**THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON SMALL AND MEDIUM ENTERPRISES FINANCING**

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**Abstract**

The importance of the SME sector is recognized worldwide. The contribution of this sector is particularly important for the achievement of several socio-economic goals such as employment generation, contribution to national production and exports, and encouraging entrepreneurship.

However, the access of SMEs to financial resources is rather limited. Financing has been a problem that troubles SMEs for a long time, which restrains them from sustainable development and international competitiveness in the long run.

As a result, a common challenge for all governments and financial institutions address the questions: how to provide enough financial support to SMEs, facilitate access to the necessary finance, how to innovate financing pattern and promote their sustainable development.

Nowadays, the problem of financing SMEs is further exacerbated as a result of serious financial and economic crises facing the world economy. The current global economic crisis has resulted in capital depletion, risk aversion and credit contraction. Since the financial market can not function properly as a source of funding, and the credit crisis continues to increase pressure on the cost of financing, companies are now left with virtually no access to finance, which seriously undermines their survival and development. In the case of small and medium enterprises, the situation is even worse. Many small and medium enterprises will be forced to go bankrupt, due to lack of finance. Therefore, financing of SMEs is a pressing issue for all economies, particularly developing economies, like ours.

*Key words:* *financial crisis, SME, problems, financing*

**Introduction**

Access to financing continues to be one of the most significant challenges for the creation, survival and growth of SMEs, especially innovative ones. The problem is strongly exacerbated by the financial and economic crisis as SMEs and entrepreneurs have suffered a double shock: a drastic drop in demand for goods and services and a tightening in credit terms, which are severely affecting their cash flows. Governments are responding generally by three types of measures aimed at: supporting sales and preventing depletion of SMEs’ working capital; enhancing SME’s access to liquidity; and helping SMEs to maintain their investment level.

SMEs and entrepreneurs play a significant role in all economies and are the key generators of employment and income, and drivers of innovation and growth. In most countries, SMEs employ more than half of the labour force in the private sector. In the European Union, they account for over 99 % of all enterprises. Furthermore, 91 % of these enterprises are micro-firms with less than 10 workers. Given their importance in all economies, they are essential for the economic recovery.[[1]](#footnote-1)

The depth and severity of the global economic slowdown that began in 2008 has caught employers, workers and governments by surprise. Governments around the world have responded by loosening monetary policy and then increasingly using fiscal policy to revive or prevent a fall in consumption and investment. The full effects of these measures are not yet known. It is hoped that they will help to ensure that the slowdown in demand is limited and that consumers will increase their spending, financial institutions will resume their lending and businesses will begin investing and hiring again.

While businesses of all sizes have been affected by the crisis, this paper focuses attention on small and medium enterprises (SMEs). They contribute substantially to output and employment in both developed and developing countries. The ability of countries to limit the layoffs and closures of these enterprises will contribute greatly to the revival of the global economy and of individual national economies.

**Importance of SMEs in “normal times” and crisis time**

The crisis is affecting firms of all sizes. While large firms grab headlines when disclosing layoffs and dramatic declines in sales and earnings, many small and medium sized enterprises are also trying to cope with weak demand, tight credit and reduced orders from larger companies. Small businesses across a range of sectors and organizational types have been affected, although preliminary evidence suggests that the cooperative form of enterprise is managing particularly well and many are adding new members. SMEs, which account for over 90% of enterprises in all countries, are an important source of output and employment.

They employ 33% of formal sector workers in low-income countries and 62% of such workers in high-income countries.[[2]](#footnote-2) Because poor countries have large informal economies, dominated by small businesses, the SME portion of total employment is much higher. In India, for example, 86% of the labour force is employed in the informal sector, including farming. The crisis has not only hit Wall Street and Main Street, but it has affected the side streets, the dirt streets and the markets where many small retailers and producers thrive.

Even in ‘normal’ economic conditions governments have recognised that, to survive and grow, SMEs need specific policies and programmes. However, at the present time, SMEs have been especially hard hit by the global crisis. These firms are more vulnerable now for many reasons: not only has the traditional challenge of accessing finance continued to apply, but new, particularly supply-side, difficulties are currently apparent. It is important to stress that SMEs are generally more vulnerable in times of crisis for many reasons among which are: it is more difficult for them to downsize as they are already small; they are individually less diversified in their economic activities; they have a weaker financial structure (i.e. lower capitalisation); they have a lower or no credit rating; they are heavily dependent on credit and they have fewer financing options. SMEs in global value chains are even more vulnerable as they often bear the brunt of the difficulties of the large firms.

The importance of the SME sector is resulting from its significant contribution to creating added value and providing jobs, but with some differences between countries (see figure 1). Regarding the contribution to the creation of added value, we remark especially the countries that are far below the EU27 average (58%), namely Romania(42.16%) and Poland (51.71%). Regarding employment, it appears that SMEs sector uses over two-thirds of the workforce in the four countries that are well above the EU27 average (68%), namely: Estonia (78.63%), Latvia (76.34 %), Lithuania (74.6%), and Bulgaria (74.05%).[[3]](#footnote-3)

**Figure 1: The role of the SME sector in the studied countries**



Source: processed data from European Commision: 2010.

The SME sector is of critical importance for economic and social development of a country because these firms through their dynamism are considered a driver of innovation and growth and contribute to poverty reduction because they are an important source of job creation.

**Impact of the global crisis on SME and entrepreneurship financing**

Although there is no internationally agreed definition of small and medium sized enterprises (SMEs), the evidence suggests that these firms are being affected by the financial and economic crisis across economies. There is evidence that SMEs in most countries are confronted with a clear downturn in demand for goods and services. Many expect a further worsening to come. For SMEs there are two related stress factors: a) increased payment delays on receivables which added - together with an increase in inventories- result in an endemic shortage of working capital and a decrease in liquidity and b) an increase in reported defaults, insolvencies and bankruptcies.

Extended payment delays on receivables, especially in times of reduced sales, are leading rapidly to a depletion of working capital in many countries. SMEs have to deal with longer payment terms from their customers.

Increased insolvency rates appear to confirm SMEs’ increased inability to obtain short-term financing. In almost all countries, the tightening of credit conditions by banks was clearly evident for all the banks’ clients. The European Central Bank (ECB) data also confirmed the tightening. The ECB attributes the tightening to the banks’ ability (or inability) to access capital, the banks’ liquidity positions, expectations regarding the recession and higher risk on collateral. Interest rate spreads have risen to unprecedented levels, thereby partially offsetting the effects of the easing of monetary policy. The main factors exacerbating the banks’ attitude towards lending to SMEs are: a) the poor SME economic prospects already discussed; b) stagnation in inter-bank lending and increased cost of capital; and c) the desire to rebuild bank balance sheets. In all countries, banks are under pressure and are trying to preserve or strengthen their capital base. As a result, they are seeking fully collateralised transactions. In consequence, by choosing to keep only the strongest clients, banks and other financial institutions are contributing to a polarisation process.

The stagnation in lending is true even of banks in countries where governments have deliberately strengthened banks’ balance sheets to allow them to grant additional credit to SMEs and/or where credit guarantee schemes exist. Most countries have not only recapitalised their banks, but also extended the funds and guarantees available for SME financing. But the effects of the incentives to lend to SMEs put in place by governments in some countries (such as the provision of additional capital) have not yet yielded the desired results. Some governments are closely monitoring this situation or have put in place “credit mediators” to ease the flow of credit to SMEs or have enacted binding codes of conduct for SME lending.

Confronted with worsening access to credit, SMEs are exploring alternative sources of finance such as the mobilisation of reserves, self-financing and factoring. Access to venture capital and private equity also appears to be constrained. The financial crisis has had a three-fold impact on venture capital and private equity markets. First, exit opportunities are reduced; second, fundraising activities seem to be shrinking; and thirdly, invested capital has stagnated or even slowly started to decline, especially investments in new projects.

*Global venture capital fundraising slowed down between* 2*007 and* 2*008*. The current economic recession and the global downward pressure on prices are expected to influence the future prospects for fundraising in the markets in the long run. Institutional investors providing funding will simply be less willing to supply new funds with fresh capital.

Under the influence of these trends, public funds (both direct and indirect investment funds) will be impacted as much as the private funds. In markets with public or semi- public investment funds, which provide capital to funds-of-funds activities, such public funds are likely to witness a more limited possibility for co-investment with private funds, simply because the private funds increasingly reduce their investment activities. As a result, public funds cannot be expected to provide the same leverage effect as before the crisis, unless supplied with more capital.

**The impact of the current crisis over the access to finance of SMEs**

The growth and the development of SMEs is influenced by a number of factors, from global business environment to the availability of educated workforce, but the lack of access to finance appears consistently as one of the most important obstacles of doing business, as it is evidenced in the numerous surveys conducted by the World Bank, regarding the enterprises in over 100,000 countries.[[4]](#footnote-4)

Access to finance of the firms is their main concern, as shown in the Flash Eurobarometer survey, realized from June 17 to July 23, 2009. Thus, to the question "What is currently the most pressing problem your firm is facing?” 29% of companies surveyed identified as the most pressing problem finding customers, and access to finance was considered as the second pressing issue, as identified by16% of respondents (see figure 2).

**Figure 2: SMEs’ main problems**



Base: all companies EU-27, in %. Source: European Commission : 2009

The current international crisis has affected more severely the SMEs sector compared to large firms because SMEs are generally more vulnerable in times of crisis for several reasons, among which we mention: it is harder for them to reduce their activities since they are already small; they are less diversified individual within their business; thay have a weaker financial structure (e.g. lower capitalization); they have a lower credit rating; they are strongly dependent on credit and have fewer financing options (OECD: 2009).

The deterioration of the economic environment and, implicitly, of the financial situation of small and medium enterprises and the rise of the costs of the financing resources on international financial markets determined banking institutions from numerous countries to be reticent in granting credits. The reaction of the banks was to make the crediting standards harsher and to increase interest rates. Thus, microenterprises and small firms in particular meet significant difficulties when trying to obtain financing resources.

In the context of the reduction of the bank credits supply and demand, a diminution in the availability of bank credits was registered. For example, according to the Flash Eurobarometer study, almost half (46%) of the interviewed firms that requested at least one type of external financing over the period January – July 2009 reported the reduction of the availability of bank credits. As regards the studied countries, the availability of bank credit has significant differences from one country to another due to the different implications of the current crisis on national economies and their financial systems.

Credits have tightened in most countries and not only where banks held mortgage- backed securities and collateralized debt obligations. Most governments have cut interest rates, lowered reserve ratios and urged lenders to pass on lower rates to their customers. As few countries set the rates that are charged by commercial banks, lower rates in the inter-bank markets are not automatically passed on to commercial customers. In addition - and in most cases more importantly – lenders are offering fewer loans. Credit has tightened for small enterprises in many countries although the actual impact is not well known.

Banks and non-bank financial institutions are consolidating their own financial positions by ensuring adequate reserves as a precaution against delinquency and default. These prudential measures have reduced the flow of new lending and the extension of existing lines of credit in many countries. Lenders are finding it difficult to assess creditworthiness in the downturn. A stable company last year may be risky this year, notably if demand has slumped for its products or services. Even enterprises with a good credit history are finding it difficult to obtain loans. In the UK, where the number of small business closures rose dramatically to 85 per day in early 2009, the Federation of Small Businesses summarized the problems succinctly: "Costs are up, orders are down and banks are not being helpful." Smaller enterprises that can access credit in good times now face difficulties. Micro-enterprises and some small business which are unable to access credit under normal conditions will continue to be shut out during the crisis.

**Policy responses of governments to SMEs financing problems**

Countries’ abilities to deal with the crisis depend to a large extent on the margin provided by their respective fiscal and monetary policies. Many of the countries have recently put in place anti-crisis packages combining in different proportions three lines of action: *stimulation of demand* (consumption packages, infrastructure programmes, tax policies); *credit enhancement* measures, including *recapitalisation of banks* which, in some cases, include explicit provisions or mechanisms to preserve or enhance banks’ capacity for financing SMEs such as public credit guarantees; and *labour-market measures* (reduced employment taxes or social security charges and extended temporary unemployment programs).

The measures put in place by countries can be classified in three different groups depending on the aspect of the SME financing problem to which they are geared. Three main groups of measures can be distinguished: (a) measures supporting sales, cash flows, and working capital; (b) measures to enhance SME’s access to liquidity, mainly to bank lending; (c) measures aimed at helping SMEs to maintain their investment level and more generally to build their capacity to respond in the near future to a possible surge in demand.

The stimulus packages are intended to revive demand either through consumption or investment spending. Some of the packages include spending on health, education, technology and infrastructure. SMEs in these sectors could benefit either directly or indirectly. More direct are the measures to increase cash flow, thereby contributing to working capital. A robust cash- flow is a condition sine qua non for business development and growth. Many governments have implemented measures to maintain or increase cash flows. For instance, they have allowed accelerated depreciation for investments already undertaken. France and Germany have introduced accelerated depreciation either on all categories of assets or on specific ones as in Germany where depreciation thresholds are targeted to SMEs thereby reducing taxable income. Some countries are also giving tax credits, cuts, deferrals and refunds. In Japan, the Government has reduced the corporate tax rate from 22 % to 18 % for the SMEs with 8 million yen (€61 thousand) or less in annual income in the coming 2 years. In the Netherlands one of the tax brackets has been reduced from 23 % to 20 % for both 2009 and 2010 for amounts up to 200,000 euros and Canada increased the income threshold for which the small business rate applies. The Czech Republic, France and Spain are refunding VAT payments immediately or monthly.[[5]](#footnote-5) Macedonia also gives tax credit to companies – there is tax release of corporate income tax for incomes up to 3 million denars. Governments give preference to reducing those taxes that are “profit-insensitive”, that is, taxes that are paid regardless of whether the SME is making a profit. This would increase the ability of SMEs to finance working capital internally. Lastly, in order to maintain employment, some governments are giving wage subsidies to enterprises so that employees can receive full wages while working part time.

To address the depletion of SMEs’ working capital, some countries have implemented specific measures that, without involving additional credit lines, are aimed at easing SMEs’ liquidity, either legal moves to shorten payment delays and enforce payment discipline or reduction of government payment delays.

Despite the fact that some of the largest banks have been recapitalised with public funds, the evidence from surveys suggests that banks have significantly tightened their credit policies. In order to alleviate the effects on SMEs of the twin shock of falling sales and more difficult access to funding, governments are using two different approaches to increase availability of credit to SMEs: (a) on the incentive side, the creation and extension of guarantee schemes for loans to SMEs, or when that fails direct public lending; (b) on the discipline or sanction side, setting targets for SME lending for banks that have been recapitalised by public monies, putting them under administrative monitoring or putting in place specific procedures to solve problems between individual SMEs and banks.

Extension and diversification of public guarantee schemes or, in some cases, even direct lending by public institutions, are among measures being widely used by countries. These policy measures deal with one of the key reasons that may explain banks’ reluctance to lend to SMEs that is, their constraint in terms of their capital requirements ratio. According to Basel II methodology, for banks operating under the “standardised approach”, the level of capital requirement for a publicly guaranteed credit line is very low or even nul, depending on the extent and the exact modalities of the public guarantee. For banks operating under the “internal rating-based approach”, the regulatory capital requirement is very low, if any, and in the last analysis depends on the internal risk model. For this reason, public guarantee schemes for SME credit are expected to be an incentive for bank lending to this segment of clients. It is also worth mentioning that even for guarantee structures without regulatory capital relief, loan guarantee schemes can improve the access to finance for SMEs through economic capital relief as an incentive for banks. For European Union member countries, the potential leverage effect of public guarantees on SME bank lending has been further extended by the decision of the European Commission to temporarily authorise Member States to ease access to finance for companies through subsidised guarantees and loan subsidies for investments. In France, for instance, this easing of rules makes it possible for the guarantee schemes to cover up to 90 % of the risks related to a loan as compared with 50 to 60 % on average before. The United Kingdom guarantees 75 % of the loan and Korea, 100 %. Japan, in principle, guarantees 80 % of the loan but there are some exceptional cases of 100 % coverage.

There are also a number of private guarantee schemes. The Association Europeenne de Cautionement Mutuel (AECM), which is composed of non-profit organisations giving SME credit guarantees, has provided 55 billion euros for 1.6 million SMEs (roughly 8 % of total SMEs in the EU). AECM members have knowledge of the local context and the SME sector and therefore they can undertake a reliable individual risk analysis of each loan. They also provide additional information to both the bank and the SME partner and act as an interface.

In the context of bleak medium-term prospects amid falling sales, many SMEs have reduced or withheld their investment plans. In consequence, their demand for long- term lending has significantly fallen. In order to prevent SMEs from losing their competitive edge in the medium term, and help them to remain ready for the upturn, some governments have put into place measures to strengthen their capital base or to develop their productive capacities, or both. These measures are either tax incentives, or provision of specific funding possibilities such as grants or credit. On the top of this, the existence of Structural Funds within the European Union gives to new-member countries a margin of maneuvre to support SMEs investment projects in specific technologies, sectors or regions.

Most of the measures described in this paper are very recent and thus have not been evaluated. In consequence it is impossible to identify best practices. It has to be stressed that these measures help SMEs by solving their immediate liquidity problem, but if the macroeconomic situation continues to worsen, they may only postpone an insolvency problem. In some countries, measures aimed at solving the long-term problem of insufficient own capital base are being taken. They address the issue either by helping enterprises to strengthen their cash-flow and self-financing or by putting in place additional sources of equity capital.

The most widely used policy measure to increase access to finance has been until now the extension of loans and loan guarantees. These measures are also very heterogeneous in their modalities, in their cost and also target groups. Time is too short to draw conclusions about what are the “best practices” in the field of emergency measures and in the field of loan guarantees.

**Conclusion**

One of the fundamental problems of any company and, in particular of the small and medium enterprises (SME) is the access to finance, as a condition for their creation, survival and development. Compared with large firms, SMEs face a number of difficulties when aiming to procure financial resources. Such difficulties are related, in particular, to insufficient guarantees offered for creditors and even to fully inform them about the situation and development prospects of SMEs.

The analysis of the financing modalities of small and medium enterprises emphasizes the significant importance of bank credits in the external financing of enterprises. This aspect can be explained by the fact that microenterprises and small firms in particular have fewer financing options in comparison with large enterprises. The SMEs, in terms of size and the specifics of their activities, face difficulties in procuring external financing resources, in conditions of normal operation of the economy. Moreover, in the context of the current international crisis, the SMEs access to financial resources is more difficult due to the deterioration of the economic environment and due to the increasing of the uncertainties about its progress.

One of the extremely serious consequences of the current global economic crisis is the changes in the access to credit for SMEs. In this context and given the crucial importance of the SME sector for economic and social development, public authorities in almost all countries were oriented towards the adoption of special measures to stimulate lending to SMEs by subsidizing interest and guarantee schemes. But so far there has been only a slow recovery of bank lending. The significant revival of bank lending depends significant on the expectations of the improvement in overall economic situation, the real economic recovery, which in turn is conditional on improved access to finance for the SME sector.

Restore the normal functioning of SME sector and hence the national economic recovery depend significantly of the improved access to finance for SME sector, which can be achieved by implementing appropriate economic policy measures and strengthening cooperation between the banking and financial institutions and SMEs.

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