

## Access of micro-, small and medium-sized enterprises (MSMEs) to finance in North and Central Asia

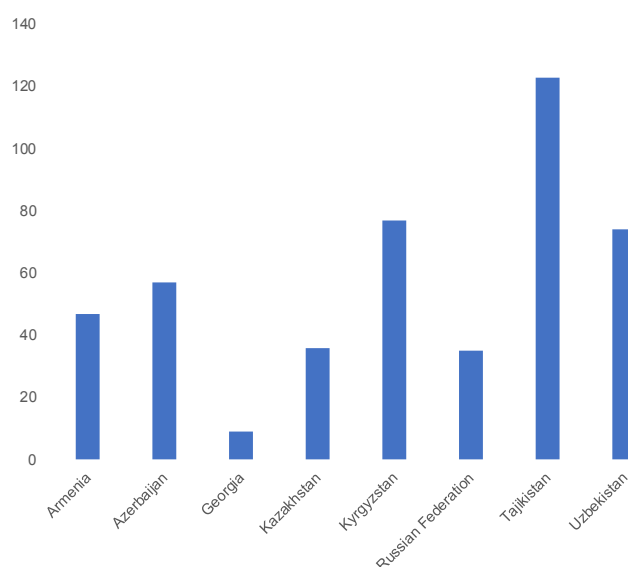
### Importance of MSMEs and constraints they face

Access to financing is one of the fundamental conditions for individuals and small businesses to be able to invest and become entrepreneurs. Several economies in the Asia-Pacific region, including those in the North and Central Asian subregion, however, lag in facilitating such opportunities for potential entrepreneurs. This situation hampers the private sector's potential contribution to the development of the country, and impedes the process of inclusive income and wealth creation.

MSMEs are a critical potential vector of positive change that can help in the development of the private sector and stimulate structural transformation. In North and Central Asia, MSMEs (often farms and agro-businesses) play a major role in economic activities of lower-middle-income countries. They account for 58.1 per cent of GDP in Georgia and 56.9 per cent in Uzbekistan.<sup>1</sup> The contribution of MSMEs to GDP in oil-exporting countries is lower but even then, they account for more than 20 per cent of the economy. MSMEs are also a key source of employment in most of countries in this subregion. They account for more than one fifth of total employment, ranging from 21.9 per cent in Georgia to 56.8 per cent in Uzbekistan.<sup>2</sup>

Despite being recognized as major sources of employment and economic growth, MSMEs in North and Central Asia operate in a challenging environment in terms of ease of doing business. The median ease-of-doing business rank of the countries in this subregion with available data is 52 (figure 1). There are several reasons for this, which vary across countries, but the main obstacles relate to permits (for trading, building and getting electricity connection) and finance (paying taxes, obtaining credit and resolving insolvency).<sup>3</sup> Approximately 20 per cent of firms in the subregion identify accessing finance as a major constraint.

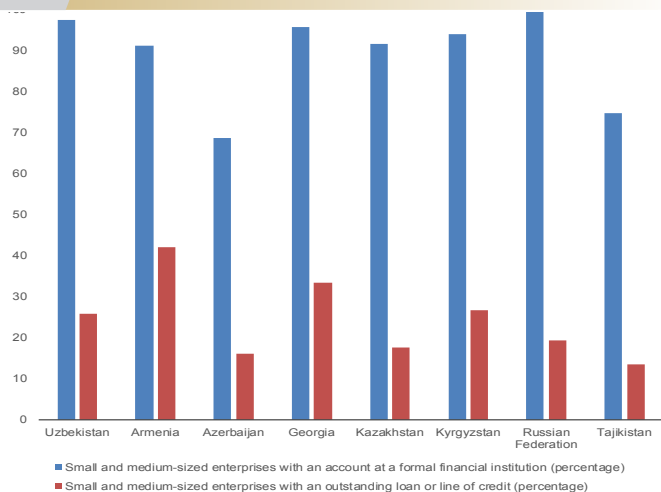
Figure 1. Ease of doing business ranks in North and Central Asia<sup>4</sup>



Source: World Bank, Ease of Doing Business Database. Available from [www.doingbusiness.org/rankings](http://www.doingbusiness.org/rankings)

Assessment of financial inclusion indicators shows that, although in some countries having an account at a financial institution is widespread among MSMEs in North and Central Asia, having access to a loan or credit line is much more complicated (figure 2). Consequently, MSMEs in the subregion tend to rely more heavily on their internal cash flows to finance their investments (relative to the global average), even in countries where MSMEs often have an account at a financial institution. Personal savings of families and friends is another source of funds for financing entrepreneurs' ventures; more than 23 per cent of adults older than age 15 borrowed money from friends and family, while only 12 per cent of the same age group borrowed from a financial institution. In some surveys, respondents have identified distrust of financial institutions as a reason for not having an account in a financial institution. This may not be surprising considering the history of bank failures and currency devaluation in North and Central Asia.<sup>5</sup>

Figure 2. Basic indicators of financial inclusion by MSMEs in selected North and Central Asian countries

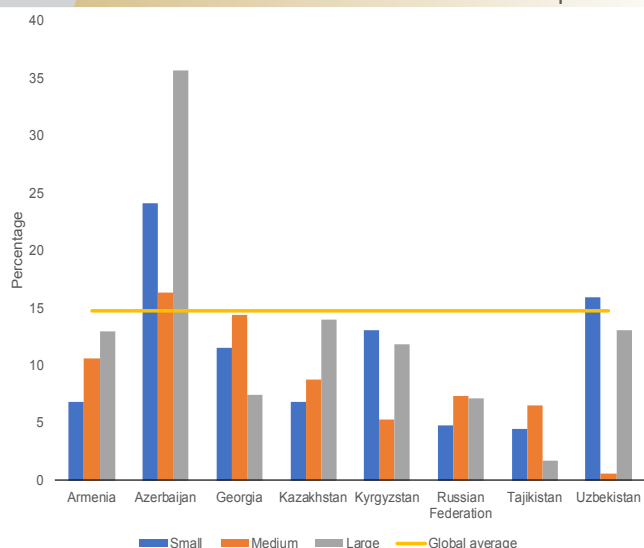


Source: Global Findex Database. Available from <http://datatopics.worldbank.org/financialinclusion/>

Other factors constraining access to finance include the high levels of required collateral needed as a percentage of the loan value (approximately 200 per cent in 2013), and high interest rate spreads that on average were 10.87 per cent in 2015 and 9.24 per cent in 2016.<sup>6</sup> These two indicators are insightful: high collateral requirements usually imply excessive costs for financial institutions to recover their loan or collateral in the case of default (which is linked to ineffective legal and regulatory frameworks), while high interest rate spreads tend to indicate poor competition in the banking sector.<sup>7</sup> Indeed, it has been noted that crucial issues hindering growth of access to credit and financing for MSMEs in North and Central Asia include weak regulatory frameworks and low diversification of financial products.<sup>8</sup>

On the supply side, although bank lending is the main source of financing in the subregion, only about 16 per cent of investments by small firms and 17 per cent by medium-sized firms are financed by banks. Moreover, the percentage of firms in the subregion whose recent loan application was denied is above the global average.<sup>9</sup> As a result, the proportion of investments of MSMEs that are financed by banks in North and Central

Figure 3. Proportion of investments financed by banks, by size of the small and medium-sized enterprise



Source: Enterprise Surveys Database. Available from [http://microdata.worldbank.org/index.php/catalog/enterprise\\_surveys/about](http://microdata.worldbank.org/index.php/catalog/enterprise_surveys/about)

Asia is generally below the global average (figure 3). Commercial banks view MSMEs as inherently riskier and as a less developed market than larger enterprises. Many of those small and medium-sized enterprises are agricultural households operating in a cash-based economy, which makes it difficult for potential borrowers to fulfil the collateral and credit requirements. The information asymmetry from low transparency and poor financial reporting standards of MSMEs, intrinsic risks for banks in lending to small firms and credit rationing due to insufficient collateral mean that lending to MSMEs is focused mostly on working capital loans, often for trade and agricultural businesses and those with short-term horizons.<sup>10</sup>

Besides bank lending, the options for MSMEs to access financing from a financial institution are very limited. The stock market is dominated mainly by large firms and is inaccessible to MSMEs; other venture capital options are virtually non-existent in most countries in the subregion.

Credit unions and microfinance institutions are possible alternatives, and several countries have implemented initiatives to expand microfinance towards the MSMEs segment. Microfinance volumes are slowly becoming more important in the subregion, as the interest rate differential between microfinance institutions and traditional banks has shrunk over time. However, penetration is still very shallow. For instance, of a population of 80.9 million, only 2.5 million are active borrowers from financial service providers focusing on microfinance, which yields a rate of 3.1 per cent of borrower participation. In some other countries, professionalism in the microfinance sector can be a concern, which can undermine sustainability.

With regard to enhancing the sources of financing, including through FinTech, it should be noted that unlike other subregions in Asia and the Pacific, the North and Central Asian subregion still has to develop an appropriate infrastructure and climate. The basic requirements for the FinTech sector to take off are far from guaranteed. Fixed broadband subscriptions are extremely weak in the subregion, ranking from 0.1 per 100 people in Tajikistan and Turkmenistan to 19.5 per 100 people in the Russian Federation.<sup>11</sup> While mobile cellular subscriptions have increased dramatically in the last 15 years and surpass 100 per 100 people, Internet users as a percentage of the population lag considerably behind, ranging from 18 per cent in Turkmenistan in 2016 to 78.2 per cent in Azerbaijan. This poor Internet penetration is partly due to frail infrastructures and partly due to widespread mistrust of the Internet. Of the seven subregional member countries of ESCAP with available data on the Freedom on the Net 2017 index, three are rated “not free”, three are rated “partly free” but only one is rated “free” (Georgia).<sup>12</sup>

## Policy recommendations

On the supply side, credit-granting institutions should consider different methodologies to assess creditworthiness. Credit scoring and risk measurement have traditionally been very difficult for the unbanked in general, because no data exist about their financial history, which in turn prevents them from getting credit. FinTech solutions for credit scoring can ameliorate the lack of data as they include decentralization and less intermediation, favouring more efficiency, transparency and competition. All these elements lower the cost of supplying credit to MSMEs, which then enables them to develop a credit history.

An alternative for lending institutions is to accompany their MSME debtors and advise them on entrepreneurship ideas and training on basic financial reporting practices, etc. This effectively would make the borrowers and the lenders partners and has been shown to succeed in some cases. For example, Damu Entrepreneurship Development Fund, established by the Government of Kazakhstan in 1997, has supported entrepreneurs in 18 rural areas by establishing service centres to provide such training and business support, together with financial assistance, such as interest rate subsidies and loan guarantees.

It is also vital to diversify the supply of financing options available to MSMEs. Financial support by Governments and international financial institutions, such as subsidized interest rates, tax exceptions and direct loans, are increasing in North and Central Asia. For instance, the Russian-Kyrgyzstan Development Fund is an example of intergovernmental cooperation for MSME development in this subregion. Since its establishment in 2015 as a form of Russian financial assistance to modernize the Kyrgyzstan economy, the fund has approved 624 projects and financed more than \$82 million in finances through partner banks to foster MSMEs in priority sectors of Kyrgyzstan, such as agricultural processing and textile industries.<sup>13</sup> Its interest rates are set 2.5-3 times lower than the market average among commercial banks: the fund imposes an interest rate of 12 per cent for loans denominated in Kyrgyz soms and 5 per cent for loans in denominated in United States dollars. The fund also developed several financial instruments, such as providing working capital financing to help borrowers in their day-to-day business.

Governments should try to stimulate equity financing as much as possible. An institutional format that has worked well in many countries, especially when accompanied by venture capital and advice on entrepreneurship, is business incubators.

To foster more market-based financing, attract foreign and private investors and create a new financial hub in North and Central Asia, Kazakhstan recently established the Astana International Financial Centre (AIFC) within Expo 2017 Astana; it embeds best practices and standards from globally successful financial centres: an independent judiciary based on British law in the AIFC territory; providing an expat-friendly and English-speaking working environment; and provision of preferential tax treatment for corporate investors, among others.

An active role of Government should also involve promoting competition in the financial sector, for example by privatizing State-owned banks or promoting the entry of foreign banks. As most banking sectors in North and Central Asia are still relatively closed, more competition would promote efficiency gains, innovation and the shrinking of interest rate spreads.

Perhaps most importantly, policymakers should work towards achieving a legal and regulatory framework where recovery of assets by lenders is much easier than it is currently. This should push down the value of collateral requirements and facilitate matching the supply of and demand for credit.

On the demand side, financial literacy could be strengthened through mass media and training programmes. It is important that people change their perception and gain trust in financial institutions. Strong transparency measures that tackle corruption would be useful too, because people would realize that the institutions are solid. Public administration reforms, ensuring active and autonomous investigation and prosecution of corruption at all levels, and involving civil society in national anti-corruption policies have been key factors in the successful reduction of corruption in Georgia.

It might be tempting to advise countries in North and Central Asia to take advantage of FinTech, and hopefully they should aspire to do so: new advances such as crowdfunding or blockchain technology offer great opportunities and leapfrogging is possible. However, currently most countries in the subregion lack basic infrastructure and essential conditions, such as reliable networks and free Internet, to make such a revolution possible on a massive scale. Hence, Governments should ensure the provision of such infrastructure and promote simpler, better-established technologies, such as mobile payments. Opening the mobile market to experienced foreign companies to provide mobile banking services would be another option with considerable potential. Finally, policymakers should also consider enhancing the Internet so that people really consider it as a trustworthy option to seek investment/financing

opportunities. The introduction of frameworks to regulate FinTech, so that investors do not face regulatory uncertainty and feel more empowered to invest, would be welcome. As with other fast-evolving technologies, it would be advisable that they take stock of lessons learned from the experiences of other countries which are ahead of the curve.

<sup>11</sup> ESCAP Statistical Database. Available from [www.unescap.org/stat/data](http://www.unescap.org/stat/data).

<sup>12</sup> Freedom House, Freedom on the Net 2017. Available from <https://freedomhouse.org/report/table-country-scores-fotn-2017>.

<sup>13</sup> For additional details, see Russian-Kyrgyz Development Fund, Annual Report 2016. Available from <http://www.nbkr.kg/DOC/12062017/000000000047196.pdf>.

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<sup>1</sup> The definition of MSME varies across countries and industries and has been changing from time to time in this subregion. Most countries employ size of staff as a criterion to identify micro-, small and medium-sized enterprises. Companies with fewer than 50 employees are often considered as small enterprises. Some countries employ annual turnover and different thresholds for selected industries to provide subsidies or tax incentives for MSME development.

<sup>2</sup> Ayyagari and others, Available from [http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/WPS5631\\_DataTables.xlsx](http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/WPS5631_DataTables.xlsx), provided a comprehensive data for the share of employment in small and medium-sized enterprises with a standardized definition of such enterprises.

<sup>3</sup> World Bank, Ease of Doing Business Database. Available from [www.doingbusiness.org/rankings](http://www.doingbusiness.org/rankings).

<sup>4</sup> The lower the number is, the more business-friendly is the country.

<sup>5</sup> For further details, see The Global Findex Database – Financial Inclusion in Europe and Central Asia. Available from <http://datatopics.worldbank.org/financialinclusion>.

<sup>6</sup> World Bank Development Indicators for available countries. Available from <http://databank.worldbank.org/data/reports.aspx?source=World-Development-Indicators>

<sup>7</sup> As benchmarks, interest rate differentials of some countries adjacent to North and Central Asia: China (2.45 per cent) and Iraq (7.44 per cent).

<sup>8</sup> Organisation for Economic Co-operation and Development (OECD), *Competitiveness and Private Sector Development: Central Asia 2011*. (Paris, OECD Publishing, 2011). Available from [www.oecd-ilibrary.org/finance-and-investment/competitiveness-and-private-sector-development-central-asia-2011\\_9789264097285-en](http://www.oecd-ilibrary.org/finance-and-investment/competitiveness-and-private-sector-development-central-asia-2011_9789264097285-en).

<sup>9</sup> Small and medium-size enterprises in the Doing Business Indicators by the World Bank are defined as follows: small enterprises are firms with 5-19 employees, medium-size enterprises are firms with 20-99 employees and large enterprises are firms with 100+ employees.

<sup>10</sup> For details, see World Enterprise Surveys Database. Available from [www.enterprisesurveys.org](http://www.enterprisesurveys.org) (accessed 15 March 2018).

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue was prepared by Hiroaki Ogawa of ESCAP's North and Central Asia Office and Jose Antonio Pedrosa-Garcia, benefitting from inputs by Yasmin Winther De Araujo Consolino Almeida and Achara Jantarsaengaram, under the guidance of Hamza Ali Malik. For further information on this issue, please contact Hamza Ali Malik, Director, Macroeconomic Policy and Financing for Development Division, ESCAP ([escap-mpdd@un.org](mailto:escap-mpdd@un.org)).

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