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Unleashing SMEs to Drive Jobs and Growth: Beyond Financing

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- Small and medium sized enterprises (SMEs) are the key to employment and innovation in Asia, but they are often starved of credit, information and support services. Over 90 per cent of companies in Asia are SMEs and they contribute to over 60 per cent of GDP, and more than two-thirds of employment and most innovations. As Asia seeks to transition to a new era of growth, correcting these weaknesses will often determine success or failure.

- SMEs are hindered not just by a lack of financing, but also by serious non-financial constraints, such as insufficient skills and technology, high transaction costs, poorly defined property rights, inadequate market access and poor coordination of government SME support.

- Asia needs to promote SME development in a more holistic manner, with closer public-private collaboration to create a supportive and technology-enabled ecosystem for SMEs to thrive:

  Government
  - Provide a one-stop agency for SME development
  - Establish standardized systems to improve information databases and create integrated payments and Internet retail trading platforms for SMEs

  Financial Sector
  - Offer both equity and debt financing options, and capitalize on supply chain finance to improve credit availability
  - Develop new business models by leveraging on new technologies

  Business Sector and Chambers of Commerce
  - Provide mentoring and guidance on marketing and distribution to SMEs
  - Improve understanding of how to link with global supply chains

  Educational Sector and Academia
  - Design curricula, vocational training and apprenticeship programs to develop the right skills for SMEs
  - Participate in periodic joint review and feedback work on the effectiveness of SME programs for innovation, job creation, exports and national competitiveness

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A jobless recovery is the biggest threat to social stability worldwide. Across economies, SMEs are a major source of job creation and growth. In 2010, SMEs accounted for more than 60 per cent of GDP and provided more than 90 per cent of employment in both developing and advanced economies[1]. The promotion of a strong SME sector is key to growth, innovation and jobs – and job creation is the most effective route to poverty alleviation. Removal of supply-side barriers to SME development is a necessary but not sufficient condition for success. SME growth also depends on demand-side policy measures that enhance domestic consumption through product innovation.

There is no single global definition of what constitutes an SME. However, the common criteria include the number of employees, size of revenue and assets.

The definition of the European Union is as follows:

	Medium Enterprises	Small Enterprises	Micro Enterprises
No. of Employees	<250	<50	<10
Revenue	< €50 million	< €10 million	< €2 million
Or Total Assets	< €43 million	< €10 million	< €2 million

Source: http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/

The most successful example of fostering SME development is the "German Mittelstand" model. "German Mittelstands" are considered as the most innovative SMEs globally, and are two to three times more profitable than large enterprises[2]. Their success reflects a long history of craft guilds, chambers of industry, banks and local governments working together in creating a supportive SME ecosystem, embracing high equity ownership, well-defined property rights, a collaborative spirit between labor and management, anti-monopoly institutional frameworks, early adoption of public-private partnerships and a strong tradition of vocational training[3]. The Mittelstand today has a global outlook, seeking regional and global opportunities. Its success is due to the fact that it is engaged in both tradables and non-tradables, since many German SMEs are also service-oriented and engaged in manufacturing of tradable products.

In many countries, especially in emerging markets, SME growth is hampered by structural financing constraints. A recent joint International Finance Corporation-McKinsey study reveals that there are about 365 to 445 million micro, small, and medium sized enterprises (MSMEs) in emerging markets. Of these, 85 per cent still face credit constraints, with a credit gap of US$2.1–2.5 trillion. This gap widens to US$3.1-3.8 trillion when high-income countries are included[4,5].

However, lack of finance is only part of the problem. SMEs are also constrained by substantial non-financial barriers. Addressing financing constraints in isolation is not enough. Policymakers need to consider the full range of issues confronting SMEs, including SME financing, entrepreneurship and skills development, innovation and technology, market access and the overall appropriate public policy framework for SME development:

- *Lack of access to appropriate forms of finance and capital.* In Asia, SMEs mostly rely on informal sources of financing or their families and friends. A wider range of financing mechanisms, including bank loans, supply chain finance provided by non-banks, angel investing,

[1] *IFC (2010), Scaling-Up SME Access to Financial Services in the Developing World.*
[2] *Finanzgruppe Deutscher Sparkassen – und Giroverband (2012), Diagnose Mittelstand 2012. http://www.dsgv.de/_download_gallery/Publikationen/Diagnose_Mittelstand_2012.pdf*
[3] *SBA Factsheet 2012. http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2012/germany_en.pdf (See Annex 1).*
[4] *Small Business Act (SBA) for Europe FactSheet. 2012 Germany. http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2012/germany_en.pdf (See Annex 1).*
[5] *Page and Soderbom (2012), Is Small Beautiful? Small Enterprise, Aid and Employment in Africa. http://www.wider.unu.edu/publications/working-papers/2012/en_GB/wp2012-094/*

venture capital and small-cap equity markets are not quite accessible for SMEs in developing economies. Also, SME loan approval, risk management, and loan recovery functions remain largely centralized, which slows down decision-making and reduces the ability to make appropriate risk judgments based on local knowledge[6]. Ideally, SME lending decisions are best left to those with local knowledge of the SMEs' operations. SME owners typically cite speed of credit access as more important than interest rate costs in evaluating credit offerings.

- *High transaction costs.* SME financing is typically at a high interest rate, with a more cumbersome loan approval process as requirements still remain geared to large corporate customers in many circumstances. SMEs' scale and cost structure make traditional and broadly available electronic payment methods and credit transfer less feasible. Cost of cross-border payment is further increased due to the lack of alignment with global open payment standards.

- *Lack of information and collateral assets.* Banks often base their lending decisions on collateral and credit history, and less on a business plan and projected future cash flows. However, as "opaque" borrowers, due to the lack of proper accounts, credit history and collateral assets, SMEs are often unable to get access to finance, especially in the absence of an implicit government guarantee. Financial technology providers that use online tools are increasingly competing with banks because they provide business-to-business platforms for SME trading, and have better flow data and real-time credit feedback from customers to assess credit risks. Innovative platforms, such as Quickbooks Financing[7], use lenders allowed to access SME accounting software to analyze SME credit worthiness.

- *Insufficient knowledge and skills with limited resources for innovation and technology improvement.* New and inexperienced entrepreneurs may not have the required skills and managerial capacity to exploit new opportunities and markets fully. Also, constrained by the small scale of their operations, SMEs cannot afford expensive new technology or spend on research and development activities.

- *Inadequate market access.* SMEs find it difficult to network with other institutions beyond their home market. This limits their access to global supply chains and their integration into the international markets.

The main objective of an SME policy framework is to improve the institutional context and ecosystem in which SMEs are operating. There are four key dimensions to the policy framework: 1) determining the overall policy approach, namely the respective roles of government and business; 2) enabling a sustainable SME financing sector; 3) strengthening talent and the role of education; and 4) harnessing technology.

A holistic policy strategy requires the government to focus on a bottom-up, sector-led approach and the provision of a top-down, coordinated and integrated initiative to gain the support of the business and academic communities, encouraging them to take ownership.

The German Mittelstand bottom-up model depends on business associations, unions, craft guilds and academia working with the German government, mostly local, to upgrade their technology, management skills and global reach. The government assumes a supportive role in SME development, reducing red-tape, providing tax incentives, research and development programs for SMEs, seed funding and loan guarantees for high-tech startups.

[6] *Beck, Kunt and Peria (2008). World Bank Working Paper. Bank Financing for SMEs around the world: Drivers, Obstacles, Business Models and Lending Practices*

[7] *Tech groups tap big data to boost SME lending, FT.com, 29 Nov. 2013.*

In contrast, a top-down approach, adopted by South Korea, Malaysia and Singapore, uses an SME Master Plan and/or the creation of a one-stop SME agency that is responsible for coordinating and approving all SME development efforts. Whatever approach is taken, good feedback mechanisms from SMEs and markets are vital for policymakers to act proactively and quickly in anticipating and addressing emerging SME issues in the face of radical uncertainty and rapid changes in the business environment.

Establishing a sustainable SME financing sector includes increasing the incentives for banks to lend to SMEs, and promoting non-bank SME financing, especially start-up equity. Regulators can always either mandate or use informal guidance to steer banks towards greater SME lending. For example, the UK government backed a bank-led initiative, the Regional Growth Fund for SMEs in November 2011.

Improving the ecosystem for SMEs requires higher transparency and information integrity. Policymakers can help with the creation of credit databases in two major ways. First, they can enforce standardized financial reporting requirements (International Financial Reporting Standards (IFRS)) for SMEs to create an improved information base. Second, they can give banks the flexibility to set lending rates to reduce information costs and enhance the profitability of SME loans.

There are different experiments with developing non-bank-lending sources for SMEs. An experiment in equity injection for SMEs is the China Hi-Tech Property Exchange, which provides stock equity transfer, venture capital investment, as well as an information platform for investors and SME issuers/borrowers[8]. Moreover, trade finance via banks currently accounts for 30 to 40 per cent of SME credit. Measures that diversify such dependence on banks, including leasing, factoring, securitization and supply chain open accounts, would ensure more sustainable sources of funding for SMEs.

Attracting and retaining the right talent is a critical bottleneck for many SMEs in their future growth. Vocational training is critical. Germany has been particularly successful in building a national culture where vocational training is seen as a natural and much-valued career path. Vocational training can be provided by a range of institutions, such as government entities, business training by academic and professional bodies and chambers of commerce, and SMEs who themselves focus on this market opportunity. Governments can help underwrite training and research and development through voucher programs and targeted grants.

Finally, reshaping the SME ecosystem will depend on the use of technology. Internet and technology-based transactions have opened up global markets and customers and suppliers for SMEs through business-to-customer and business-to-business models such as e-Bay. Technology can improve access to information and reduce transaction costs. For example, Alibaba has harnessed the data generated from its internet business in order to gain a deep understanding of the credit risk of its customers, having extended as of July 2013, over RMB100 billion (US$16 billion) to more than 320,000 small businesses in three years[9].

However, innovative technology-based SME business and financing need proper government policies to address potential risks, build trust, improve efficiency and ensure a level playing field. The Korean government adopted nation-wide broadband in 2000 as a deliberate policy to establish Korea as a leader in e-commerce and the world's most connected society. The European Commission has plans to promote widespread cloud use and cloud provision as the basis for greater communication and coordination between government departments and between government and SMEs.

[8] *Bloomberg Business News. 2013. http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapid=54342347*

[9] *http://www.bloomberg.com/news/2013-07-14/billionaire-ma-s-aliba-ba-gets-nod-to-stir-up-loans-china-credit.html*

The importance of government-backed standards of reporting, processes and technology is critical to the data integrity, privacy and anti-fraud problems brought about by technological change. Alibaba's expansion into SME lending raises questions about how these non-bank lending activities are best regulated, such as competition issues in banking, for example, capital requirements on risk-weighted assets. Furthermore, regulations on data security and the precise mechanics of online transactions determine gains from online or mobile transactions.

Ultimately, success in SME development at the firm, supply chain, sector or national level is a question of governance. A strong SME sector can be a major source of job creation, growth and innovation. It depends, however, on creating and maintaining a strong, supportive ecosystem.

SME development strategy cannot be independent of national strategy on industrialization, education, national technology and innovation and employment. Given the different levels of development, institutional and talent capabilities, there is no one-size-fits-all policy or implementation model for SME development in Asia. However, there are ample experiences from a number of successful models of SME development from which Asian economies can learn to adapt for domestic conditions.

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