EXECUTIVE SUMMARY

Findings from ERIA's SME research project in FY 2009 confirms that access to finance is amongst the most critical factors determining the competitive readiness of regional SMEs and their ability to fully exploit and participate in the global economy and business opportunities from regional economic integration and, in particular, participation in regional production networks. Well recognized in the literature, access to funding is the lifeblood of any enterprise, enabling it to grow, and to generate more output and employment. There is considerable evidence to support the contention that SMEs, in particular, face a number of obstacles and problems in accessing finance, mainly related to their limited resources and perceived risk by lenders. This is particularly problematic and worrisome for policy makers, given that SMEs and entrepreneurship are widely recognized as being the key sources of dynamism, innovation, and flexibility in advanced industrialized, emerging market and developing economies, and are major net job creators in these economies. Without access to finance, SMEs are unable to invest, impairing their capacity to: improve productivity; raise competitiveness; promote innovation; generate employment; and contribute to economic growth and development.

1. Objective and Scope of the Project

This report attempts to shed some lights as comprehensively as possible on the issue of SMEs' financing in selected East Asian economies (Cambodia, China, Indonesia, Laos, Malaysia, Philippines, Thailand and Vietnam) using a uniform questionnaire survey, with the intention of elaborating upon the following questions: (i) what are the major sources of external finance for SMEs, (ii) what is the extent to which, if any, the SME sector identified by size, country, and in aggregate for a sample of countries in East Asia is systematically disadvantaged, or rationed, with respect to access to external financing, (iii) what are the key factors contributing to the extent of this rationing (stringent requirements) focusing upon firm characteristics, owner characteristics, and firm performance, and (iv) what is the importance of rationing for the performance of SMEs in a sample of East Asian economies.

The first three chapters cover the overview, theoretical framework of the study, and the integrated chapter using the whole sample of SMEs in the project. The next chapters are dedicated to country-specific study, starting from less developed ASEAN countries, which include Cambodia, Lao PDR, and Vietnam, followed by four chapters on Thailand, Malaysia, Indonesia, and the Philippines. The final chapter is on China. These chapters on individual country provide interesting findings that contain both common and different problems and policy implications for SMEs' access to finance.

2. Summary of the Key Findings

Findings from the integrated chapter can be summarized as follows. First, although a significant number of SMEs still rely on their internal resources for both start-up and business expansion, external finance is very important for aspiring smaller domestically owned companies in less developed economies which make lower profits and which have insufficient access to funds. Moreover, the size of the SMEs and stage of the country's development (reflecting the financial market conditions) also affect the diversity of choices of financial institutions and financial products that SMEs can access.

Second, there is potential for credit rationing, or risk premiums exercised by the financial institutions on SMEs. The key findings from our analysis suggests that size and stage of country development (financial market development) do affect the conditions of external finance offered to SMEs, i.e., larger SMEs in more developed economies tend to get bigger loans, with longer terms, and at a lower interest rate than otherwise.

Third, the results suggest that the owners' net worth, collateral, business plan, financial statement, and cash flow are critical for financial institutions in devising the financial conditions they extend to SMEs. In other words, financial intuitions seem to put higher risk premiums on opaque SMEs by offering less favourable financial conditions to less well-established and transparent SMEs.

The last two findings suggest that financial institution behaviour is strongly linked to the legal, institutional and regulatory legal environment in which they operate. In an economy where the legal system does not adequately protect property rights and a bankruptcy law is lacking or non-existent, where there are inefficiencies in the operation of institutions themselves and the regulatory environment is lacking in terms of disclosure and transparency requirements relating to firm operations, it would be perfectly rational for financial institutions to restrict credit or impose a risk premium on opaquely operating enterprises. Consequently, problems in accessing finance for SMEs may not be due solely to distortions or inefficiencies in the financial sector itself, but also by weaknesses in the legal, institutional and regulatory environment in which these institutions operate.

Finally, financial access has a significant impact on SMEs' innovation capability and participation in the export market. The study suggests that bigger SMEs with access to larger loans with longer terms and at a lower interest rate are more capable of innovation and exporting activity, since these external finances with favourable conditions would provide SMEs enough time and resources to innovate and enter foreign markets.

3. Policy Implications

In order to address these shortcomings in terms of SMEs' access to finance, particularly in emerging market and developing economies, a number of policy measures need to be addressed and in particular the following:

a. Macroeconomic Policy

Regional governments, particularly in emerging market and developing economies, will be required to maintain frugal and sustainable macroeconomic policy settings. Overly expansionary macro policy measures that contribute to sizeable budgetary imbalances and inflationary pressures would reduce the availability and increase costs of finance for productive firm investment in the private sector. This will further compound difficulties faced by private sector SMEs, in particular, in gaining access to finance. Government policies that place emphasis on rapid industrialization through discriminatory measures that favor large firms will also add to the problems facing SMEs wishing to gain access to finance.

b. Financial Market Reforms

Measures will be required to deepen and broaden financial markets in regional economies with the aim of encouraging greater competition in terms of providers, reducing the cost of borrowing, and greater provision of sources of finance (non bank financial institutions, equity markets, venture capital markets etc.) that will enhance the provision of diversified products and services, bringing them more into line with meeting the needs of SMEs.

c. Legal and regulatory reforms

Empirical results suggest that smaller SMEs in emerging market and developing economies have serious difficulty in obtaining finance, and face higher interest rates. This is not surprising, and consistent with the literature, in the context of economies where a lack of transparency in firm operations and poor corporate governance contributes to asymmetric information and greater lending risk as perceived by financial institutions. In this context it is essential to implement policy measures aimed at improving the legal, institutional, and regulatory framework. The legal framework should ensure property rights and contain provisions that protect lenders against bankruptcy and delinquent loans, encouraging lending institutions to lend to SMEs. In addition, they should also contain provisions that ensure access to land and land-use rights, which is particularly important for SMEs as a source of collateral in emerging market economies.

The institutional and regulatory framework should also encourage the formal registration of SMEs and not contain bureaucratic and regulatory processes that make the costs of formalization (compliance costs) greater than the benefits obtained from formalization. Finally, the regulations should be as transparent and simple as possible, aimed at improving corporate governance and transparency arising from the adoption of stringent book-keeping and accounting standards.

d. Microeconomic Policy

Microeconomic policies aimed at opening up markets and creating a level playing field for all enterprises will encourage more efficient resource allocation and improve productivity. The establishment and nurturing of a vibrant SME sector will encourage greater competition. This should also be encouraged in the financial sector, with the objective of, promoting access to finance in general as well as reducing the cost of finance.

The government should encourage the establishment of industry organizations for SMEs that will represent the interests of members and provide market information and capacity building. Closer bank-client relationships should be fostered to overcome some of the problems relating to asymmetric information and moral hazard.

It is necessary to introduce credit guarantee schemes subject to rigorous and viable business plans, credit rating, and information systems. Establish specialized and more effective development financial institutions such as an SME bank, and the provision of business development services such as basic business training (e.g. management, business planning, book keeping, accounting, and financial literacy) and network promotion.

In the more developed economies, governments need to play a targeted role in establishing venture capital markets, in collaboration with the private sector, for high tech SMEs, as well as access to equity markets. Target wealthy entrepreneurs/owners to establish new firms or expand their existing businesses, upgrading skills and innovation capability etc. Moreover, business-friendly environment is also essential to welcome foreign owned enterprises to establish in the country, or establish majority foreign owned joint ventures with local SMEs.