FINANCING SME IN EMERGING ECONOMIES

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Rezumat:
This paper explores the degree of financial market integration between the new and old EU member states, it also considers the likely effects of the ongoing integration process on the new members' financial sectors. In particular, the paper discusses the implications of the high concentration of financial services and the dominance of foreign-owned institutions for the provision of financial services to small and medium-sized enterprises (SMEs) in the accession countries. Using enterprise data on a certain number of companies, the paper finds that access to finance still constitutes a major problem for business development and that financing conditions are considerably more difficult for SMEs than for larger entities.

Financial inegration, financial development, economic growth

A common presumption in the literature on financial integration is that it spurs financial development in the less financially developed regions or countries of the integrating area. The financial systems and their degree of sophistication should therefore become more similar, in the sense that the less developed financial sectors catch up and move towards the standards of the most financially developed sectors. Financial integration should thus increase the supply of finance in the more backward regions. This should be reflected in an expansion of the national financial systems of these countries.

There are basically two ways by which integration could have an effect on the development of national financial markets. Firstly, financial integration is expected to improve the efficiency of the financial intermediaries and markets of the less financially developed countries. As integration facilitates the actual or potential market entry of foreign institutions to the financially less developed market, domestic institutions will find themselves exposed to increased competitive pressure from more sophisticated and cheaper foreign intermediaries.

Foreign institutions may choose to enter the market via direct penetration or cross-border acquisitions of intermediaries. Banks that extend their operations abroad are likely to be among the most efficient in their home country and can be expected to outperform the local banks. This is likely to set new standards in management and efficiency, and enhance the quality and range of financial products offered. Domestic institutions will increasingly face pressure to improve their own efficiency by cost-cutting and organisational restructuring to secure profitability. The competitive pressure should thus erode the local banks' rents and lead to a more efficient financial market with better credit conditions for firms and households.

Secondly, as a rule, financial integration would require an improvement in the regulation and supervision of the national financial market. Issues such as banking supervision, corporate governance, accounting standards and auditing procedures need to be brought in line with best practices in the integrating area to guarantee a "level playing field" (Gianetti *et al.*, 2002). An improvement in the regulatory standards of less developed financial markets should not only reduce the vulnerability of these markets, but may also help to promote their development by reducing adverse selection as well as the distortions induced by inadequate regulation.

There is a firm consensus nowadays that a well-functioning financial sector is a precondition for an efficient allocation of resources and the exploitation of an economy's growth potential. While there is still an ongoing debate on the exact transmission channels from finance to economic activity, and its quantitative impact in particular, a large and growing amount of empirical research has documented a robust correlation between finance and growth and a causality running from financial development to economic growth. The economic literature highlights three main channels by which financial development can affect growth. Firstly, a more efficient financial system reduces the cost of financial intermediation and hence raises the fraction of savings funnelled to investment. The more efficient the transformation of savings into investment, the lesser the loss of resources, and the more savings are channelled towards productive investment .

Competition and increased efficiency should bring interest-rate margins down, and the availability of credit to firms and households should correspondingly tend to increase.

Secondly, a well-functioning financial sector is a precondition for the efficient allocation of resources, and improvements in financial intermediation may ameliorate the allocation of resources across investment projects. A better trading, hedging and pooling of risks allows the funding of highly profitable, but risky investment projects that would be relinquished otherwise. The more advanced financial systems become, the better they should be able to deal with the problems of asymmetric information that are persistent in financial markets.

This should further reduce the cost of financial intermediation. Moreover, a more sophisticated financial sector should be more capable of distinguishing between good and bad investment opportunities, increasing the social marginal productivity of capital.

A third way by which financial development could affect economic growth is through influencing households' savings rate. While the effect in the two channels mentioned before is generally positive, it is ambiguous in this case. A higher efficiency of the financial system should yield more favourable return-risk combinations for savers. But it is not clear whether or not the prospects of higher returns or lower risk on savings would induce households to save more, which in turn would stimulate higher economic growth.

Financing conditions in the Accesion Countries (AC's).

This section uses data from the 2002 Business Environment and Enterprise Performance Survey (BEEPS) which was implemented jointly by the EBRD and the World Bank. The BEEPS aims to investigate the extent to which government policies and practices facilitate or impede business activity and investment in central and eastern Europe and the Commonwealth of Independent States. It also includes unique information on the access to finance and the financing conditions for firms in the region. The 2002 BEEPS covers 6,153 firms in 26 transition countries and includes data on 2,427 firms from the ten ACs.

The results given in Table 1 indicate that, with the exception of Poland, the financing conditions for businesses have improved in the ACs since the first survey in 1999. This is what would have been hoped for, as integration should theoretically bring about an improvement in the less developed region .

Table 1: average score for the financing of bussiness, 1999 and 2000

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovak Republic	Slovenia
1999	3.05	2.88	2.84	2.86	2.84	3.24	2.86	3.71	3.37	2.73
2002	2.83	2.49	1.99	2.26	1.91	1.81	2.91	2.67	2.53	2.00

Source: Calculations with BEEPS 1999 and 2002 datasets

Note: The average score is based on a scale of 1 (best case) to 4 (worst case)

In the following, the results of the BEEPS 2002 are looked at more closely to see whether the survey indicates differences in the financing conditions of SMEs and large firms, and between rural and urban firms. It is important to note that for the BEEPS, firms were asked to appraise the conditions of their business environment, and that these evaluations are subjective by nature. Hence the judgments of firms of different size, location and nationality cannot be compared at face value. Nevertheless, the BEEPS gives a best possible picture of the sentiment in the region.

Table 2 gives the average score for the firms that were questioned in the ACs with respect to access to financing (e.g. collateral required) and to the cost of financing (e.g.interest rates and charges) on a score from 1 (no obstacle) to 4 (major obstacle). Distinction with respect to geographical location does not give any clear pattern for either “access to finance” or “cost of finance”. Looking at the size of firms, however, shows that small firms (with less than 50 employees) on average find it harder to obtain financing than large firms (250-9,999 employees). The same seems to be true for the cost of financing: on average, smaller firms perceive the cost of financing as a greater obstacle for the operation and growth of their businesses than do large firms.

Table 2: Access to and cost of finance, average score for all Acs

	Access to finance	Cost of finance
For all firms	2.32	2.56
By geographical location (city or town)		
(1) Capital	2.21	2.31
(2) Other, over 1 million inhabitants	2.75	3.5
(3) Other, 250,000-1,000,000	2.58	2.96
(4) Other, 50,000-250,000	2.26	2.5
(1-4) 50,000 and above (urban)	2.32	2.56
(5) Under 50,000 (rural)	2.34	2.63
By size of firm		
Small (2-49 employees)	2.41	2.63
Medium (50-249 employees)	2.21	2.49
Large (250-9,999 employees)	2.07	2.36

Source: Calculations with BEEPS 2002 dataset

Note: The average score is based on a scale of 1(no obstacle) to 4 (major obstacle)

In general, small firms seem to have greater problems in obtaining finance than medium-sized firms, which lag behind large firms. The evidence is somewhat mixed for the other countries, as medium-sized firms sometimes give worse rankings than small firms. Nevertheless, with the exception of Latvia, in all countries small firms on average face bigger obstacles in financing their businesses than larger firms.

This pattern is confirmed by the results presented in table 3. Firms were asked how easy it would be for them to obtain a short-term working capital loan on commercial terms, and how easy it would be for them to obtain a longer term banking loan for new investment. As before, there is not a strong geographical pattern, but small firms again seem to have most problems in accessing both short-term and long-term finance. While small firms on average describe their prospects to obtain short-term finance as “fairly difficult”, large firms tend to judge it as“fairly easy”, with medium-sized firms in between. The exact question in BEEPS 2002 was: “How problematic are these different factors for the
operation and growth of your business?”

Firms with less than two or more than 10,000 employees were excluded from the BEEPS.

The results by country show that in Bulgaria, the Czech Republic, Estonia and Lithuania urban firms on average experience less difficulty in accessing short and long-term capital from commercial banks than rural firms. The same is true for short-term finance in Hungary and Latvia, and for long-term finance in Romania and Slovenia. The differences, however, are rather marginal.

Table 3: Access to short-term and long-term capital, average score for all Acs

	Access to short-term finance	Access to long-term finance
For all firms	3.32	3.06
By geographical location (city or town)		
(1) Capital	3.42	3.09
(2) Other, over 1 million inhabitants	3.75	3.75
(3) Other, 250,000-1,000,000	3.16	2.91
(4) Other, 50,000-250,000	3.35	3.14
(1-4) 50,000 and above (urban)	3.34	3.07
(5) Under 50,000 (rural)	3.27	3.05
By size of firm		
Small (2-49 employees)	3.16	2.91
Medium (50-249 employees)	3.54	3.24
Large (250-9,999 employees)	3.78	3.49

Source: Calculation with BEEps 2002 dataset

Note: The average score is based on a scale from 1 (impossible), 2 (very difficult), 3 (fairly difficult), 4 (fairly easy) to 5 (very easy)

The picture becomes more complete when the sources of finance are reviewed. Table 4 shows that the proportion of external finance as part of the total financing is rather small, and that borrowing from banks in general is very low. Only 9.59 per cent of working capital is financed by local private commercial banks, state-owned banks and foreign banks, and only 9.98 per cent of long-term financing comes from these banks. This reflects the low level of financial deepening in the Acs.

Table 4: Sources of finance for working capital and new investment, average for all ACs (in per cent)

Source of finance	Working capital	New investments
Internal funds/retained earnings	64.79	48.83
Equity (i.e. issue of new shares)	5.12	3.41
Borrowing from local private commercial banks	5.48	5.40
Borrowing from state-owned banks, including state development banks	3.14	3.35
Borrowing from foreign banks	0.97	1.24
Loans from family/friends	3.15	2.33
Money lenders or other informal sources (other than family/friends)	0.90	0.65
Trade credit from suppliers	5.63	1.33
Trade credit from customers	1.45	0.36
Credit cards	0.52	0.37
Leasing arrangement	2.20	5.69
Government (other than state-owned banks)	1.81	1.70
Other	2.33	2.11
Sum	97.49	76.77

Source: calculations with BEEPS 2002 dataset

Tables 4 and 5 show that roughly half or more of the financing of working capital and of new investments of the interviewed firms is generated by internal funds. In their financing of working capital small firms rely to almost 70 per cent on internal funds, much more than large and medium-sized firms. Financing through equity generally plays a minor role, which reflects the low market capitalisation in the ACs. Equity financing only plays a considerable role in Hungary and Latvia, and interestingly also for small firms in the Czech and Slovak Republic. Trade credit from suppliers is a relatively important source of finance for large and medium-sized firms in Bulgaria, Latvia, Lithuania and Poland, and for small firms in Latvia. Government finance appears to be of importance for larger firms in Bulgaria and medium-sized firms in the Czech and Slovak Republic.

Table 5: Sources of finances for all ACs by size of firm (in per cent)

	Large firms		Medium firms		Small firms	
	Working capital	New investment	Working capital	New investment	Working capital	New investment
Internal funds/retained earnings	56.25	48.08	59.73	49.47	67.99	48.82
Equity (i.e. issue of new shares)	3.75	1.82	5.09	3.31	5.40	3.77
Borrowing from local private commercial banks	9.66	9.89	8.73	8.42	3.71	3.65
Borrowing from state-owned banks, including state development banks	4.87	4.16	3.22	2.64	2.75	3.37
Borrowing from foreign banks	2.55	3.48	1.45	1.89	0.50	0.59
Loans from family/friends	0.65	0.47	0.58	0.78	4.35	3.14
Money lenders or other informal sources (other than family/friends)	0.26	0.32	0.77	0.47	1.07	0.77
Trade credit from suppliers	7.20	1.82	6.75	1.40	5.01	1.20
Trade credit from customers	1.77	1.03	1.40	0.28	1.42	0.24
Credit cards	0.36	0.12	0.10	0.02	0.67	0.51
Leasing arrangement	2.05	5.84	1.89	4.85	2.31	5.88
Government (other than state-owned banks)	2.17	2.20	3.78	3.88	1.19	1.00
Other	2.01	3.17	4.27	3.27	1.86	1.57
Sum	93.55	79.23	93.48	77.40	96.38	72.96

Source: Calculations with BEEPS 2002 dataset

Effects of banking competition and concentration on SME finance

Though financing conditions have improved over the past years, the level of financial deepening is nevertheless very low. Access to finance still constitutes a problem in most ACs. This is particularly true for SMEs.

It is widely acknowledged that the underdevelopment of domestic financial markets mainly constrains the growth of relatively small and medium businesses. Larger firms find it easier to overcome local financial market imperfections by raising funds abroad, where they are more abundant and available. In a study for the European Commission, Gianetti *et al*. (2002, p. 3) point out that "if financial market integration among European countries helps develop local financial markets or widens the geographical limits within which SMEs can raise funds, it will prompt a disproportionate growth of SMEs." This section will discuss whether this improvement will also reach SMEs or if the benefits of financial integration will mostly advance financing conditions for large enterprises, leaving SMEs aside.

While financial integration – especially through the presence of foreign banks – is likely to spur the efficiency of the financial intermediaries and markets of financially less developed countries, this section argues that the restructuring of the ACs' financial sectors might mostly benefit larger companies while SMEs will be left on their own. Competition is likely to entail concentration in the banking sector. The central importance of banking is its relationship with other businesses. If banking becomes more concentrated and dominated by foreign banks – a process that can already be observed in the ACs – large companies will be favoured recipients of loans and other financial services whereas small and medium companies, especially in peripheral regions, will find it more difficult to get finance.

In a perfect market situation, where all information is readily available to all parties, there would be no such financing gap. But reality is characterised by market imperfections which are due to information asymmetry. Because the lender cannot easily assess the riskiness of the borrower's project, it is a costly exercise to obtain information regarding the quality of the business and its management. This lack of information may lead credit institutions to adverse selection and thus credit rationing. In order not to crowd out the borrowers with good risk who are only willing to pay lower interest rates, the rates are set below the market clearing level with a resulting shortageof available funds.

As can be seen from table 6, concentration in the banking sector is relatively high in all ACs.

With the exception of Bulgaria, Hungary and Poland, the market shares of the five largest banks in the ACs is markedly higher than the unweighted average of 55 per cent for the EU-15 countries.

Table 6: Total assets of five largest banks relative to total assets of all banks (in per cent)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bulgaria	na	na	na	na	na	0.62	0.62	0.61	0.57	0.55
Czech Republic	0.81	0.74	0.70	0.69	0.67	0.66	0.65	0.66	0.68	0.66
Estonia	0.69	0.68	0.75	0.78	0.87	1.00	0.99	0.99	0.99	0.99
Hungary	0.72	0.66	0.59	0.58	0.53	0.54	0.54	0.53	0.57	0.55
Latvia	na	0.51	0.53	0.52	0.51	0.61	0.61	0.62	0.66	0.65
Lithuania	na	na	0.76	0.80	0.84	0.90	0.91	0.88	0.88	0.84
Poland	0.55	0.53	0.53	0.51	0.48	0.45	0.50	0.49	0.53	0.56
Romania	na	na	na	na	0.76	0.70	0.67	0.70	0.71	0.68
Slovak Republic	0.87	0.82	0.75	0.68	0.63	0.60	0.59	0.63	0.67	0.67
Slovenia	na	0.62	0.63	0.63	0.62	0.63	0.63	0.63	0.69	0.69

Source: EBRD country database.

Another indicator for increased competition and consolidation in the ACs' banking sectors is the number of banking institutions. The number of banks decreased markedly over the past years. Between 1995 and 2002, the number of banks decreased by 63 per cent in Estonia, 45 per cent in Latvia, 43 per cent in Slovenia, 39 per cent in the Slovak Republic, 32 per cent in the Czech Republic and 27 per cent in Poland. The only country to register a rise in the number of banks between 1995 and 2002 is Romania.

The analysis of the BEEPS data showed a very clear positive relationship between the size of firms and their financing through bank credit. Whereas the BEEPS makes no distinction between large and small banks, and thus cannot be employed to empirically verify or refute the large-bank barriers hypothesis, the fact that the ACs' banking sectors are highly concentrated and hence dominated by larger banks gives reason to assume that large banks in the ACs indeed do not extend their services to small enterprises on the same scale as they do to large businesses.

Another issue is the dominance of foreign banks. The *foreign-owned-bank barriers hypothesis* states that foreign-owned banks are less likely to lend to informationally opaque small businesses than domestically-owned banks.

The argument is similar to the *large-bank barriers hypothesis*: because banks entering a foreign market are likely to be large and headquartered far away from small local businesses, they will find it difficult to extend relationship lending to these borrowers. In addition, cultural and language barriers, as well as non-familiarity with the local markets, may make it more difficult and hence costly to gather and process locally-based relationship information.

Empirical evidence also seems to support this hypothesis. In general, foreign banks appear to allocate greater shares of their lending portfolios to commercial and industrial loans, providing indirect evidence that foreign banks may be more important in the market for loans to large companies.

We discussed the dominance of foreign banks, with foreign investors currently owning more than two-thirds of the banking system of the ACs as a whole. In 2002, 189 out of the 285 commercial banks in the region were controlled by foreign owners, with a strong tendency towards larger institutions. The presence of foreign banks is likely to increase in the course of the next years, particularly as a result of the EU's single passport policy. This allows a bank that is registered in one EU member state to open branches in other member countries on the basis of home licences alone. The single passport policy has also been applicable to the new member states since 1 May 2004.

Again, the BEEPS data cannot be employed to affirm the *foreign-owned-bank barriers hypothesis*. But given that (with the exception of Slovenia) the ACs' banking sectors are highly dominated by foreign-owned institutions, the results of the BEEPS analysis present a picture that would rather support this hypothesis. Interestingly, firms in Slovenia, the country with the lowest foreign-bank penetration, are amongst those with the least complaints about access to finance.

If the *large-bank barriers hypothesis* and the *foreign-owned-bank barriers hypothesis* apply, this could imply that the structures of the ACs' banking systems as they have evolved over the past decade will pose a serious constraint to the development of SMEs. Further, SMEs might not see an improvement in their financing conditions on the scale that will be the case for larger enterprises.

In addition to increasing competition in banking, the local stock exchanges will increasingly face problems competing with the major financial centres of the west, and their future might be in question. While larger firms will find much more favourable financing conditions as they can raise funds both domestically and overseas, the majority of small and medium-sized firms will not be able to go directly overseas. Since these firms are important for economic growth and need to raise capital, a decline in local market activity could prove to be a costly outcome for the ACs.

Summary and conclusions

The analysis of the BEEPS data covering information on 2,427 enterprises in the ACs showed a clear pattern regarding firms' access to finance. In general, small firms appear to have much larger problems in getting funding than medium and large enterprises. Furthermore, an analysis of the sources of finance for working capital and investment gave evidence of a strong positive relationship between the size of firms and their financing through bank credit.

While these results cannot be taken as sufficient empirical proof of the *large-bank barriers hypothesis* and the *foreign-owned-bank barriers hypothesis*, they do support these hypotheses.

Also the national and European authorities have started to become aware of this problem.

For example, in a recent report, the European Commission recognises that the need to promote entrepreneurship in Europe requires focused public action to close gaps in the availability of market finance for small businesses. In particular, "the accession and candidate countries need to pay attention to the further development of their financial systems. This includes capacity building throughout the financial sector making it easier for banks to become more acquainted with SMEs and more willing to provide medium and long-term lending. Furthermore, a gradual emergence of an equity culture will open the way for a more developed venture capital industry." (European Commission, 2003)

However, despite these issues, one should not paint a too gloomy picture in regard to foreign bank penetration. The entrance of foreign banks has significantly increased the standards and the efficiency of the ACs' banking systems.

Guarco *et al*. (2003) state that "By and large western ownership and control have proven highly beneficial to banks in CEE [central and eastern Europe]. They brought expertise, in the form of product knowledge, risk management, or technology. They brought advantages for funding and capitalization, as well as a welcome shield against government interference."

Furthermore, if improved efficiency in the banking system results in an expansion in total lending, the amount of lending to SMEs might increase even if the share of lending to them falls. Also, increased pressure from the presence of foreign banks might cause smaller and domestic banks to modify their behaviour and make them seek new market niches. A focus of large and foreign banking institutions on providing financial services to larger corporations could offer opportunities for small local banks to extend their services particularly to SMEs. Nevertheless, to ensure a favourable business environment also for small businesses, both national and European financial services authorities need to keep an eye on these developments, and be ready to step in if appropriate.

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