

Financing SMEs in Central and Eastern Europe

Some introductory notes

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Introduction

- Small and medium enterprises play a central role in the growth process of CEE countries. Understanding whether SMEs face severe financing constraints, impeding their performance and their expansion is thus of paramount importance.
- In addition to the quantitative access to finance by SMEs, it is also increasingly important to understand the role of the nature of such financing: maturity of loans, currency denomination.
- Furthermore, it is increasingly apparent that many SMEs require a package of services, of which credit is only one component. Finally, it is important to ask whether for SMEs market-based finance can be a relevant complement to bank loans.



Are SMEs severely financially constrained in CEE countries?

Evidence from EBRD surveys (BEEPs) suggests that SMEs are financially constrained, both for their fixed investments and for working capital. The degree of such constraint appears much stronger than for larger firms.



Evidence from EBRD surveys

Table 1
Financially constrained firms
(in per cent of the sample)

	Small firms		Medium firms		Large firms	
	Without bank loans	Without bank loans and financially constrained	Without bank loans	Without bank loans and financially constrained	Without bank loans	Without bank loans and financially constrained
CEB	60.8	27.3	41.9	13.1	29.2	7.4
SEE	59.7	29.1	39.8	15.9	32.1	11.0
CIS	67.5	34.9	51.5	24.4	45.8	13.4
Germany	37.2	14.6	24.6	9.8	15.3	4.8

Source: BEEPS 2005

Notes: A firm is classified as "small" with fewer than 49 employees, "medium" with between 50 and 249 employees, and "large" with more than 250 employees. A firm is "financially constrained" if it does not have a loan, while it is either in the process of applying for a loan, has already applied but was rejected, or has never applied for a loan, but report that it would need one.



How different banks approach financing to SMEs?

Privatized banks owned by foreigners seem to penalize SMEs; not newly create foreign-owned banks



By banks type

Table 2

Portfolio composition by bank type (in per cent of total lending), 2005

	Newly created foreign banks	Privatised foreign banks	Private domestic banks	State-owned domestic banks	Small banks	Large banks	CEB	CIS	SEE
Mortgages	12.1	11.7	5.8	1.6	7.7	14.7	17.5	2.5	6.8
Other consumer lending	18.3	18.1	14.0	16.4	15.4	15.4	16.5	12.0	19.1
SMEs	41.1	27.0	47.0	31.3	56.9	28.4	31.7	46.6	45.3
Large enterprises	15.0	23.7	27.4	9.0	12.5	26.3	13.4	28.8	16.9
State-owned enterprises	3.6	3.8	2.4	14.2	4.3	3.4	3.9	3.6	3.8
Other	9.9	15.6	3.5	27.4	3.2	11.8	17.0	6.5	8.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BEPS, Bankscope

Note: Bank is classified as "Small" when it's total assets are less than 200 US\$ millions; "Medium" when between 200 \$US millions and 1 \$US billions; "Large" when above 1 \$US billions. This classification follows Haselmann and Wachtel (2006)



Role of institutions

- The improvement in both the quality of the legal system and in bank regulation increases the share of loans to SMEs



Basel II and SMEs: Soft and hard information on SMEs.

- It is likely that a large share of banks, especially foreign, will adopt the system of internal rating foreseen in Basel II.
- It is still unclear whether this will imply more restrictive credit policies towards SMEs.



Credit and services

- For many SMEs availability of credit may not be the main constraint, as their profitability may allow them to finance investment from their own resources.
- Technical advice on different areas of enterprise development may actually be a more severe bottleneck. Credit lines combined with technical advice could be a key factor for SMEs growth.
- This issue relates to a broader question on the efficient use of credit by SMEs.



Credit diversion

- In a micro study on Bulgaria and Romania we found that a significant share of loans to SMEs get diverted to personal uses of firms' owners.
- This raises issues on the optimal design of loans to SMEs in CEE countries.



Percentage of firms involved in a given activity after receiving a bank loan, 2004

	Empl < 10	Empl >10
Expanded production	65	57
Maintained production at existing level	28	26
Hired new workers	9	23
Maintained existing workers in employment	34	26
Hired skilled workers	7	19
Repaid older loans	24	17
Made personal purchases	24	12
Developed a major new product line	18	20
Upgraded an existing product line	29	19
Introduced new technology	10	14
Opened a new plant	5	7
Agreed a new joint venture with foreign partners	3	2
Obtained a new licensing agreement	4	4
Incorporated major production activity prev. outsourced	2	1
Other	53	59



Banks vs. markets

- Even though bond market and private equity are still a minor component of financing SMEs in CEE countries, market based finance may play a key role, especially because of some difficulties lined to the ability of banks to effectively finance SMEs.
- As one of the key issues in SMEs growth is the expansion of firms, the dynamism and the innovation associated to SMEs development, market based finance could play a much more important role.
- IFIs can contribute to the development of local currency bond markets for SMEs, as well as venture capital financing.

