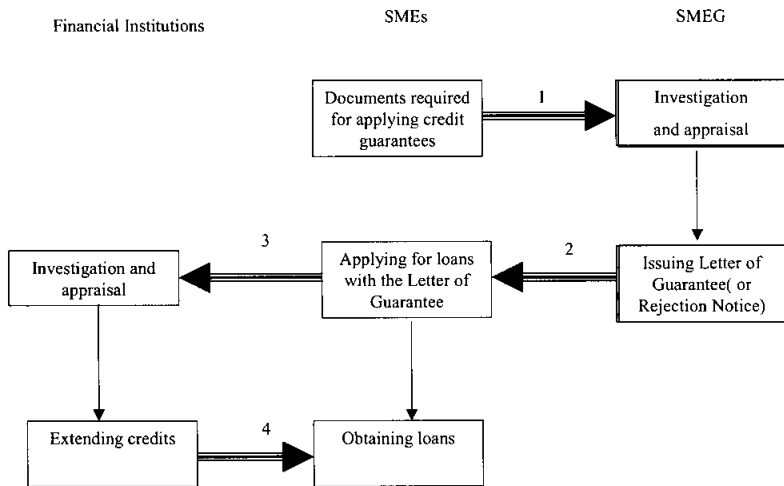
SMEs may also obtain loans for medium-term use at low interest rate from financial institutions via the package credit guarantee approach. Under this approach, financial institutions compete with each other for a quota of package credit guarantee from the SMEG and then extend this quota as credits to SMEs. The rest of the procedure is similar to but simpler than that of the normal approach (see Figure 10.13).

Figure 10.13
The Package Credit Guarantee



Source: SMEG

Figure 10.14
The Direct Guarantee



Source: SMEG

5.4.4 Direct Guarantee

When SMEs experience difficulties in obtaining loans through the normal procedure, they may apply to the SMEG for direct guarantees. If approved, the SMEG will issue letters of guarantee for which the SMEs can take to financial institutions for loan extensions (See Figure 10.14).

5.4.5 Growth and Development of SMEs under SMEG's Assistance

From 1974 to 2003, the SMEG had assisted 2,333,015 cases with guarantee value equaling NT \$2,685.8 billion. Also according to the SMEG statistics, those who applied for financing with SMEG's help received a total of NT \$3,770.7 billion from financial institutions. With this help, they grew significantly - more than 3,000 SMEs had grown into large enterprises, 193 have been listed on the stock exchange, and 202 have been listed on the OTC (Over-The Counter) market. They also account for around 70 percent of the winners of the National Awards for SMEs, the Little Giant Award and the SME Innovation and Research Award. In addition to aiding these accomplishments, the SMEG had also assisted in developing new guarantee programmes such as the Young Entrepreneur Loans, Brand Development Loans, Special Loans for Traditional Industries (NT \$1.4 trillion), Reconstruction Loans (for rebuilding after the occurrence of natural disasters), and Special Loans to Micro-enterprises.

5.5 Government's Resources Allocated to SMEs

Government agencies assist SMEs financially and provide them with professional guidance using funds allocated by the Ministry of Economic Affairs. For example, the SMEA provides the SME Development Fund, the Industrial Development Bureau guides industrial technology upgrading and provides the Industrial Development Zone Management Fund, the Board of Foreign Trade guides overseas market development and provides the Promotion Fund, the Commerce Department promotes the modernisation of commerce and technology development, the Department of Industrial Technology and the Industrial Development and Investment Center guides overseas investment and the recruitment of overseas experts.

Table 10.13 provides a clearer sense of the degree of government assistance with figures based on central government's subsidies, guidance and related measures for SMEs, government purchases of goods and services from SMEs, and special project loans to SMEs.¹ From 2001 to 2003, the government's allocations to SMEs averaged NT \$692 billion and purchased 93 percent of SMEs' goods and services.

Table 10.13: Government's Resources Allocated to SMEs

	In billions of NT\$					
	2003		2002		2001	
	amounts	shares %	amounts	shares %	amounts	shares %
Government Purchased goods and services from SMEs	653.00	94.56	643.20	92.78	626.60	90.60
The Ministry of Economic Affairs provided guidance to SMEs	18.98	2.75	22.70	3.27	17.70	2.56
Special project loans for SMEs	18.61	2.69	27.38	3.95	47.30	6.84
Total	690.59	100.00	693.28	100.00	691.60	100.00

Source: White Paper on Small and Medium Enterprises in Taiwan, 2002-2004

1. The SMEA, beginning in 2001, has published statistics on the allocation of government's resources to SMEs.

6. Roles of the CBC in SMEs' Financing

The Central Bank of China (CBC) provides special loans for SMEs at reasonable costs through loans extended by authorised banks.² During the last four decades, many firms, particularly SMEs (as they account for more than 98 percent of all enterprises) benefited from these loans.

In addition to special loans, the CBC extends selective credit accommodation to assist in SMEs' financing. In essence, the CBC supplies banks NT dollar to meet the normal funding needs of SMES as well as the needs of exporters and the general public. Other than providing these groups with credit, selective credit accommodations also include financing the development of infrastructure using the special fund for medium- and long-term credit, supplying low-cost foreign exchange to manufactures via accommodations of foreign exchange loans to banks, and providing relief measures for adverse economic and financial circumstances or events.

The following subsections will describe these measures in greater detail.

6.1 Policy-based Loans

The CBC has retired a majority of the special loan programmes as they have accomplished their goals (The following subsections describe these special loan programmes and selective accommodations). Nevertheless, the CBC continues to extend preferential loans and credit guarantees to traditional industries and SMEs for general purchases of machinery and equipment or in increasing working capital.

2. Measures helpful for the development of firms implemented by the CBC, such as policy-based loans, are in accordance with guidelines provided by the Executive Yuan and the objectives specified in Article 2 of the *Central Bank of China Act*, which are: (1) to promote financial stability; (2) to guide sound banking operations; (3) to maintain the stability of the internal and external value of the currency; and (4) to foster economic development within the scope of the above-mentioned objectives.

6.1.1 Export Loans

The CBC's role in assisting exports evolved over time based on economic and financial conditions. In the 1960s, export loans extended by banks were restricted to financing exporters' liquidity needs. They mostly consist of project and bridging loans at terms stipulated in the *Principles of the Provision of Export Loans* promulgated by the Executive Yuan's Foreign Trade Examination Committee.

In August 1970, the CBC enacted the *Regulation Governing the Central Bank of China's Accommodation of Export Loans*, which reclassified export loans into pre- and post-shipment loans. Since 1974, the CBC ceased to accommodate project export loans due to difficulties in controlling how firms utilise these loans and what they use to repay their creditor institutions. In 1979, the *Guideline on the Discount of Export Loans by the Central Bank of China* replaced regulations regarding export loan accommodation.

For most of the 1980s, firms that provided letters of credit (L/C), documents against acceptance (D/A), and documents against payment (D/P) may obtain credit at 85 percent of the letter of credit or collection bill for periods of less than 180 days at the CBC's rate on accommodations of export loans. In April 1989, the CBC temporarily suspended export loan accommodation in conformity with the contraction monetary policy at the time.

6.1.2 Accommodation to Small- and Medium-sized Enterprises

In addition to accommodating exports of all firms, the CBC also implemented measures to accommodate liquidity needs of SMEs. For example, in 1974, the CBC put forth the *Guideline on the Central Bank of China's Accommodation of Loans to Small- and Medium-Sized Enterprises* in June and the *Guideline on the Processing of Petty Loans to Small- and Medium-Sized Enterprises* in December for loans shorter than six months to assist SMEs' raw material purchases. In June 1989 and April 1990, the CBC appropriated a total of NT \$30 billion in specialised credit to accommodate the Chiao-tung Bank and six other banks for funding investment projects in strategic technology industries, development projects of SMEs, and the production of brand-name products. In May 1991, the Chiao-tung Bank received another NT \$10 billion (the Executive Yuan's Development Fund) to fund firms' purchases in automated machinery and equipment. In April 1993, the CBC appropriated a total of NT \$40 billion

for two one-year loans, which was extended twice to assist manufacturing and technological services industries in research development and SMEs in funding productive investment, capital expenditure, and short-term working capital. In 1998, the CBC appropriated NT \$60 billion obtained through postal savings redeposits (described in greater detail in Appendix 10.3) to assist SMEs and the manufacturing industry in general purchases of machinery and equipment or in increasing working capital or for rebuilding factories damaged or destroyed in the September 1999 earthquake. As of the end of 2003, 3,114 cases have received a total of NT \$25.7 billion. As of now, the CBC still helps SMEs to obtain funds through this programme.

6.1.3 Special Fund for Medium- and Long-term Credit

In 1972, the CBC promulgated the *Regulation Governing the Central Bank of China's Accommodation of Medium- and Long-Term Credit to Small and Medium-Sized Enterprises*, which enabled SMEs to obtain medium- and long-term credit from banks, investment and trust companies, and medium business banks that were formerly referred to as mutual companies. In 1973, the CBC established and organised a committee to manage a medium- and long-term development fund using funds obtained from private savings, deposits from the postal savings system and the Taiwan Cooperative Bank, special funds provided by the government, and surpluses arising from the usage of these funds to finance basic infrastructure projects such as electricity, petroleum, fertilizer, transportation and communications, and mining.

6.1.4 Provision of Foreign Exchange for Technological Purchases of all Firms

In January 1973, the CBC promulgated the *Regulation Governing the Central Bank of China's Accommodation of the Foreign Exchange Needed by Manufacturers for the Importation of Machinery*, which allowed banks extending loans to firms for importing machinery and equipment or for purchasing new technology from abroad to apply for accommodation in foreign exchange with the maturity of the loan being five years. Later, similar credits were provided for the procurement of locally manufactured machinery.

6.1.5 Provision of Foreign Exchange for Technological Purchases of Technology-Intensive Firms

In 1973, the CBC appropriated US \$300 million in loans to technology-intensive industries for importing machinery and equipment or for purchasing new technology from abroad. It also appropriated US \$300 million in loans to firms in exporting industries for equipment replacement to increase their productivity and international competitiveness.

6.1.6 Special Loans Extended to Traditional Industries

In October 2000, the Ministry of Finance and the CBC jointly formulated the *Principles Governing the Provision of Special Project Loans and Credit Guarantees to Traditional Industries by Financial Institutions* to finance the needs for medium and long-term capital expenditure and short-term working capital of firms in traditional industries at the cost of 1.15 to 1.65 percent higher than the interest paid on a two-year post savings deposit account. Between 2000 and 2003, the Ministry of Finance raised the designated amount to this fund three times from NT \$450 billion to NT \$1,400 billion. As of the end of 2003, a total of 147,754 cases had granted loans from this programme amounting to NT \$1,251 billion.

6.1.7 Relief Measures

Since January 1974, the CBC has implemented a series of measures in compliance with the government's *Programme for the Stabilization of Current Economic Conditions* to respond to specific economic situations. In May 1974, for relieving liquidity problems experienced by exporters, the CBC lowered interest rates on export loans and accommodated export and commercial credit refinancing and deferment of repayments. In addition, the CBC set aside NT \$1.5 billion to accommodate SMEs' liquidity needs for short-term credit and another NT \$5 billion to accommodate the export needs of manufacturers.

6.2 Enhancing the SME Credit Guarantee System

The CBC enhances the credit guarantee system by backing up the window at the SME Instant Problem-solving Center (also known as Trouble-shooting Center) of the Ministry of Economic Affairs with CBC's staff, which assists SMEs with loan applications rejected by banks. Beginning in 2003, the CBC

started to monitor banks regarding the performance of SME loans on a monthly basis.

7. Main Challenges SMEs Face

With Taiwan becoming a member of the WTO, increasing competition from Mainland China, and the rapid growth of E-commerce and the IT industry, SMEs have to face new challenges arising from innovation, R&D, marketing, human resources management, IT technology, etc and existing challenges such as the lack of a standard accounting system in order to succeed.

Right now, as comprehensive as government's assistant programmes discussed in Section five may be, it can still be improved upon in light of the three main challenges that the SMEs will face which will be discussed in the following subsections.

7.1 Improving SMEs' Financial and Accounting System

Because of a lack of standard accounting system and the majority of Taiwan's SMEs are family businesses, SMEs' financial statements often lack the quality compared to statements of large corporations. To improve upon this, the government has provided training programmes on accounting systems. In addition, SMEs have updated their IT techniques. With cooperative efforts from the government and the SMEs, financial statements of SMEs are becoming more transparent, which are beneficial to both business owners and investors.

7.2 Ensuring SMEs' Access to Credit under the New Basel Accord

As most of the SMEs in Taiwan do not have external credit rating, the implementation of the New Basel Accord, which will assign 100 percent risk weights for loans sought by those without external credit ratings beginning in 2007, will be an obstacle for SMEs in Taiwan to obtain credit in the future. Although SMEs may obtain credit through consumer loans, which are risk weighted at 75 percent, banks are generally unwilling to grant loans in such conditions. As such, the government ought to make necessary adjustments in advance to provide SMEs access to credit under the New Basel Accord. The Ministry of Finance and the Bank Association have considered utilising SMEG as the loan guarantor for SMEs' loans as a solution because under the old Accord, such measure has helped SMEs to obtain loans at a risk weight of 50 percent. The above risk weight of new accord declined from previous 50 percent to 35 percent.

7.3 Managing Trans-national Issues

Many SMEs are able to extend their business globally, especially to Southern East Asia and Mainland China in this age of globalisation and internationalisation. However, because they are generally small in scale, they often lack overseas bases to send updates on the changes in consumer behaviour in foreign markets and lack knowledge on foreign markets' distribution networks. In addition, they may experience difficulties in recruiting employees overseas thus making human resource management of foreign subsidiaries a challenging task.

8. Conclusion

SME's are the backbone of the Taiwan economy not only in terms of the number of enterprises but also in terms of their contribution to a large share in production value, value-added, employment, and exports. "small is beautiful," a well-known phrase, is therefore a title that SMEs deserve.

In retrospect, during the export-oriented period, SMEs were the pioneers of external trade. Over the years, they have provided a large number of employment opportunities as they have grown to account for approximately 98 percent of all firms. From 2002 to 2003, domestic sales of SMEs grew at an impressive rate of 20.1 percent, which is much higher than that of the 5.84 percent of large enterprises. Nevertheless, their success was not only due to their flexibility, resilience, and competitiveness, but also due to the financial assistance from the government and the CBC such as the government's effort in creating a sound environment for their development and in guiding them in terms of marketing, R&D, etc. and the CBC's help in obtaining credit.³ The CBC, in addition, has provided selective accommodations to SMEs as well as manufacturers via authorised banks, of which, the SMEs, among other firms, benefited immensely from this.

On a different note, despite of SME's past and current success, they have to overcome new and existing challenges. SMEs especially need to improve upon their financial statements and accounting system, to ensure credit availability under the New Basel Accord, and to manage trans-national human resources as they establish new foreign subsidiaries.

3. The CBC not only provided funds for SMEs but also for meeting needs of economic development in general.

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The Evolving Definition of SMEs in Taiwan

Year of Modification	Industry	Manufacturing	Construction	Transport and Warehousing	Commerce, Transportation, Services and Other Services
September 1967		Capital under NT\$ 5 million; and regular employees under 100 persons.			Annual operating revenue under NT\$ 5 million; and regular employees under 50 persons.
March 1973		Registered capital under NT\$ 5 million and total assets not exceeding NT\$ 20 million, or registered capital under NT\$ 5 million and the number of regular employees in accordance with the standards as below: (1) under 300 persons for garments, clothing and electronics industry; (2) under 200 persons for food products industry; (3) under 100 persons for others.			No change
August 1977		Paid-in capital under NT\$ 20 million and total assets amount not exceeds NT\$ 60 million, and the number of regular employees not exceeds 300 persons.		Paid-in capital under NT\$ 20 million and the number of regular employees not exceed 500 persons.	Annual operating revenue under NT\$ 20 million; and regular employees under 500 persons.
February 1979		No change		Paid-in capital under NT\$ 40 million.	No change
July 1982		Paid-in capital under NT\$ 40 million and total assets amount not exceed NT\$ 120 million.		No change	Annual operating revenue under NT\$ 40 million.
November 1991		No change, except for extending industry terms into construction.		No change	No change
September 1995		Paid-in capital not exceeds NT\$ 60 million; or regular employees not exceed 200 persons.			Total operating revenue in the preceding year not exceeds NT \$80 million; or its regular employees not exceed 50 persons (extending industry terms to agriculture).
May 2000		Paid-in capital not exceeds NT\$ 80 million; or regular employees not exceed 200 persons.			Total operating revenue in the preceding year not exceeds NT\$ 100 million; or its regular employees not exceed 50 persons (extending industry terms to agriculture).

Source: White Paper on SMEs in Taiwan, 2004. SMEA, Ministry of Economic Affairs.

Financial Institutions and Financial Markets in Taiwan

The financial system in Taiwan consists of financial institutions and the financial market. Financial institutions consist of deposit money banks including domestic banks, local branches of foreign banks, medium business banks, credit cooperative associations and credit departments of farmers and fishermen's associations, and other institutions such as the Central Trust of China, and other financial institutions such as the postal savings system, investment and trust companies, and insurance companies, etc. Among them, domestic banks account for the largest share (50.17 percent) of total assets. The postal savings system, established in 1964 and now renamed as the Chunghwa Post Co. since July 2003, plays an important role in the financial system. It is a major component of the redeposit system as it is prohibited from making loans. As the end of 2003, it's share of assets accounted for 7.38 percent of the total of financial institutions. The medium business banks, another important player in Taiwan's financial system, in addition to providing standard financial services, provide services mainly to SMEs. Their share of total assets was 2.7 percent at the end of 2003. (Table 10.14 displays these statistics in detail). This figure was lower than that of the last decade, which mainly reflects the transformation of three medium business banks into commercial banks.

Table 10.14: Taiwan's Financial Institutions

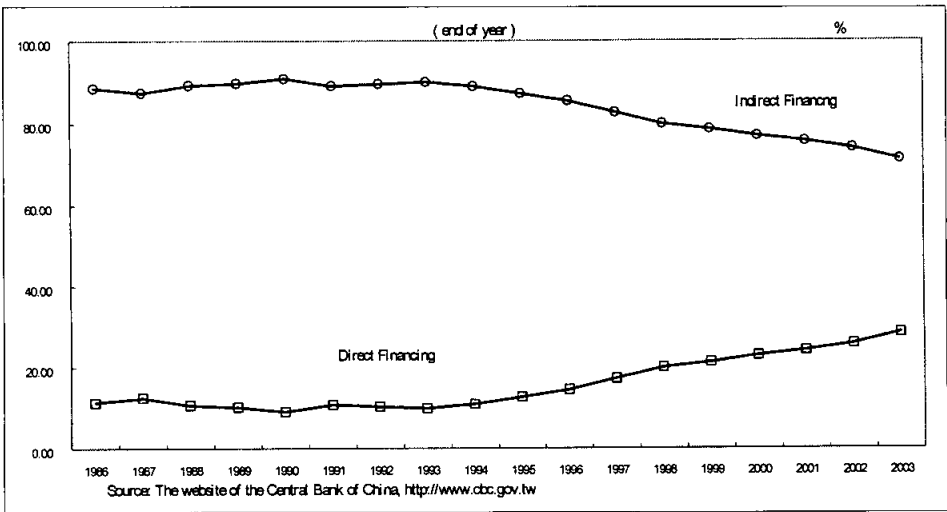
end of 2003		unit: Billions of NT\$, number		
	Assets	As a percentage of total	Head Office	Branches
Total	45,802	100.00	433	5,930
Central Bank of China	8,145	17.78	1	
Deposit Money Banks				
Domestic Commercial Banks	22,978	50.17	45	2,884
Medium Business Bank	1,238	2.70	5	289
Local Branches of Foreign Banks	1,785	3.90	36	69
Credit Cooperations	720	1.57	35	341
Credit Departments of Farmers' and Fishmen's Associations	1,441	3.15		
Credit Departments of Farmers' Associations			253	828
Credit Department of Fishermen's Associations			25	39
Other Financial Institutions				
Chunghwa Post Co.	3,381	7.38	1	1,322
Investment and Trust Companies	187	0.41	3	28
Life Insurance Institutions	4,620	10.09	29	130
Property and Casualty Insurance Company	149	0.33	24	165
Bills Finance Companies	1,074	2.34	14	45
Securities Finance Companies	84	0.18	4	4

Note: The above data are not presented on a consolidated basis.

Source: Financial Statistics Monthly, The Central Bank of China, Aug. 2004

Financial markets in Taiwan include the money market—market for short-term debt and securities, and the capital market—market for long-term debt and securities. The money market has grown considerably since its establishment in 1976. The capital market, especially the corporate bond market, remained small until 1998. Before that, because the issuance of bonds requires banks' guarantees, firms typically preferred to finance via borrowing from banks or issuing short-term bills. Since 1998, with the growth of bond funds, the growth rate of the corporate bond market has picked up. Figure 10.14 displays this trend (direct financing) along with the trend of indirect financing.

Figure 10.15: Direct Financing and Indirect Financing in Taiwan



The Postal Savings Redeposit System

The postal savings redeposit system is a major source of the CBC's policy-based loans and many of the government's special loan programmes.

According to the earliest regulation that mandated the resumption of the operations of the Postal Savings System in Taiwan, all postal savings received apart from cash reserves were re-deposited with the CBC. As such, the CBC has at its disposal a huge pool of the nation's savings for redirecting towards investment such as the Special Fund for Medium- and Long-term Credit established in April 1966 to accommodate banks that extend medium- and long-term loans.

During the past few decades, a number of reforms were introduced in response to changing economic and financial conditions. For example, from March 1, 1982 onwards, the Central Bank, with the ratification of the Executive Yuan, instructed the DGPRSB (the Directorate-General of Postal Remittances and Savings Bank) to redeposit the incremental postal savings with four specialised banks namely, the Chiao-tung Bank, the Medium Business Bank of Taiwan, the Land Bank of Taiwan, and the Farmers Bank of Taiwan, their respective shares being 40 percent, 25 percent, 25 percent, and 10 percent. Later, the proportion of these postal savings redeposit with the Central Bank and the four specialised banks was adjusted in accordance with changing economic and financial conditions. Beginning January 1992, the newly increased postal savings can be freely deposited to banks according to the Postal Savings System's own discretion.

CHAPTER 11

FINANCIAL ACCESS OF SMES IN THAILAND: WHAT ARE THE ROLES OF THE CENTRAL BANK?

by

Chaipat Poonpatpibul and Watsaya Limthammahisorn*

1. Introduction

Since the economic crisis in 1997, the formerly overlooked small and medium enterprises (SMEs) have been turned into one of the main engines for sustainable economic growth. Realising their importance and potentials, the government has initiated a package of policies, aimed at fostering SMEs development by reducing various problems facing SMEs in marketing, human resources and management, technology, infrastructure and regulations, and financing.

This paper will focus on SMEs' financial challenges as they are most relevant to the central bank. The paper would endeavour to address the issues of the constraints of potential and existing SMEs of accessibility to financial funding and the roles of the central bank in promoting better financial access for SMEs. To address these issues, the paper relies on earlier works by Townsend and his colleagues concerning financial constraints in rural and semi-rural Thailand while the analysis on SMEs' financial access and structure of funding would use data from the Bank of Thailand (BOT)'s survey on demands for financial services, as well as qualitative data related to SMEs credit access problems from both creditors and borrowers' perspectives.

The paper will also analyse the government's financial funding (including both debt and equity funding) initiatives as well as the BOT's policies related to SMEs funding particularly through the recently adopted financial sector master plan. The remaining gap of SMEs' funding is then assessed from the above

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analysis. In addition, a set of policy recommendations would be proposed that should further reduce the remaining financing gap of SMEs especially for the start-ups as well as very small firms.

The rest of paper is organised as follows: Section 2 discusses the definition of SMEs and their importance to the Thai economy. Challenges facing SMEs with a focus on financial access problems are presented in Section 3. Section 4 provides the national policy for SMEs development and its evaluation. The remaining gap of funding for SMEs, the BOT's roles, and policy recommendations are presented in Section 5. Finally, conclusion and suggestions for further studies are provided in Section 6.

2. Characteristics of Thai SMEs

2.1 Definition of Small and Medium Enterprises (SMEs)

Definitions of SMEs vary from country to country and between different sources of the SMEs statistics. For example, the SMEs definition of the European Commission focuses on the need of companies to acquire funding whereas that of Basel II is based on credit risk of lending institutions. The commonly used factors for categorising the size of firms for different reporting purposes include the choices of employment, fixed assets, sales, balance sheet, and structure of shareholders. In Thailand, an official definition of SMEs, proposed by the Ministry of Industry, covers the number of employees and the value of total fixed assets (excluding land) as shown in Table 11.1. The criteria of these two factors differ among the 4 business sectors of manufacturing, service, wholesale, and retail. Any firm is considered a small firm or a medium firm if either one of the above two variables meets the requirement of a smaller class. This is also the definition that the Bank of Thailand (BOT) has adopted.

Table 11.1
Definitions of SMEs

	Employees		**Fixed asset		Turnover		Balance Sheet		Independence
	Small	Medium	Small	Medium	Small	Medium	Small	Medium	
Ministry of Industry*									
Manufacturing Sector	< 50	51-200	< THB50 mil	50< THB mil <200					
Service Sector	< 50	51-200	< THB50 mil	50< THB mil <200					
Wholesale Sector	<25	26-50	< THB50 mil	50< THB mil <100					
Retail Sector	<15	16-30	< THB30 mil	30< THB mil <60					
Basel II					< Euro 50 mil (can be substituted by total assets according to national supervisor's discretion)				
European Commission	<50	<250			< Euro 10 mil	< Euro 50 mil	< Euro 10 mil	< Euro 43 mil	Given by < 25% capital shares by third party

*Source :Ministry of Industry (issued on the 11 th of September 2002)

** excluding land

2.2 Size and Importance of SMEs

It is undeniable that SMEs play a crucial entrepreneurial role in Thailand, as almost all registered firms are SMEs. They also account for more than two-third of total enterprises' employment. However, the share of SMEs' employment declined from 76.4% in 1997 to 69.0% in 2002 due to recovery of large corporations from the economic crisis in 1997. In terms of contribution to GDP, the share of SMEs production was 38.9% of the GDP in 2002, slightly increasing from 37.7% in 1997. Similarly, the proportion of SMEs' products in total exports has been slightly lower than 40%. It is evident that the number of firms grew and declined significantly in the retail and manufacturing sectors respectively. The manufacturing sector has been replaced by the retail sector as the sector with the highest number of entity. The highest number of employment was in the manufacturing sector in 2002. However, the rising number of firms in retail, and service sectors renders approximately equal shares of employment among manufacturing, retail, and service sectors in 2002.

Table 11.2: The Importance of SMEs to Thailand Economy

	1997	2002
Number	799,033	1,639,427
(%)	99.5	99.7
Employment	4,057,595	4,990,217
(%) in total enterprises	76.4	69.0
GDP (%)	37.7*	38.9
Export(%)	38.5**	38.2

* GDP as 1998

** Export as 2000

Source: Reports on the Manufacturing Census, 1997 and reports on

Trade and Service Businesses Census, 2002 from the National Statistical Office.

Table 11.3: Number of SMEs firms Classified by Sector (%)

	1997	2002
Manufacturing	36.5	21.8
Wholesale	3.2	3.0
Retail	34.8	44.7
Service	25.6	30.6

Source: Reports on the Manufacturing Census, 1997 and reports on

Trade and Service Businesses Census, 2002 from the National Statistical

Financial Access Of SMES In Thailand: What Are The Roles Of The Central Bank?

Regarding ownership, 93.3% of SMEs in Thailand are in the form of sole proprietorship (family-run or one-man operation). Private and public companies constitute about 4 percent of all SMEs.

Table 11.4: Number of SMEs Employment Classified by Sector (%)

	1997	2002	% Growth
Number of SMEs Employment	4,057,595	4,990,217	23.0
<i>Manufacturing</i>	<i>1,852,691</i>	<i>1,668,303</i>	<i>-10.0</i>
(%)	45.7	33.4	
<i>Wholesale</i>	<i>183,063</i>	<i>256,643</i>	<i>40.2</i>
(%)	4.5	5.1	
<i>Retail</i>	<i>1,033,116</i>	<i>1,563,221</i>	<i>51.3</i>
(%)	25.5	31.3	
<i>Service</i>	<i>988,725</i>	<i>1,502,050</i>	<i>51.9</i>
(%)	24.4	30.1	

Source: Reports on the Manufacturing Census, 1997 and reports on

Trade and Service Businesses Census, 2002 from the National Statistical Office.

Table 11.5: Number of SMEs Classified by Legal Registration, 2002

	Number	(%)
Sole proprietorship	1,530,072	93.3
Private & public company limited	62,704	3.8
Partnership limited & unlimited	31,243	1.9
Others	13,254	0.8
Community cooperation	1,914	0.1
State Owned enterprises	240	0.0
Total	1,639,427	100.0

Source: Reports on Trade and Service Businesses Census, 2002

from the National Statistical Office.

3. Challenges facing SMEs in Thailand

Problems facing SMEs in Thailand include the lack of entrepreneurship, outdated technology, insufficient R & D and low standards of production, difficult access to funding, as well as high and increasing competition both in the domestic and global markets. Even with a comprehensive package of government's measures to promote and support SMEs, challenges abound.

3.1 Overall Challenges of SMEs

The last sectoral SMEs survey by the National Economic and Social Development Board shown in Table 11.6 aimed to assess the effectiveness of the reinforced measures to help the Thai SMEs. The survey found that problems in technology, management and finance are major obstacles for SMEs development especially for very small firms.

Table 11.6 Ranking of SMEs Problems

	Textile	Jewelry	Leather	Food
Production Problems				
Raw material	1	2	2	1
Labor	3	1	3	2
Finance	2	4	1	4
Technology	2	5	5	3
Package	4	3	4	5
Marketing Problems				
Channel of Distribution	1	1	1	1
Marketing Officer	3	2	2	2
Export Incapability	2	-	3	4
Information	-	-		3

Problems	Tourism		
	Hotel	Guide Tour	Souvenir
Government Policy	1	3	4
Marketing	2	1	1
Personel Officer	3	4	2
Finance	4	2	3
Administration	5	5	5

Source: Summarize from NESDB Survey (September 2004)

At the present, the most crucial marketing problem is the lack of channels of distribution. As for technology, low R&D and innovation levels are the biggest concern. Besides, the current low labour productivity level in the SME sector also main challenges in human resources and management. However, this paper will concentrate on the challenges concerning financial funding of SMEs as they are most relevant to the central bank.

3.2 Financial Funding Challenges

The issue in this Section is the reason for the importance of financial access of SMEs to the economy. The constraints to the access of credit of SMEs are then analysed. In looking at these concerns, the results of important and pioneering studies concerning credit access conducted at the micro-level by Townsend and his colleagues using panel data from rural and semi-urban Thailand¹ are looked into. The studies have important implications for both households with entrepreneurial potentials and households with existing small businesses. Second, further investigation concerning financial access of the existing SMEs using the cross sectional BOT survey data in 2002 will be presented. Third, credit access problems from the views of SMEs owners in the BOT and NESDB surveys compared with those from the views of financial institutions are presented. This Section will end with a summary of the findings about financial constraints facing SMEs at different stages of development in Thailand.

3.2.1 Townsend's Studies about Household Financial Constraints

Gine and Townsend (2001) and Townsend and Ueda (2000) demonstrated that moderate improvement of financial intermediation in Thailand should lead to significantly higher GDP growth. Business investment of households is determined much more by personal wealth than ability and underlying productivity. Hence, if saving can be mobilised to households and corporations with high-yield activities, growth will leap. More importantly, the benefits would not be uniform in the Thai population but highly tilted toward those which can start up small or medium enterprises or expand the existing ones. In particular, the group with low wealth but high entrepreneurial talent will gain most from alleviation of the problem of imperfect credit market. They discovered that households with higher wealth are more likely to do business and tend to invest up to the point where the marginal

1. These studies include Gine, X. and R. Townsend (2001), Kaboski, J. and Townsend, R. (2000), Kaboski, J. and Townsend, R. (1998), Paulson, A. and Townsend, R. M. (2000), Townsend, R. (1995), and Townsend, R. and Ueda, K. (2000).

product of capital equates the interest rate. However, many households with high entrepreneurial potentials are constrained by limited wealth². Mandated lending, subsidised interest rates, and establishments of new credit institutions, although can help, may be too blunt and may not be pertinent. Inaccessibility to credit of constrained households in the poor northeastern region is still a big problem even with all the above policies in place.³

Paulson and Townsend (2001) find that financial constraints, which vary with wealth, are crucial in determining the patterns of entrepreneurship in Thailand. Limited liability is a major concern for the poor households. On the other hand, limited information and moral hazard are concerns for wealthier households as, for this group, credit decreases in wealth.

3.2.2 Firms Credit Access Analysis from BOT Survey's Data

In this paper, factors influencing SMEs' credit access are investigated by using data from the BOT's survey concerning households' and businesses' demand for financial services.⁴ With various sizes of firms in the survey, factors determining their access to credit are different. In addition, the data allow the investigation into whether those factors affect their choices of funding which include loan from an informal sector, loan from a formal sector, equity offering, bond issuance, owner's saving, and retained profit.⁵

The Binary Logit Regression is used to help identify variables indicating access to credit from financial institutions. The binary dependent variable here has the value of 1 if a firm states that either short-term loan, long-term loan, or credit guarantee from financial institutions is important but it cannot gain access to at least one of them. On the other hand, it has the value of 0 if it can gain access to all those deemed important. The explanatory variables available from the data are age, asset, sale, location, nationality of ownership, location, region,

2. In these studies good entrepreneurial potential is determined by education and whether parents the households' main income earners had had business in
3. Lending by the Bank for Agricultural and Agricultural Cooperatives (BAAC), which is highly in the form of relationship- based practice in other regions, is found to be dictated by households' collateral in the northeast.
4. This survey was done in 2002 in preparation for the Financial sector master plan.
5. This study focuses on analysing the funding of registered firms. However, the data from the survey in the part of households' demand for funding can also be further analysed to see the constraints facing households with an intention to become start-up SMEs. This will be examined in a future extension of this paper.

and business sector ⁶. The age of firms should show the level of firm's specific information that banks have acquired. The older a firm is, the more information about that firm banks have accumulated. Both assets and sales represent the size of firms whereas the former will also allow us to infer about the importance of collateral.

Table 11.7
Factors Determining Credit Access to Financial Institutions

Variable	Coefficient	Sample mean	Base Unit	Marginal Effect
C	0.28**			
Foreign ownership	0.40	0.14	Thai ownership	0.10
Rural	0.38	0.90	Urban	0.09
Log (Age)	-0.28**	2.41		-0.07
Asset between 5-50 million baht	0.05	0.32	Asset<5 Million baht	0.01
Asset between 51-200 million baht	-0.74**	0.66	Asset<5 Million baht	-0.18
Asset above 200 million baht	-1.28**	0.16	Asset<5 Million baht	-0.31
Sale between 5-50 million baht	-0.03	0.36	Sales<5 Million baht	-0.01
Sale between 51-200 million baht	-0.40	0.18	Sales<5 Million baht	-0.09
Sale above 200 million baht	-1.12**	0.22	Sales<5 Million baht	-0.27

McFadden R -squared = 0.1

** = significant at 95% confidence interval

We find that credit access increases with ages for all sizes of firms, assets for medium and large corporations and sales for large corporations.⁷ It is essential to mention that the age provides a statistically significant result only when it enters the regression in a logarithmic form. This should be because an additional increase in age reveals firms' information a lot more at young ages, than at old

6. See Appendix 1 for the statistics concerning the characteristics as well as credit access according to firm's size.

7. This regression analysis still has a noted concern as an endogeneity problem might prevail. The causal relationship between credit access and the variables indicating firm's size can be both ways. Specifically, access to credit may be important in explaining the size of firms as it allows for greater asset accumulation and greater potentials for an increase in sales.

ages.⁸ Equally important is that an increase in assets does not provide greater access to loans for small firms. Besides, an increase in sales does not help small and medium size firms gain better access to credit. This exemplifies the case for policy assisting small firms to gain easier credit access. This will be particularly crucial for those new enterprises with limited assets whose information available to financial institutions is limited.⁹

Next, as the data also provide proportions of different sources of funding for each firm, we analyse further if the above set of explanatory variables can also help explain the existing structure of firms' funding. Two groups of dependent variables are constructed to examine factors influencing different aspects of funding. The first group demonstrates the degree of sophistication in acquiring funding whereas the second group distinguishes debt type from equity type of funding. The dependent variables in the first group are primitive, formal, and advance funding. The dependent variable representing primitive funding here shows the combined percentage of funding in total funding from the most primitive sources of funding: informal sector loan and owners' private saving. The formal funding represents the proportion of funding raised from formal sector loan, equity offering, and bond issuance in total funding. Focusing on the most advanced form of funding, the last variable in this group includes only the proportion funding raised through equity and bond issuances in total funding. As for the second group, the equity-funding variable includes all funding in the form of equity, owner's private saving, and retained profit as a percentage of total funding. On the contrary, the debt-funding variable shows the percentage of debt form of funding from formal and informal sector loans in total funding.

We find that firms' size determines the sources of funding.¹⁰ Medium and large firms use significantly more funding from the formal sector and less from the informal sector and owners' saving. Comparing firms in the manufacturing sector with those in the services and trading sectors, the former tends to use higher proportions of loans from the formal sector.¹¹ This reflects that collateral

8. Examining whether firms with ages above a certain threshold get easier loan approvals should be worthwhile for a further analysis.

9. It should be noted that this analysis is subject to one important limitation that, among those firms who have credit access problems, the data do not allow us to differentiate those with potential profitability and viability from those who do not deserve credit access.

10. See the detailed results in Appendix 11.2

11. Firms in the non-manufacturing sectors (even though historically having higher profit margins than in the manufacturing sector) tend to have more difficulties getting credit from financial institutions.

Table 11.8: Factors Influencing Choices of Funding

	Primitive	Formal	Advance	Equity fund	Debt funding
	Loan from Informal Sector+ private saving	Loan from formal sector +Equity+bond	Equity + Bond	Equity+private saving+profit	Loan from formal Sector +Loan from Informal Sector+bond
Age	-	+	+	-	+
Asset between 5-50 million baht	+ *	-	-	+	-
Asset between 51-200 million baht	- **	+ **	+	- **	+ **
Asset above 200 million baht	- **	+ **	+ **	- *	+ *
Sale between 5-50 million baht	-	+	-	-	+
Sale between 51-200 million baht	- **	+ **	+	- **	+ **
Sale above 200 million baht	- **	+ **	-	- **	+ **
Manufacturing Sector	- **	+ **		+ **	+ **
Service Sector			+ **		
Wholesale Sector				+ **	
Retail Sector				+ **	
Ownership (Thai VS Foreign)	+ **	- **	+ **	+ **	- **
Location (city VS upcountry)	+	-	+	+	-
Adjusted R-squared	0.160875	0.091743	0.038972	0.07477	0.07477

+ = positive relationship

- = negative relationship

** = significant at 95% confidence interval

* = significant at 90% confidence interval

based lending practice gives the manufacturing sector better access to credit compared with other sectors. This should be because manufacturing firms' values of assets (mostly in the form of factories and machines) are usually greater than other sectors'.¹² The other interesting observation here is that foreign firms tend to use owners' saving and retained profit in a greater proportion and rely less on debt funding than domestic firms. The advance from of funding (stock and bond issuance) is found to increase in large firms where the asset size is over 200 million baht, foreign owned firms, and firms in the service sector.

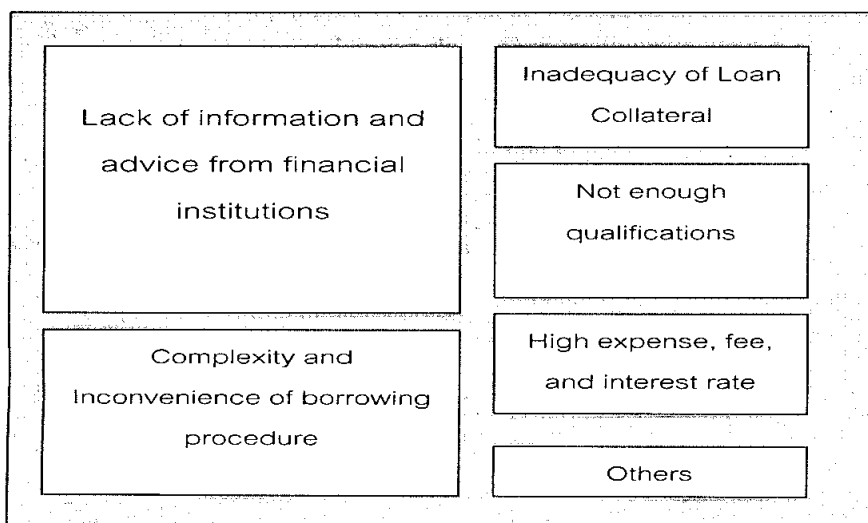
12. Consistently more than 40 percent of all bank loans go to the manufacturing sector.

Comparing all forms of equity funding against all forms of debt funding, we find that firms' funding structure leans more towards debt of funding as assets and sales reach the medium size criteria and increases more for the large size firms. On the other hand, small firms' funding is more in the equity form of funding as owners' private saving is still the most important source of their funding. However, foreign firms' funding regardless of the size tends to be more of the equity type due to the use of owners' saving and retained profit.

3.2.3 Obstructing Factors Facing Creditors and Borrowers

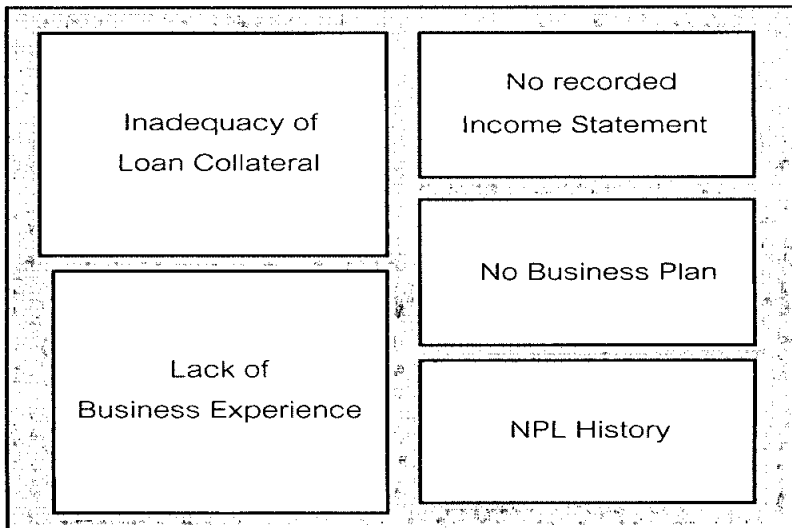
Together with the data for the above analysis, the BOT survey also requests those firms with difficulties getting credit access from financial institutions to identify the obstacles. It was found that the relative importance of different problems is uniform across firm size. The most important reasons regardless of firm size are lack of information and advice from financial institutions as well as complexity and inconvenience related to the borrowing process. Compared with large firms, a higher percentage of SMEs have problems with the former factor than with the latter. Insufficient qualifications, high related expense, fee and interest rate, and lack of collateral are subordinate reasons. These answers coincide with those in the survey conducted by the NESDB in 2004.

**Figure 11.1: Financing Problems of Existing SMEs
(SMEs' View)**



From the side of financial institutions (information collected by the Office of SMEs Promotions), as shown in Figure 11.2, the reasons constraining them from lending to SMEs differ from the reasons given by the SMEs. The most important factor limiting loans to SMEs especially for start-up and very small SMEs is inadequate collateral, supporting Townsend's and our findings. Also mentioned is the lack of business experience on the part of new entrepreneurs requesting for SME loans. Another reason is inability of SMEs to provide income and cash flow statements for loan approvals as proper accounting implies administration cost for firms. In addition, a great number of firms purposely omit formal and correct accounting practice to avoid taxes. The fourth important problem is the lack of business plan writing capability. Those with good business ideas and potential entrepreneurial talents need to be equipped with this ability or assisted by professionals. The last problem, albeit with decreasing severity, is that having a NPL history obstructs some existing SMEs from receiving new loans.

Figure 11.2
Financing Problems of Start-up and Existing SMEs
(Financial Institutions' View)



To sum up, better access to credit of SMEs especially the start-up SMEs with entrepreneurial talents will be beneficial to economic growth. Overall, the above empirical analysis have revealed the following key challenges facing SMEs as well as financial institutions, and the authorities.

First, SMEs' access to loans from financial institution is constrained espcailly for new firms and those without sufficient assets. As information is limited to creditors, these new firms need to submit convincing and realistic business plans showing potential future returns and viability. This can be a daunting task particularly for novices. It is also important to be able to show a consistent income stream with an up-to-standard accounting book and understand the borrowing process.

Second, lending practice of financial institutions is still largely based on the asset back lending model. Augmenting credit assessment capability of financial institution's credit models is vital for young firms with a good business plan (most likely with limited collateral) to gain credit access. Relationship-based lending where credit officers are geographically in the proximity of borrowers and can monitor their business conditions closely will reduce information asymmetry between banks and the borrowers. This kind of lending model will provide a more appropriate interest charge according to risk and return profiles that are closer to the true levels. Credit guarantee, which is already in place, should still be important going forward as long as most of lending is still collateral based. However, a moral hazard problem associated with credit guarantee should be attentively monitored. These practices related to bank lending will be discussed further in the section about the BOT's role.

The financing problems facing SMEs at different stages of development can be summarised in Figure 11.3 whereas the summary of the main findings about financial access problems facing SMEs is shown in Table 11.9 below.

Table 11.9: Main Findings about Financial Access Problems of SMEs

Studies	Source of Data	Samples	Main Findings
Townsend's studies	Panel data from Townsend's household survey (2001)	Households in provinces in each of the 2 geographical regions in Thailand (Central and Northeast regions)	- Moderate improvement of financial access in Thailand should lead to significantly higher GDP growth - Many households with high potential entrepreneurship are constrained by limited wealth - Households with higher wealth are more likely to do business
Analysis about firm's credit access and structure of sources of funding	BOT's survey on demands for financial services (2003)	1,195 firms	- Firms' credit access increases with age, asset and sale. - Firms' funding structure leans more towards debt of funding as assets and sales increase. - Firms in the manufacturing use greater proportions of debt funding than other sectors.

Studies	Source of Data	Samples	Main Findings
Reasons for SMEs credit access problems	<u>Firms' side</u> - BOT's survey on demands for financial services (2003)	1,195 firms	- Lack of information and advice from financial institutions as well as complexity and inconvenience regarding the borrowing process are major obstacles.
	- NESDB survey (2004)	224 firms	
	Financial institution side - the office of SMEs promotion	Qualitative	- Inadequacy of collateral, lack of business experience and plans, and below-standard accounting are major obstacles.

Figure 11.3: Financing Problems of SMEs at Different Stages of Development .

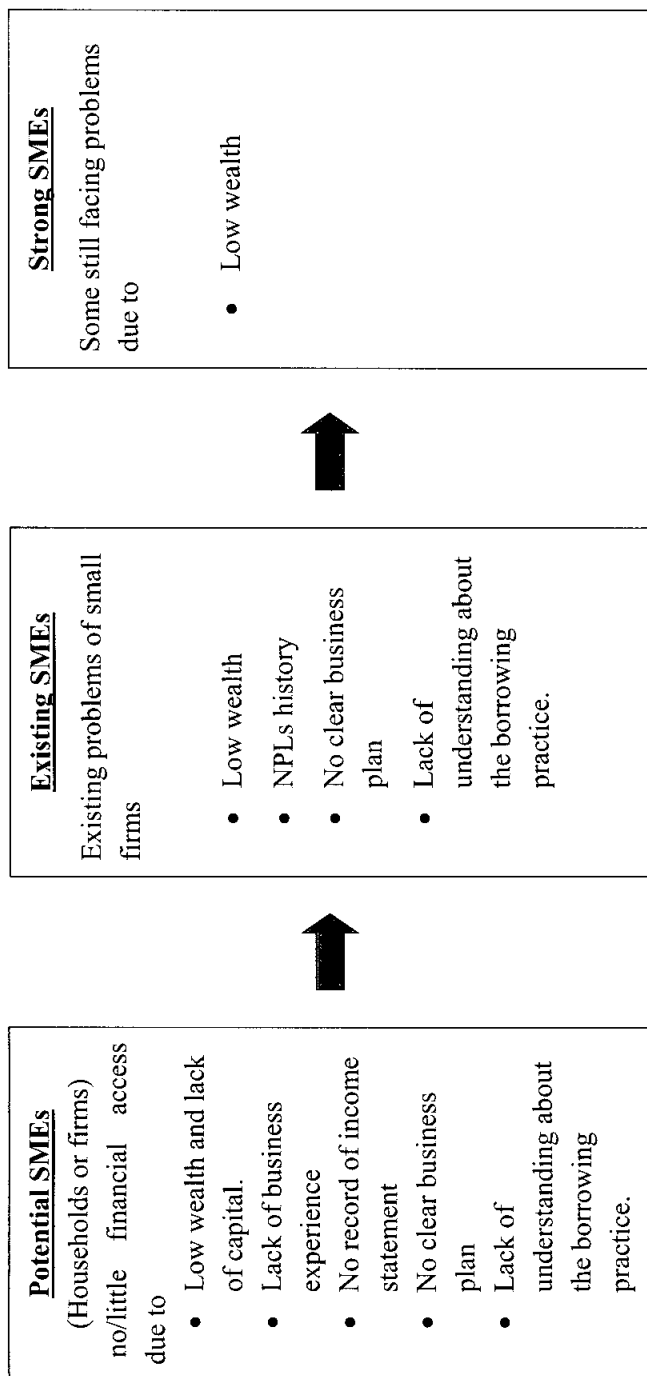
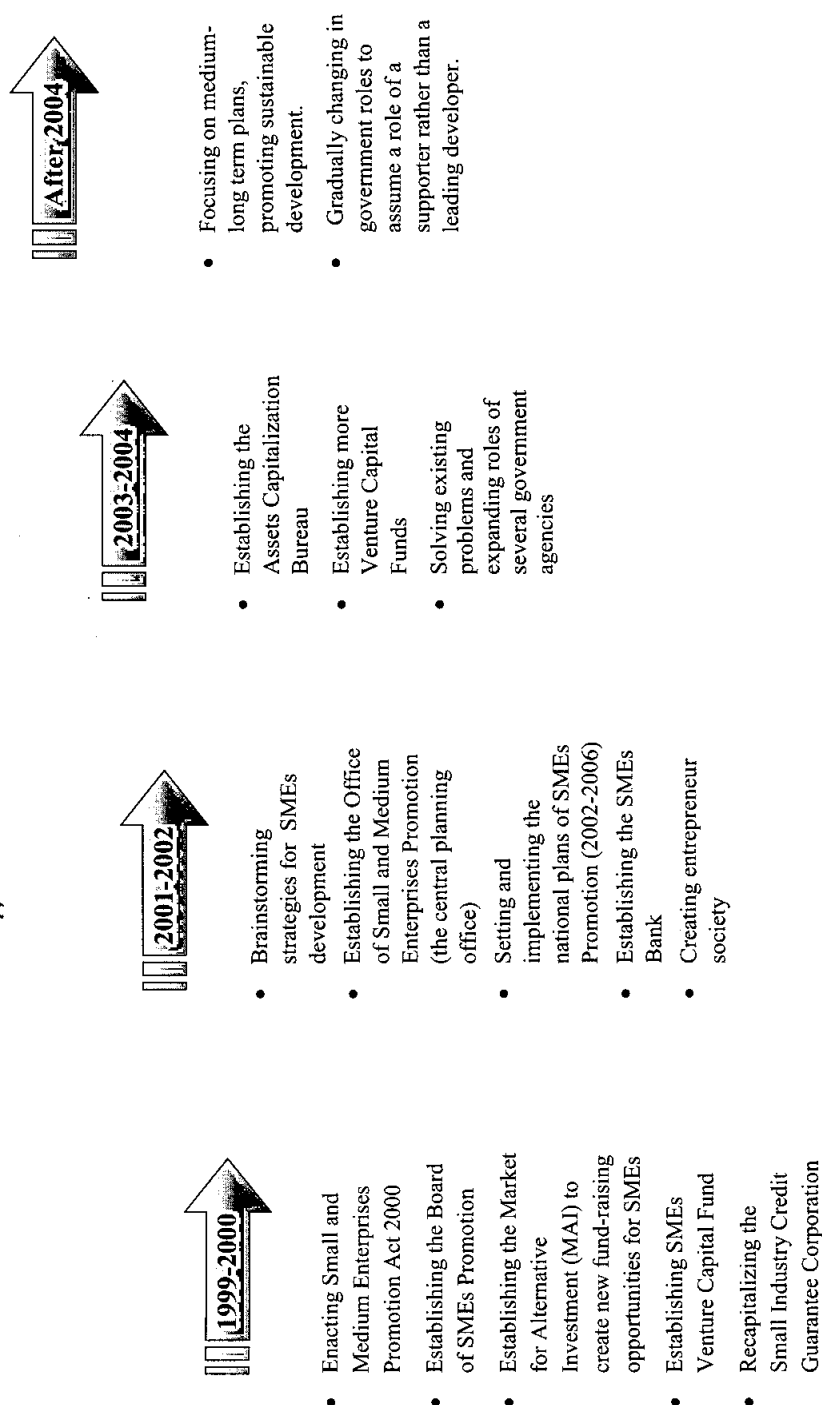


Figure 11.4: SMEs



**Box 11.1: The Promotion Plan of Small and Medium
Enterprises of Thailand
(2002-2006)**

In line with the five-year National Economic and Social Development Plan, the Promotion Plan of Small and Medium Enterprises of Thailand (2002- 2006) was proposed to emphasise the importance of SMEs development. The goal of this plan is “ to make Thai SMEs the engine for the economy as a whole, functioning environmentally friendly yet fully-competitively at international levels, while maintaining high standards of quality and doing so with sustainability, to the benefit of the entire population.”

Goals of the Plan

- Increase contribution to the nation's gross domestic product (GDP) by SMEs to 50 percent by the year 2006.
- Increase employment in the SMEs sector by 181,700 people a year.
- Reach a minimum growth of 6 percent in export value in SMEs, or 436.5 billion baht by the year 2006.
- Increase the number of SMEs businesses by 50,000 a year.
- Reach a minimum increase of 10 percent per year of professional groups with entrepreneurial capability, and have 6,300 business clusters by 2006.
- Encourage target groups of capability enhancement and promotion.
To achieve the above goals, the strategies aiming to solve temporary as well as medium and long term problems are proposed.
- Urgent Measures are drawn to solve financial and marketing problems following the economic crisis. These problems include NPLs, difficulties in borrowing, liquidity shortfalls and difficulties in adapting to changes in the market environment.
- Medium to Long Term Measures are employed to lessen structural problems and increase the number of SMEs potentials by improving infrastructure conducive to sustainable growth, promoting research and development, and eliminating obstructing regulations in selected businesses.
- Measures to encourage coordinating efforts among SMEs in local communities and regions in the form of clusters are emphasized to improve their efficiency and to attain to export standards.

Source: Annual report of the office of SMEs promotion in 2002

4. National Policy of SMEs and its Evaluation

As a result of the economic crisis in 1997, most of large companies in Thailand were overwhelmed with huge foreign debts and as well as high NPLs. With the quagmire of problems in large corporations, the Thai government has turned to SMEs as an alternative engine for economic recovery and sustainable growth. This Section will discuss the national policy in promoting SMEs, covering development and financing aspects as well as qualitative policy evaluation.

4.1 National Policy in SMEs Promotion

In 2000, the Thai Parliament enacted the Small and Medium Enterprises Promotion Act, aimed to promote SMEs, prompting the establishment of the Office of Small and Medium Enterprises Promotion later that year. This Office is an independent governmental agency, acting as a central planning office, coordinating the strategic plans and works of all relevant agencies related to SMEs development. The National Plan for Small and Medium Enterprises Promotion (2002-2006) was launched in 2002 after nationwide brainstorming efforts between related agencies and the private sector. In addition, The SMEs Bank was established in December of 2002, as a specialised financial institution, providing financial support to SMEs and promoting new SMEs.

The National Master Plan, coordinated by the Office of SMEs Promotion, consists of several reinforcing strategies for SMEs development and financial measures as presented below (See Figure 11.5 for the chart of strategic planning structure of SMEs promotion policy).

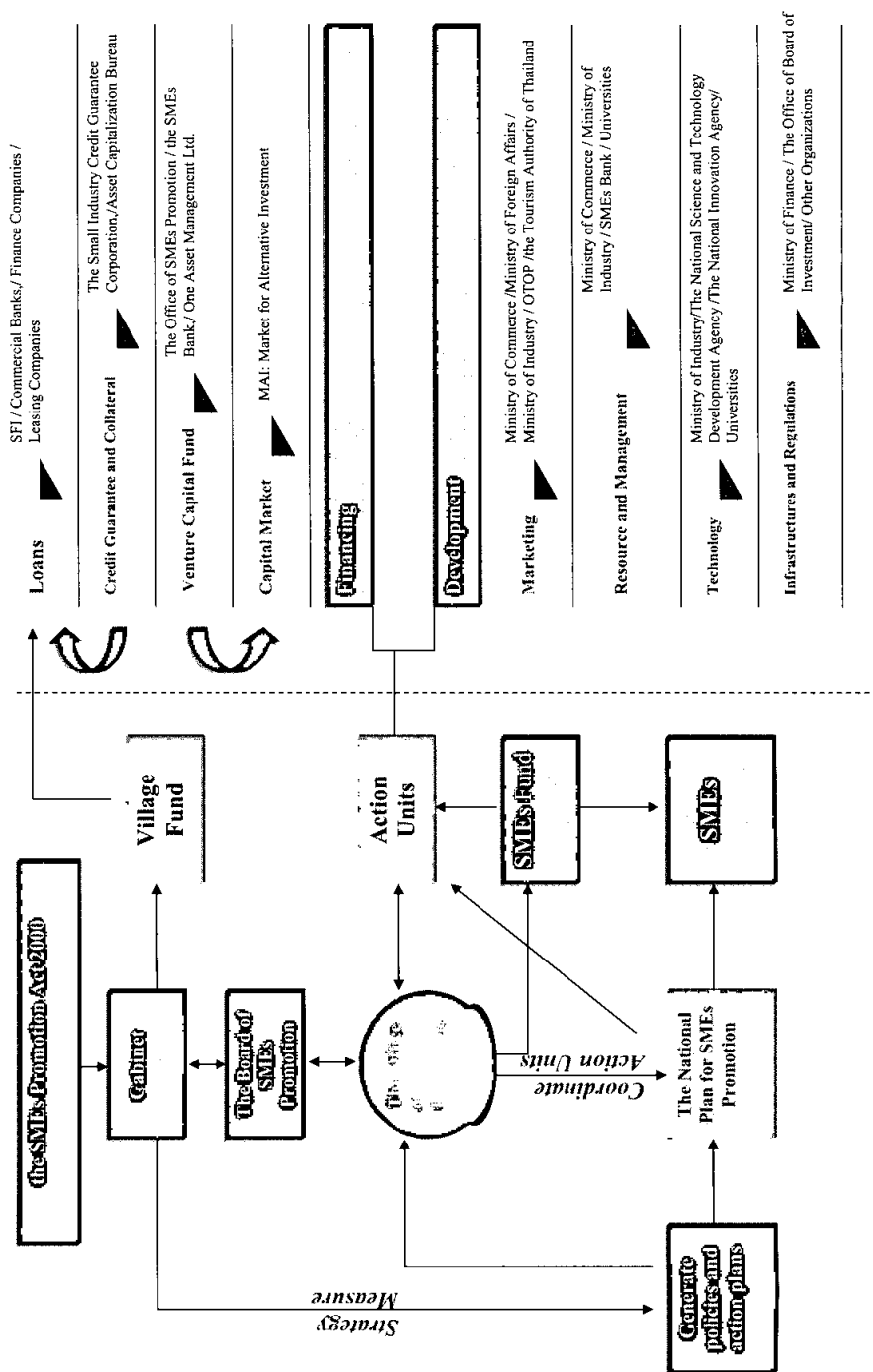
4.1.1 Development

Prior to the economic crisis, entrepreneur development at the grass root level was not a focal point of attention and there is a need therefore for systematic development measures focusing on marketing, human resources and management, technology, and infrastructure and regulations.

- *Marketing*

As marketing is one of the major obstacles, measures to expand market opportunities for SMEs are urgently needed. Measures include searching for new domestic and foreign markets, expanding the existing market, reducing obstacles for SMEs in their marketing, improving product distribution, promoting

Figure 11.5: Strategic Planning Structure of SMEs Promotion Policy



the use of local products and services, improving product designs, and promoting free and fair trading practices.

- *Human Resource and Management*

Improving competitiveness of SMEs through human resource development is essential for sustainable economic growth. Several measures have been proposed and implemented for skill development in technology, management and accounting. These include measures to incubate new SMEs and develop their capabilities, create an entrepreneurial climate in the universities and through the media, and provide appropriate knowledge and trainings for the existing SMEs.

- *Technology*

In the long-term, it is essential to enable SMEs to apply updated know-how for competition in the international market. The proposed measures include knowledge and technology sharing platforms between research institutions and SMEs, support funding for research related to SMEs products, and promotion of the use of information and communication technologies (ICT). The main goal is to increase productivity by fully utilising existing technologies and encouraging knowledge sharing for technology development.

- *Infrastructure and Regulations*

In order to increase competitiveness in the SMEs sector, government's provision of infrastructure conducive to production, marketing and management capacity enhancement for SMEs are important. The relevant measures involve tackling problems and reducing impediments due to government rules and regulations. The current government measures include reduction and exemption of tariff duties on raw materials, corporate income tax rate cut for small enterprises, expansion of income bracket for small enterprises exempted from the value-added tax ¹³, and enlargement of investment promotion for SMEs from the Office of Board of Investment (BOI).

4.1.2 Financing

The following are urgent as well as medium to long-term financial funding measures related the banking sector and the capital market that have been initiated following the Promotion Plan of Small and Medium Enterprises. They include

13. See Appendix I for the list of tax incentives.

both debt and equity aspects of funding. As for the debt side, the measures focus on both loans and collaterals as follows:

- *Loans*

One of the urgent measures in the National Plan is to resolve credit access problems of SMEs. The Thai government has taken a major role in easing access of financial assistance to SMEs by setting target loans provided through the Specialized Financial Institutions (SFIs) and promoting loans provided by commercial banks. These measures are intended to allow faster release of financial credit to SMEs and resolve NPL problems.

Other than the measures in the National Master Plan, the government has also launched the Village Fund Project aimed at alleviating poverty particularly in rural areas and to boost economic recovery. This project provides working capital amount of one million baht per village¹⁴ for small home industries in villages.

- *Credit Guarantee and Collateral*

The Small-Industry Credit Guarantee Corporation, a state-owned specialised financial institution, founded in 1991, has continuously provided credit insurance and cooperated with commercial banks. Its 4,000 million baht recapitalisation in 2000 has allowed guaranteed credit lines for a greater number of SMEs.

A new and innovative strategy to lessen loan collateral problems is the establishment of the Assets Capitalization Bureau in 2003. The objective of this strategy is to increase more funding opportunities for firms especially retail businesses and small enterprises, by allowing potential assets of household and firms to be used as collateral for loans.¹⁵

As for equity funding, the two main initiatives are the establishments of venture capital funds and the stock exchange for SMEs called "Market for Alternative Investment (MAI)". In principle, not only will they help raise funds through equity offering but will also help improve firms' debt/equity ratios.

14. By the end of 2004, a total of 224,000 million baht was allocated to the villagers throughout the country. The proportions of allocated funds are 67% for agriculture, 17% for trading, 6 for emergency, 4% for industry and 4% for service.

15. These assets include land and property, leasing and hire-purchasing contracts, permits to utilise public lands and other licenses or permits, intellectual property, and machines.

- *Venture Capital Fund*

The government has founded three venture capital funds and also tried to promote this type of funding with tax incentives¹⁶. The goals of this initiative are to look for investors who will invest in shares of potential SMEs looking to long-term objectives and helping the SMEs improve their business capability and efficiency.

- *Capital Market*

The MAI started its operation since 1999 with the objectives to provide an alternative funding channel for SMEs as well as offer a greater range of investment alternatives for investors. This funding channel should allow for lower funding costs compared with bank borrowing. At the present, with the existing tax incentives, there are 27 listed firms in the market.¹⁷

Other than these two initiatives, corporate income tax reduction for the small firms as well as the allowance for special depreciation rates for SMEs' durable assets should also help provide greater funding from increasing retained profits.

4.2 Evaluation of National Policy

The coordinated government measures have been implemented to overcome the obstacles and challenges facing the SMEs but the extent to which these measures are germane to the problems varies, leading to varying degrees of success as well as problems which remain as mentioned in the earlier Section.

On the development side, the effectiveness of government policies in promoting human resource development and management, and technology need to be looked into further. Tangible policies regarding national human capital development will be most crucial in the long term. However, in the short and medium terms, the government efforts to coordinate knowledge and management expertise sharing and training should still be emphasised and promoted.

16. See Appendix 1 for the list of tax incentives.

17. See Appendix 11.1 for details.

On the financial side, government initiatives are more successful on the debt-funding side than on the equity-funding side. In 2003, bank loans to SMEs from the SFIs and state owned banks stood at 152 billion baht, exceeding the target by approximately 40 percent. The expansion of credit guarantee has helped more SMEs to acquire loans from banks especially after the recapitalisation of the Small-Industry Credit Guarantee Corporation in 2000. Moreover, Assets Capitalization has played an increasing role in alleviating collateral problems. In 2004, as many as 220,000 borrowers benefited from this scheme. However, there remain a great number of small firms without access to bank credit due to insufficient collateral. There is a need to foster entrepreneurial capability especially in drawing up good business plans and demonstrating viability to creditors. New credit institutions such as the village funds need further evaluation if they have allocated the funds to the most productive households and whether appropriate repayment incentives are in place. There is only one available assessment in this area by Kaboski and Townsend (2004) who found that, although the village funds help alleviate constraints in existing rural business and agriculture, they are not found to facilitate business investment.

Concerning equity-funding policies, venture capital funds as well as the MAI have fared much less satisfactorily. The venture capital fund scheme has made very little progress since its inception in 1999. Currently, the total value of the three existing funds is far below the government's original targets. So far, less than one hundred SMEs have found counterpart investors. Factors preventing this scheme from taking-off range from inadequate promotion, insufficient information and understanding among SMEs, as well as not conducive regulations (originally providing tax incentives only for SMEs with clear demonstration of innovation). Moreover, embedded risk in the venture fund setting makes it less attractive to most investors with no prior experience.

Table 11.10: Value of Investment in the Three Venture Capital Funds

Funds	Estrablishment	Target (Million baht)	Value of Investment (Million baht)	Number of SMEs
The Office of SMEs Promotion Fund	2004	5,000	145	15
The SME Bank Fund	2003	N.A.	534	28
The One Asset Fund	1999	1,000	492	54

Source: Manager Magazine Online, September 2004.

As for the MAI, even though the goal was set at having 500 listed companies in the market, there are currently only 27 listed firms. The most important factor limiting the number of firms entering the market is their obligations to reveal financial information to the public. It is costly for SMEs outside the MAI to upgrade their accounting practice to meet the required standard. In addition, with a small market size, it difficult to attract investment institutional investors and the market also at times, exhibits excessive price volatility.

The above evaluation suggests that better designed mechanisms and incentives for both debt and equity funding need to be further explored. As Thailand will still be a bank-based economy for many years to come, risk-based lending with proper allocations of funding according to firm's productivity and potentials should be the first priority of policy. However, being an alternative to risk-sharing property, equity funding should still be promoted.

5. Bank of Thailand's Role in promoting SMEs

Although, government initiatives have helped lessen financial constraints of SMEs in general, many still face credit access problems. This Section will start with a discussion about the remaining gap of financial access of SMEs. Existing BOT's policies related to financing of SMEs will be described and end with suggestions for the BOT policies to reduce the gap.

5.1 Remaining Gap: Small Enterprises and Low-income Households

The analysis on financial challenges in Section 3 and government policies in Section 4 have shown that there remain problems for SMEs' demand for funding to be met by credit supply from financial institutions and investors. In the BOT survey, 30 percent of the firms indicating needs for loans from financial institutions in the observations have credit access problems. However, among them, as high as 42 percent of small firms encounter this problem, compared with 23 and 13 percent for the cases of medium and large firms respectively¹⁸. The remaining gaps of funding especially for the cases of small firms are a result of a combination of factors related the SMEs themselves as well as the creditors and investors mainly due to *information asymmetry*. The main reasons the earlier analysis can be summarised as follows:

18. These unofficial organisations are in the form of voluntary gathering of people in the same communities with the main objectives in promoting saving of members, serving small-scale credits to member, and encouraging moral supports among themselves.

- 1) Collateral-based lending is traditional for Thailand's financial institutions.
- 2) Risk-based credit assessment and management of financial institutions have not been fully adopted to differentiate different risk profiles among SMEs.
- 3) Inadequate business experience and financial literacy problems have led to an information revelation problem on the part of SMEs

It should be noted that part of the gap has been partially reduced by the establishment of several evolving unofficial micro-finance units by local community members in various parts of Thailand. These organisations which include credit unions, production-oriented saving groups, trust groups and village banks, are a good examples of relationship-based financial services institutions.¹⁹

However, they still have some limitations in that there are too few networks across groups resulting in low diversification and insufficient loans for the members. Moreover, the lack of leadership continuity as well as lack of good accounting systems are prevalent as they are organised by non-professionals on a voluntary basis.

5.2 The Roles of the Bank of Thailand

The current roles of the BOT in promoting SMEs are on restructuring the Thai financial institutions to allow for better financial access in the medium and long terms and providing direct financial assistance via financial institutions.

5.2.1 Financial Sector Master Plan

This plan is currently playing a major role in reducing the remaining gap. Two main measures of the plan include broadening the general access to financial services and increasing efficiency of the financial sector, which will both directly and indirectly help increase SMEs' access to credit. The former includes measures to promote grass-root financial services, transform the Bank for Agriculture and Agricultural Cooperatives (BAAC) into a rural development bank, and encourage existing financial institutions to increase the level of financial services to low-income households. On the other hand, the latter includes three measures directly related to SMEs - lower capital requirement for qualified retail banks with a focus of lending on retail customers and SMEs, lower risk weights for retails and SMEs (consistent with Basel II) in the loan portfolios of commercial and retail

19. See Appendix 2 for BOT's financial assistance to SMEs

banks, and disentanglement of the Credit Bureau's problems. In addition, measures to streamline rules and regulations, remove impeding regulations, strengthen financial institutions will also enhance the funding channels of loans to SMEs.

Box 11.2: The Financial Sector Master Plan

To develop and strengthen the country's financial system, the Financial sector master plan was launched in 2002. This plan is a guiding principle for the development of the financial sector over the next 5-10 years, with a focus on increasing efficiency of financial institutions and promoting the roles of the capital market. The main objectivess of the plan are to provide:

1. Comprehensive financial services for all potential users, with no significant difference in the level and quality of services between urban and rural areas.
2. Efficient, stable, and competitive financial sector, with a balanced composition of available sources of financing, namely: financial institutions, debt instruments, and equity market.
3. Fairness and protection for consumers.

See the details of the Financial Sector Master Plan in the BOT website: www.bot.or.th

The above measures should help reduce the remaining gap to a certain extent, as they will help lessen the three main problems mentioned in Section 5.1. The corresponding measures for each of the factors obstructing credit access to SMEs are shown in Table 11.11 below.

**Table 11.11: Factors Obstructing Credit Access and
Corresponding Helping Measures in the Financial Sector Master Plan**

Problem	Measures
1. Traditional Collateral-based Lending	• Transforming the Bank for Agriculture and Agricultural Operatives (BAAC) into a rural development bank (providing relationship lending to the larger public) • Promoting grass-root financial services (micro-finance units) through capacity building and a set up of better framework for the long-term
2. Inadequate Credit Risk Management	• Giving more incentives for lending to retail customers and SMEs (consistent with Basel II's criteria) • Lowering capital requirement for qualified retail banks with a focus of lending on retail customers and SMEs. • Encouraging existing financial institutions to increase the level of financial services to low-income household. • Improving credit bureau functioning.
Low Experience and Financial Literacy	• Increasing efficiency of the banking sector by rationalising the structure and roles of financial institutions to better meet customer demand. Encouraging existing financial institutions to increase of financial services to low-income household.

5.2.2 Financial Assistance Programme for SME.

The BOT initiated a financial assistance programme for the SMEs sector in 2000 which extends working capital to SMEs by providing low interest rate loans through commercial banks and the SFIs.²⁰ Although this assistance is not the main focus of BOT's policy, the amount of loans channeled increased quite significantly in 2004, following the increasing trend of SMEs loans in the whole banking system.

20. See Appendix 2 for BOT's financial assistance to SMEs

The summary of channels of government and BOT's policies related to SMEs' financial access assistance at different stages of development is shown in Figure 11.6.

5.3 Policy Recommendation for the BOT

It has been shown that several measures in the Financial Sector Master Plan play a significant role in promoting credit access for Thai SMEs. However, together with the above measures, it is suggested that the BOT emphasise the following principles and policies so that funding will be directed further toward viable and productive SMEs.

Firstly, *relationship based lending* where credit officers have very good understanding about the borrowers' prospects and closely monitor their business conditions, should be encouraged and further promoted especially for very small and start-up firms. Even with possible higher operational costs, this lending practice should allow the creditors to obtain better information about the SMEs and reduce the importance of collateral in loan approval.

Secondly, an *interest rate ceiling policy* is not desirable for SMEs, particularly those which have potentials but are considered having higher risk. This is because the interest rate ceilings prevent potential SMEs from obtaining loans from willing formal sector creditors who know how to assign appropriate prices of funding to higher risk borrowers.

Thirdly, augmenting credit assessment capability of financial institution's credit models (in pricing risk) should be supported, as it will help small and young firms with good business plans (most likely with limited collateral) to gain easier credit access. For example, a Credit Scoring System should be encouraged since it would assist low risk SMEs, formerly without credit access, to enter the formal credit market. Credit risk management of financial institutions should be stressed and monitored closely by the supervisor. Moreover, the SFIs (currently being monitored but not supervised by the BOT) should be encouraged to enhance their credit risk management.

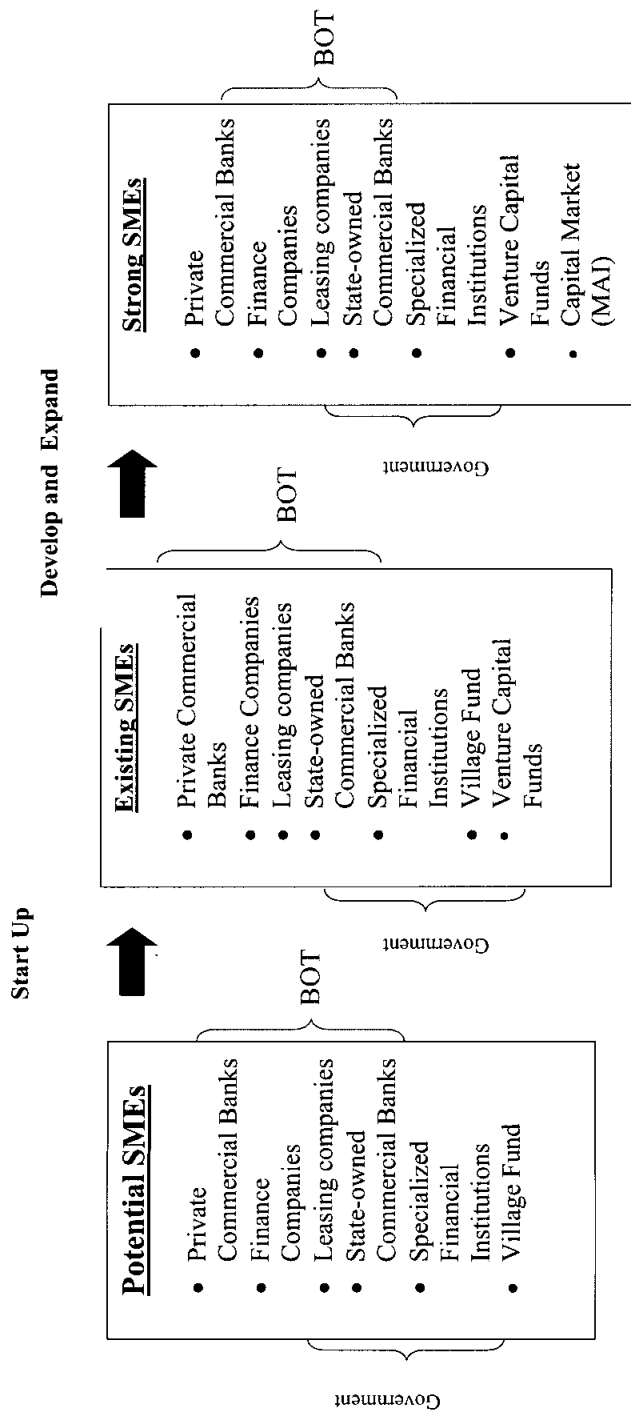
Fourthly, policies related to financial access should pay attention to firms' size, sector, as well as their stages of development and should be differentiated along those dimensions. This follows from the analysis which finds that firms with different characteristics possess different credit access problems. Additionally, the definition of micro size firms should be provided so that those

firms can be distinguished from relatively larger firms in the small size group and, therefore, can be targeted by a different set of policy tools.

Fifthly, the borrowing process should be made easier to comprehend and less cumbersome for firms especially the new SMEs. Creditors and the authorities should have a joint role in providing information and improving financial literacy of SMEs.

Lastly, the functions of unofficial micro-finance units in the financial system should be further studied and promoted because these organisations have good potentials to help reduce the funding gap of SMEs. More networks across these micro finance groups should be increased for better risk diversification and greater availability of loans. Nevertheless, more professional training on management and accounting is necessary for their expansion.

Figure 11.6: Channels of Government and BOT's Financial Access Assistance for SMEs at Different Stages of Development



6. Conclusion and Suggestions

SMEs have a crucial role in the Thai economy as they constitute over 99 percent of registered firms and also account for more than two-third of employment in all enterprises. In addition, their contribution in GDP has been gradually growing since the economic crisis and currently is 38 percent of total GDP.

The focus of this paper is on financial access problems and the analysis relies on earlier works and data from various sources. Based on the studies by Townsend and his colleagues, moderate improvement of financial intermediation in Thailand should lead to significantly higher GDP growth as many households with potentially high entrepreneurship are constrained from credit access by limited wealth.

Second, we find that credit access increases with firms' ages, assets and sales. Asymmetric information facing banks is an important factor limiting credit access for young firms for which information and potentialities are not known to banks. Increasing credit access of firms with higher levels of assets reflects the collateral based lending practice of banks. The structure of sources of funding varies with size and sectors of firms. Medium and large firms and those in the manufacturing sector are found to use significantly more funding from the formal sector and less from the informal sector and owners' saving. Firms' funding structure also leans more toward debt funding (rather than equity funding) as assets and sales reach the medium size criteria and increases even more for the large size firms.

Third, it was revealed that the reported reasons for credit access problems of SMEs differ between borrowers and lenders. According to the point of view of the borrowers, the important reason regardless of firm's size are lack of information and advice from financial institutions as well as complexity and inconvenience on the loan process. On the contrary, from the point of view of the creditors, factors limiting loans to SMEs are inadequacy of collateral, lack of business experience and plans, and poor quality accounting practices.

To cope with the above funding problems, the government has initiated policies related to both debt funding and equity funding. Policies on the debt side include targeting loans for SMEs channeled through the SFIs and commercial banks, working capital for the rural areas through the Village Fund Project, and Assets Capitalization. On the equity-funding side, the two main initiatives are the

establishments of venture capital funds and the stock exchange for SMEs called "Market for Alternative Investment (MAI)".

So far, the government initiatives are more successful on the debt-funding side than the equity-funding side. Bank loans to SMEs have increased but there remain a number of small firms without access to bank credit due to insufficient collateral and lack of ability to demonstrate feasible and viable business plans. Till date, most firms still do not possess enough information and qualifications to participate in the sophisticated schemes of equity funding.

Another problem facing the SMEs as well as the creditors and investors mainly is information asymmetry and therefore, it is essential to enhance information exchange between the SMEs and the creditors/investors. Several of BOT's measures have been geared towards improving the structure and giving more appropriate incentives for financial institutions. The 2002 Financial Sector Master Plan, which attempts to increase efficiency of banks, promote information flows through improvement of the credit bureau, and reduce overlapping roles of certain financial institutions, will broaden financial access to meet the needs of households and firms. Furthermore, an expansion of the BAAC's role to become more akin to a rural development bank will help extend relationship-based loans to the rural areas. The adoption of Basel II criteria will lower risk weights for loans to retail customers and SMEs, and therefore increase incentives for commercial banks to provide retail and SMEs loans.

Together with the above measures, it is suggested that BOT emphasise the following policies so that funding will be further directed further towards viable and productive SMEs. First, relationship based lending, where credit officers know the borrowers very well, should be encouraged and promoted. Second, an interest rate ceiling policy is not desirable for SMEs which have potentials but are considered to have higher risk. Third, augmenting credit assessment capability of financial institution's credit models (in pricing risk) should be supported as it will help small and young firms with good business plans (most likely with limited collateral) to gain easier credit access. The SFIs should be encouraged to enhance their credit risk management. Fourth, credit policy should pay attention to firms' sizes and sectors, as well as their stages of development and be differentiated along those dimensions. The definition of micro (very small) firms should be provided as they need a different set of policy tools. Fifth, the borrowing process should be made easier to comprehend and less cumbersome for firms especially the new SMEs. Creditors and the authorities should have a joint role

in providing information and improving financial literacy of SMEs. Lastly, the functions of unofficial micro-finance units in the financial system should be further studied and promoted.

For further studies, it is suggested that firstly, data concerning productivity and innovation of SMEs should be further explored and incorporated into the assessment on their long-term contribution to the economy. Second, conducting a survey on bank's SMEs lending behaviour will help in understanding the depth of problems from various factors better. Finally, the investigation into household credit constraint problems from the BOT survey in the next stage should allow the analysis of this problem more thoroughly especially in the case of potential SMEs.

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Appendix 1 : Statistics of Data from the BOT Survey According to Firm's Size

Characteristics for Firms with Different Sizes

	Total	Small firm	Medium firm	Large firm
Number	1,195	555	440	200
Age	15.8	13.3	17.7	18.6
Asset *	2.6	1.5	2.9	4.8
Sales **	2.6	1.6	3	4.4
Number of firms with foreign partnership	153	24	77	52
Number of firms outside cities	1,072	510	392	170

Classifications of Assets and Sales

Amount of Assets*	Amount of Sales**	Class
Assets below 5 million baht	Sales below 5 million baht	1
Assets between 5-50 million baht	Sales between 5-50 million baht	2
Assets between 51-100 million baht	Sales between 51-100 million baht	3
Assets between 101-200 million baht	Sales between 101-200 million baht	4
Assets above 200 million baht	Sales above 200 million baht	5

Credit Access According to Firm's Size

	Total	Small firm	Medium firm	Large firm
Number of firms	1,195	555	440	200
Number of firms who need loans from formal sector	899	381	348	170
Number of firms who have difficulties getting loans from formal sector	266	163	81	22
Percent of firms encountering credit access problems	29.59	42.78	23.28	12.94

Appendix 2 Regression Results Concerning Factors Influencing Choices of Funding

Number of Observation = 1195

Explanatory Variable	Primitive funding		Formal Sector Funding		Advance Funding		Equity fund		Debt funding	
	Coefficient	t-Statistics	Coefficient	t-Statistics	Coefficient	t-Statistics	Coefficient	t-Statistics	Coefficient	t-Statistics
Constant	69.11	14.71	27.28	5.57	-0.95	-0.74	61.42	11.68	26.29	5.18
Dummy for Foreign ownership	4.11	1.11	-15.34	-4.10	3.09	3.04	16.25	4.31	-16.25	-4.31
Dummy for Rural Area	6.39	1.63	-4.28	-1.09	0.26	0.24	4.10	1.03	-4.10	-1.03
Log(age)	-2.00	-1.70	0.90	0.76	0.25	0.76	-0.74	-0.62	0.74	0.62
Dummy for Asset between 5-50 million baht	4.85	1.52	-1.86	-0.54	-0.46	-0.52	1.45	0.42	-1.45	-0.42
Dummy for Asset between 51-200 million baht	-17.05	-4.16	13.23	3.14	0.87	0.78	-10.17	-2.39	10.17	2.39
Dummy for Asset above 200 million baht	-18.87	-3.55	16.30	2.96	5.24	3.58	-9.52	-1.71	9.52	1.71
Dummy for Sale between 5-50 million baht	-3.79	-1.13	2.88	0.79	-0.35	-0.37	-5.11	-1.50	5.11	1.50
Dummy for Sale between 51-200 million baht	-15.53	-3.69	12.82	3.00	0.54	0.46	-12.47	-2.89	12.47	2.89
Dummy for Sale above 200 million baht	-28.46	-5.80	20.30	4.06	-0.49	-0.36	-21.95	-4.35	21.95	4.35
Dummy for Manufacturing Sector	-7.51	-2.44	7.63	2.08	1.41	2.04	12.29	3.54	12.29	3.54
Dummy for Services Sector			-3.10	-1.03			10.66	2.69	1.63	0.46
Dummy for Wholesale Sector			-2.65	-0.73	0.05		9.01	2.43	3.28	1.08
Adjusted R-squared	0.16		0.09		0.04		0.07		0.07	
S.E. of regression	37.87		38.07		10.45		38.40		38.40	
Durbin-Watson stat	1.85		1.88		1.83		1.89		1.89	

APPENDIX 3 : Tax Benefits for Small and Medium Enterprises in Thailand

Tax benefits	
1	Reduce corporate income tax rate for Thai company with paid-up capital of 5 million Baht and below. These companies are subject to a Corporate Income Tax (CIT) rate of 20% on net profit of up to 1 million Baht (in the process of lowering to 15%) and 25% on net profit over 1 million Baht up to 3 million Baht. Profit exceeding 3 million Baht is subject to CIT ordinary rate of 30%.
2	Thai company with durable assets (excluding land) less than 200 million Baht and hiring employee less than 200 people grant an initial allowance on assets as follows: • Computer hardware and peripheral can depreciate on the acquisition date at 30% of its total cost. The remaining will be depreciated at a regular rate for at least 3 accounting periods. • Durable building and plant can depreciate on the acquisition date at 25% of its total cost. The remaining will be depreciated at a regular rate not exceeding 5% of the total cost per annum. • Machinery and equipment can depreciate on the acquisition date at 30% of its total cost. The remaining will be depreciated at a regular rate not exceeding 25% of the total cost per annum.
3	Full corporate income tax exemption for qualified venture capital (VC) company on dividend income and capital gain from sale of stock receiving from investing in Thai company with durable assets (excluding land) less than 200 million Baht and hiring employee less than 200 people. A qualified VC company must be as the following: • A company incorporate in Thailand which doing venture capital business as prescribed in Ministerial Notification with capital not less than 200 million Baht and paid-up capital at least of 50% in the first year. The remaining capital will be paid up within 3 years starting from the date of registration. • VC company must be registered with the office of Securities and Exchange Commission (SEC) within 3 years from 31st January B.E.2545. • VC company must have share of paid up capital in SMEs not less than 20% for the first year, 30% for the second year, 70% for the third year and 80% for the forth year. • VC company must hold SMEs stock for at least 7 consecutive years or at least 5 years if that SMEs can register in Stock Exchange of Thailand. • A manager of VC company must hold a securities business license in a type of joint investment management which is approved by the offices of the securities and exchange commission (SEC).
4	Income tax exemption on dividend or income from sales of securities receiving from the VC's exempt income.
5	Extend income base for small enterprises that have not to register in value-added tax system form 1.2 to 1.8 million Baht.

Source: Revenue Department of Thailand

APPENDIX 4: BOT's Financial Assistance to SMEs

Financial Assistance Scheme	
1. Objective	To provide working capital support to SMEs.
2. Procedures	Extending low-interest loans through commercial banks, finance companies, finance and securities companies and the Specialized Financial Institutions.
3. Eligible Enterprises	Manufacturing industries, handicraft and household industries, services, wholesale and retail trades, and sub-contracting businesses. The BOT reserves the right to withhold financial assistance to any enterprises as it deems appropriate.
4. Size of SMEs and Amount of Refinancing	Depend on the judgment of each financial institution.
5. Amount of Refinancing	BOT: 60% of the total value of promissory notes issued by SMEs Financial institution: 40% of the total value of promissory notes
6. Minimum Value of P/N	Baht 10,000
7. Maturity of P/N	Not exceeding 120 days from the day P/N is issued.
8. Interest Rate	• BOT : 1% p.a. for the amount purchased which is 60% of the amount of the promissory notes. • Commercial banks : not more than each bank's MLR minus 2.75% p.a.. • Special Financial Institutions (SFI) : not more than each SFI's Prime Rate minus 2.75% p.a.. • Other financial institutions: not more than the average MLR of the 4 largest banks minus 2.75% p.a..
9. Duration of financial assistance	Not more than 5 years.
10. Penalty	5.0% p.a. with respect to amount and duration involved.