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*FOUR PROPOSALS FOR IMPROVED FINANCING OF SME DEVELOPMENT IN ASEAN**

Thitapha Wattanapruttipaisan

* Ms. Thitapha Wattanapruttipaisan is a Senior Officer in the Bureau of Economic Cooperation, ASEAN Secretariat, Jakarta, Indonesia. The views expressed in this paper are the author's and do not necessarily reflect those of the ASEAN Secretariat. Mention of any firm or licensed process does not imply endorsement from the ASEAN Secretariat. The author is thankful to Mr. Noordin Azhari, Director of the Bureau of Economic Cooperation, ASEAN Secretariat, for his encouragement in research; Dr N. V. Lam, Adviser, Foundation for International Human Resource Development, Bangkok, Thailand, for extensive and useful discussions; and the two anonymous referees for their many constructive comments and suggestions. The usual disclaimer applies, however.

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SMEs are of great socio-economic significance although their long-term growth and competitiveness has been compromised by the chronic and often acute constraints on their access to formal-sector finance, among other systemic and institutional problems in developing countries, including ASEAN. Largely as a result, SMEs' share of financing resources is disproportionately less than their relative importance in domestic employment and, to a lesser extent, value added. SME financing problems are due to both demand- and supply-side factors which have to be addressed as part and parcel of the on-going development and modernization of the financial sector in response to the increasing volume and complexity of business transactions associated with the integrated growth and globalization of ASEAN economies. Proposals on the demand side relate to the needs for more systematic disclosure of information on finance and governance, and better business planning by SMEs. Parallel capacity building efforts on the supply side include greater reliance on credit information systems, and SME risk scoring and competitiveness benchmarking. A number of concrete approaches and practical methodologies are also presented in support of the four proposals made in the discussion.

I. INTRODUCTORY OVERVIEW

Small- and medium sized enterprises (SMEs) are the backbone of virtually all economies in the world, including those within the Association of South East Asian Nations (ASEAN).[1] Notwithstanding various definitional issues and data problems, SMEs number in the hundreds of thousands and account for upward of 90 per cent of all non-agriculture firms in most parts of ASEAN. They also employ an overwhelming proportion (mostly in the 75-90 per cent range) of the domestic

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[1] For example, SMEs in the European Union (with 250 workers as the upper threshold for medium-sized businesses) account for about one-half of the total value added and two-thirds of the domestic workforce (European Union 2002, p. 118). Comparatively, small businesses with less than 100 employees in the United States are the source of about one-third of both domestic employment and sales value (Velasco and Cruz 2001, p. 19). SMEs contributed between 40 and 50 per cent of manufacturing output in Chinese Taipei, Japan, and Republic of Korea in the mid-1990s (UNCTAD 1998, pp. 17-19). Meanwhile, SMEs in Central and Eastern European economies in transition are found to be more dynamic than state-owned enterprises (SOEs) as a source of output growth and employment generation. They had emerged from the reform-driven break-up and/or privatization and commercialization of SOEs from the early 1990s and have benefited considerably from a variety of on-going international assistance programs in their favour (Klapper and others 2002, pp. 12-17; and Svejnar 2002, pp. 14-15).

workforce, especially young persons and women.[2] On the other hand, SMEs contribute a disproportionately small share -- in the range of 20-30 per cent to gross sales value or manufacturing value added, and 10-20 per cent to export earnings in the region.[3] However, their actual share in total exports is considerably larger because of the participation of many SMEs as subcontractors to export-oriented local firms and transnational corporations (TNCs).[4] Nevertheless, the range of direct exports from the SME sector remains typically narrow and their value added relatively limited.[5]

Currently, there is a great shortage of a core of dynamic and networked SMEs as leading subcontractors or joint-venture firms in their own right within ASEAN. The levels of SME manufacturing value added, for example, tend to be much lower than those from the large firms (with over 200 workers) as well as those from their counterparts in East Asia, the United States and Europe (see footnote 1 above). This "hollowness" in ASEAN industrial structure has acted as a barrier to SMEs in their efforts to achieve higher productivity and, more generally, the gainful graduation from small (or medium-sized) enterprises to dynamic medium- (or large-) scale businesses. Notably, many large regional firms and those with transnational business activities in ASEAN at present had a humble start as SMEs several decades ago.[6] In addition, it is

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[2] As regards gender empowerment, a study by the Asia-Pacific Economic Cooperation (APEC) grouping shows that women entrepreneurs own and operate up to 30 per cent of SMEs in such countries as Indonesia, Philippines and the Republic of Korea (APEC 1999).

[3] For further details, see Hall (2002, p. 30), Harvie and Lee (2002, p. 6), Lee and Tan (2002, p. 377), Richards and others (2002, pp. 111-112), Tecson (2001, pp. 69-73), Regnier (2000, pp 112-114) and Tambunan (2000, p. 28).

[4] See, for example, Rodriguez and Berry (2002); Wattanapruttipaisan (2000a), Borrus, Ernst and Haggard (2000); Regnier (2000); Tambunan (2000); Levy, Berry and Nugent (1999); Liedholm and Mead (1999), Altenburg and others (1988); and Humphrey (1998). Additionally, clusters and networks of SMEs are also behind the emergence of competitive industries as well as the revitalization of many stagnant or declining regions in both developed and developing countries, including ASEAN. A detailed discussion on the diverse global and regional patterns of enterprise clusters and inter-firm networks and alliances can be found in Berry, Rodriguez and Sandee (2002); Boari (2001); Tambunan (2000); UNCTAD (2000, volume one); Liedholm and Mead (1998); Porter (1998), UNCTAD and Gate (1993); and Sengenberger, Loveman and Piore (1990).

[5] Featuring prominently in SME exports from Indonesia, Philippines, Thailand and Viet Nam are food products, textiles and garments, leather and plastic goods (including toys), furniture items, handicrafts, jewelry and, to a less extent, mature-technology automotive and consumer electronics parts. For further details, see Hill (2002, pp. 166-169 and 1995, pp. 13-16), Richards and others (2002, pp. 102-106), Rodriguez and Berry (2002, pp. 145-151), Steer and Taussig (2002, pp. 26-29); Regnier (2000, pp. 22-24), Tambunan (2000, pp. 33-36 and 96-109) and Tecson (2000, pp. 69-73).

[6] Notwithstanding his somewhat nuanced perspectives and interpretations, Yoshihara (1988, pp. 153-263) provides an interesting account of the stellar rise and transformation into large enterprises or TNCs of formerly small and family-owned or controlled firms (with many being SMEs) in South-East Asia. In a related context, many famous TNCs in the developed countries – including such well-known enterprises as Microsoft, Apple, Sony, Honda and so on – also started out as small companies.

both essential and pressing to provide adequate employment and business opportunities for the several millions of workers and numerous SME entrepreneurs displaced by the 1997-1998 crisis as well as for persons ready to enter the workforce or resume risk-taking activities.[7]

Furthermore, there is now a new development context or a paradigm shift to be managed by all business firms regardless of size. Firstly, the liberalization of global trade and investment flows has created vast demand opportunities but has also engendered fiercer competition from global and regional suppliers of goods and services. Indeed, many SMEs in South Asia and South-East Asia have already felt intense competitive pressures from China in a wide array of manufactured goods. Besides, China has gained a larger foothold (including in clothing, footwear, and telecommunication equipment) in the most important export markets for both ASEAN and China.[8] Secondly, consumer preferences and market demands are changing constantly as well as becoming more exacting. At the same time, such non-price parameters as product quality, health and safety in consumption, social equity in employment and production, and ecological implications of products and processes have become more important as a determinant of business advantage. All these have necessitated the adoption of new and innovative business and industrial organization models, and the upgrading of production and marketing processes by most SMEs (Wattanaprutipaisan 2002b, pp. 63-64; Momoya 2000, pp. 160-161; and Altenburg 1999, pp. 32-34).

As such, the promotion of SME growth and competitiveness in ASEAN countries can be expected not only to yield increasing social and economic returns domestically but also to empower the private sector in its on-going integration into the

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[7] Between 1997 and 1998, for example, the rate of unemployment more than doubled in Malaysia and Thailand, and rose by more than fourfold in Indonesia. The number of persons without a job went up to 0.6 million in Malaysia, 1.5 million in Thailand and 20 million in Indonesia. Female workers suffered a particularly severe impact because they were concentrated in the most precarious forms of low-skilled wage employment. In addition, during the high-growth era of 1980-1996, female participation rate in the labour force had expanded from 38 to 41 per cent in Indonesia, and from 34 to 37 per cent in Malaysia (UNESCAP 1999, pp.114-121).

[8] The trade patterns between ASEAN and China during the 1990s are examined in ASEAN (2001) while a detailed analysis of the gains, issues and implications associated with the proposed ASEAN-China Free Trade Area, made at the summit of ASEAN and China leaders in Singapore in November 2000, can be found in Wattanapruttipaisan (2003). The patterns of China'a penetration into

global economy. However, the process has long been constrained by the limited availability and accessibility of financial resources to meet a variety of operational and investment needs within the SME sector. Both demand- and supply-side factors have contributed their share to this financing problem in the region. These factors, together with four proposals for an enhancing SME access to finance as well as institutional capabilities in SME financing, are discussed with special focus on the banking sector in ASEAN.

It should be clarified at this juncture that the following discussion does not address micro-enterprises and related financing arrangements and issues.[9] Nor does it examine in any length a variety of supplementary financial arrangements suitable for SME financing except where these arrangements have a bearing on the issues considered in the text. Organizationally, section II examines the available evidence and indications of the limited share of SMEs in domestic business financing as well as the typical barriers and constraints on SME financing on both the demand and supply sides in ASEAN. The third section contains four specific suggestions to enhance SME access to bank finance and institutional capabilities to provide SME financing. These proposals are backed up by specific approaches and methodologies for implementation purposes. The concluding section reiterates some of the main issues and proposals discussed in the text.

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the G-7 markets are discussed at some length by Organisation for Economic Cooperation and Development (2002, pp. 138-142).

[9] Financial and other assistance measures with micro-enterprises as the primary beneficiaries have their own deserved place in the policy and institutional framework of any economy. This applies as regards efforts made to improve micro-enterprises' efficiency and competitiveness (growth and graduation considerations) and/or to safeguard social welfare by, among other avenues, offering self-employment to individuals or disadvantaged social groups with few other means of earning income (equity and safety net considerations). The trade-offs between efficiency and welfare policy orientation are discussed by Hill (1995, pp. 19-21 and 26) and Webster (1991, pp. 59-60) raises some pertinent issues based on a detailed assessment of 70 SME projects (33 of which had been completed), worth US$3.2 billion (plus US$4.3 billion of counterpart and local funding) implemented by the World Bank in 36 developing countries in Africa, Asia and Latin America during 1973-1989. Meanwhile, a sample survey of exporters of rattan and carved wooden furniture in Indonesia found virtually no micro-enterprises or small subcontractors which had graduated to become fully-fledged direct exporters (Berry and Levy 1994, p. 10). Coleman (2002, pp. 1-3) provides a brief review of some pertinent issues on micro-finance while an extensive literature survey on finance and development can be found in Levine (1997).

II. ISSUES AND CONSTRAINTS IN SME FINANCING

SME financing problems have to be seen against a more general context. Firstly, financial resources for development (whether of domestic and/or external origin) are in short supply in virtually all developing. Secondly, government has become "leaner and meaner" and new and innovative policy measures have to be introduced to widen and deepen investor interest and the investment base. Thirdly, financial intermediation and the related infrastructure and facilities (both financial and non-financial) can be improved and make more sophisticated in ASEAN as part and parcel of the development process itself.[10] Fourthly, SME financing difficulties also reflect other systemic and institutional issues, such as the underdeveloped legal and regulatory infrastructure (both hard and soft) and the prevalence of non-transparent practices.[11]

A. Limited SME Share in Domestic Financing

Bank finance has remained the dominant source of capital and credit for domestic business in most developing countries, including those in ASEAN.[12] It is also the main source of SME financing in both developing economies and even in

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[10] Financial sector development is approximated as the as the size of financial markets or the relative share of outstanding financial market assets in gross domestic product (GDP). The process has a positive impact on economic growth via, among other channels, the facilitation of risk sharing, the allocation of mobilized resources to the most efficient long-term applications, the minimization of moral hazard and adverse selection and, in various forms or guises, the monitoring and enforcement of good of corporate governance. The growth stimulus operates generally as well as in terms of sectoral structure, namely banking sector and capital market development. An extensive survey of literature on this subject can be found in Levine (1997, pp. 688-726).

[11] Weaknesses in the legal and regulatory framework governing creditor rights, collateral matters, and bankruptcy and exit procedures have combined with legal system inefficiencies and overloads to constitute another barrier in the case of SME financing. This barrier is prevalent in many developing countries, particularly among economies in transition in Central and Eastern Europe (Klapper and others 2002, pp. 8-11) and in Asia such as Viet Nam (Richard and others 2002, pp. 117-118 and 122-125). This is because institutional designs, and the related provision of incentives and sanctions, is a process of trial-and-error and of searching for workable ways to adjust most effectively and timely to changing circumstances. Shifting between coordination and enforcement mechanisms in many economic and social spheres is necessarily a lengthy and complex process (Postma 2002, 98-100).

[12] It is pertinent to note two of the lessons from the financial and economic crisis in East and South-East Asia during 1997-1998. One, over-dependence on bank finance tends to increase financial systemic risks, including through the contagion (or cascading) effects. Two, corporate governance problems (which have been in existence) will accumulate without outsider control functions, such as those exercised by the equity and capital (bond) markets.

financially advanced countries such as the United States.[13] Bond financing is not a viable option for most small businesses, due to the substantial cost in the underwriting and distribution of paper securities, while equity financing has its own limitations, especially in terms of the tight market listing requirements and the possible loss of control to the external investors (Takagi 2002, pp. 74-75). Generally, concerted efforts have been made in ASEAN and elsewhere to encourage commercial banks to lend to SMEs by means of loan quotas, interest subsidies, tax breaks, guarantees against default and so on. These efforts have also been supplemented by a variety of other measures such as the establishment of development financial institutions (DFIs) for agriculture and industry, and other specialized banks. Moreover, the qualified or targeted SMEs are also provided with financial support under various business development services (BDS) ranging from training, export marketing, participation in trade and technology fairs to inter-firm linkage promotion.[14]

On balance, direct and indirect intervention in the financial sector has not been able to compensate for the various biases against the SMEs sector unintentionally introduced into, or inherent within, the domestic policy and regulatory framework. Firstly, there is the (scale-based) "perverse" incentive syndrome whereby tax, financing and other benefits and privileges are granted by government in exchange for certain minimum or baseline requirements to be undertaken by the enterprises concerned as regards investment size, employment volume, and/or export quantities and values.[15] Secondly, import substitution policies in several ASEAN countries used

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[13] In particular, corporate equity and debt securities were equivalent to 115 and 53 per cent respectively of the combined GDP of the group of seven richest countries in the late 1990s. However, the corresponding figures for Indonesia, Malaysia, Philippines and Thailand were 56 and 6 per cent respectively. In addition, the stock of outstanding bank loans in these four ASEAN members was about 92 per cent of their combined GDP, compared to about 45 per cent in the two major emerging economies in Asia (India and Republic of Korea) and four per cent in Central Europe (World Bank and International Monetary Fund 2001, p. 363-366).

[14] There is a relatively extensive literature on various government assistance programmes in favour of SMEs in Indonesia (Hill 2002, pp. 160-164; and Urata 2000, pp. 21-26), Malaysia (SMIDEC 2002, pp. 12-13), Philippines (Viloria 2001, pp. 135-159), Singapore (Hew 2002, pp. 9-14), Thailand (Brimble and others, 2002, pp 208-221; and Mizutani 1999), and Viet Nam (Richards and others 2002, pp.117-135). A checklist of SME assistance programmes among 21 APEC members, including 7 from ASEAN, is presented in APEC (2002, pp. 88-99).

[15] According to Regnier (2000, p. 65), about 70 per cent of the big, locally-owned and joint-venture firms enjoyed various incentives and privileges from the Board of Investment in Thailand during the 1970s to the early 1980s. In textiles and garments, for example, some four-fifths of the large enterprises receiving public-sector assistance between 1960 and 1976 were in joint venture with Japanese firms. Another trade-off from the scale-based syndrome is the implicit constraint on foreign direct investment (FDI) in local SMEs, and on the formation of linkages between these local enterprises

to protect sectors dominated by large-scale and capital intensive firms. Thirdly, the complex legal and regulatory environment has often combined with opaque discretion to raise significantly the transaction costs on SMEs on account of their limited size and resources (Hallberg 2001, pp. 9-11).[16] Fourthly, SMEs are not well or adequately represented in private-public interaction and dialogues. Lastly, social perceptions and administrative attitudes in economies in transition are not yet wholly judicious to private enterprise, including SMEs (Richards and others 2002, pp. 117-118 and 122-125).

By and large, financial and other support measures, and the massive subsidies involved, in SME financing have not been as successful as originally intended; there are also a variety of unfavourable trade-offs and negative externalities so generated in the process.[17] Indeed, limited outreach at disparate cost to stakeholders is the perennial weakness, although at varying orders of magnitude, of SME financing from the formal financial sector in a large number ASEAN countries (Hill 2002, p. 174; Tescon 2001, p. 146; and Sahami-Malmberg 2000, pp. 117-119). Indeed, the persistent constraints on SMEs financing, and the restrictive terms and conditions on approved loans, are virtually a universal and significant problem among developing countries (UNCTAD 1995, pp. 7-10). However, this unsatisfactory state of affairs is not wholly due to the limited supply of finance because there are examples of significant under-disbursement of public-sector resources allocated to SMES within the system itself (more later).

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and overseas firms. Thus, these SMEs are deprived of valuable opportunities to obtain crucial technological and financial inputs, and market access associated with such FDI or inter-firm linkages.

[16] Research in Indonesia indicates that the cost penalties arising from bureaucratic procedures and other transactions with public-sector agencies may be equivalent to 5-8 per cent of operating costs to SMEs. More generally, however, the political economy of regulation tends to necessitate the cultivation of personal connections with key officials in government and public-sector bodies, the so-called pork barreling and relationship banking. Large companies are comparatively in a much better position than SMEs in theses regards (Hill 2002, p. 163).

[17] These include slow progress in the development of sustainable financial schemes, the structural diversification of financial institutions and the emergence of a “non-repayment culture” among enterprises, especially if the resources concerned are regarded as part and parcel of poverty reduction efforts from the public sector (Hallberg 2001, p. 12). More generally, many financial and technical assistance programmes from government are perceived by SMEs as of limited impact and relevance, with the possible exception of market information dissemination and assistance in trade fair participation (Hill 2002, p. 174; Berry, Rodriguez and Sandee 2001, pp. 377-379; Holtmann and others 2000, pp. 5-7; Regnier 2000, p. 67; and Webster 1991, pp. 46-47 and 51-53).

Although many analytical studies have been carried out on SME financing problems, there exist very few comparable data or empirical surveys on the nature and extent of SME participation in commercial bank financing across ASEAN.[18] Besides, most of the studies and surveys so far undertaken focus on a few, and often individual, ASEAN members while many surveys are additionally plagued by a number of methodological problems, making cross-country and cross-sectional comparisons less reliable.[19] Even with such limitations, it is apparent that to meet various financing needs between 75 and 90 per cent of SME entrepreneurs in the region rely largely on their own savings, internal resources of the firm (such as retain earnings and other enterprise funds), short-term (unsecured) borrowings from relatives and friends (also known as business angels or informal equity investors), and grey-market loans.[20] In addition, bank finance does not often cover all the financing needs of SMEs. In Malaysia, for example, funds from commercial banks met respectively 62 and 21 per cent of working capital and long-term investment requirements from the surveyed SMEs; the corresponding figures for SMEs in Thailand being 57 and 37 per cent. Public financial institutions and private finance companies remain a minor source of SME financing in both countries.[21]

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[18] The shortage of up-to-date and comparable data is particularly evident in terms of the sectoral and industrial composition of SMEs; the structure and characteristics of SME inputs and turnovers; the contribution of SMEs to income, employment, exports and taxation; and the share of SMEs in fiscal and monetary allocations and incentives. A more detailed discussion on these matters can be found in APEC (2002, pp. 11-14 and 24-35), Regnier (2000, pp. 35-37), International Labour Office (1997, pp. 36-37), Hill (1995), and APEC (1994a and 1994b).

[19] Among the major weaknesses are the small and non-representative sample of firms within the same or in different industries, under-reported or mis-measured data (including those from follow-on interviews), limited controls over local or industry-specific factors that may impact on the perceptions and responses, the absence of regular or time serial surveys, and the lack of cross-sectionally comparable questionnaires. In particular, enterprises are frequently selected on a non-random basis, and this bias "over-states" the degree of SME participation in bank financing (or in the focal areas of attention) since the surveys concerned, for reasons of accessibility, tend to cover better performing firms or SMEs which are in the top segments of their class in term of size, growth, and outward and networking orientation. In all fairness, however, it should be noted that selection bias is perhaps unavoidable. As indicated earlier, the number of non-agricultural SMEs is massive – ranging from 50 thousands in Singapore, 100-350 thousands in, Thailand and Viet Nam, 800 thousands in Philippines to some 16 million in Indonesia (APEC 2002, p. 37). In addition, SMEs are widely found across domestic regions, provinces, and urban and peri-urban areas. Moreover, private enterprise is a relatively new phenomenon in economies in transition to a market-based system.

[20] A similarly heavy degree of reliance on internal sources of funding for enterprise operating and investment needs in China is also obtained by the International Finance Corporation (IFC) from a survey of 628 firms in four major cities (2000, pp. 48-49), and by the Asian Development Bank from a survey of 724 firms (with an average number of 228 workers per enterprise) in five major cities (2003, pp. 73-77).

[21] The survey was conducted in 1999 by Japan Bank for International Cooperation and involved a sample of 221 and 642 relatively large firms within the SME sector, which were still operating after the crisis in Malaysia and Thailand respectively. It provides further confirmation that the larger and

Furthermore, on the basis of survey results in developing countries outside ASEAN, it can also be expected that the financing constraint is particularly severe on start-up enterprises and relatively young firms (some three years old or less), as well as on smaller firms in lower-income developing economies in the region. For example, only 10 per cent of start-up firms in Ghana can obtain bank loans but medium-sized enterprises and older firms (presumably with a good credit history and hence relationships with banks) are provided with start-up credit three times more often than their smaller counterparts. These results are, by and large, confirmed by a survey in Sri Lanka and Tanzania where four-fifths of firms with 16 or more workers and with 6 or more years in operation are able to access bank loans -- compared to the success rate of around 55 per cent in the case of smaller firms (6-15 employees) of similar age, and less than 10 per cent for firms with 5 or fewer workers, regardless of age.[22] Another survey in China shows that the share of bank loans increases with the size of the firms although it still remains relatively low, ranging from between 20 and 35 per cent of the required capital of the (relatively large) enterprises concerned (IFC 2000, p. 51).

It is very difficult at present to obtain comparable indicators of the total amount and relative share of institutional or bank finance secured by SMEs in ASEAN and elsewhere, too. Despite concerted efforts, APEC is able to estimate the financing share of SMEs for just seven economies (out of 21 members) with four

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older SMEs are better placed to obtain bank finance. Additionally, public-sector financial institutions are only a minor source of SME financing, and this issue will be discussed further in the text. The same is also true for private financial companies which provided respectively only 7 and 16 per cent of working capital and investment needs of Malaysian SMEs in 1999. The corresponding ratios in the case of Thai SMEs were just over one per cent in each instance (Urata 2002, p. 4 and table 4). As regards China, bank loans are equivalent to just 10 per cent or less (or over 50 per cent) of the needed capital of 63 (or 6) per cent of the enterprises with access to institutional credit (Asian Development Bank 2003, p. 95).

[22] Aryeetey and others (1994, pp. 18-19) conducted a survey of 133 firms, of which 76 had less than 10 workers, in various industries in Ghana in the early 1990s. Levy (1993, pp. 69-71) surveyed 38 firms (with 15 having 5 workers or less) in the leather industry in Sri Lanka, and 20 firms (with six of them having 5 workers or less) in the furniture industry in Tanzania in the late 1980s. In comparison, Klapper and others (2002, p. 20) found a positive correlation between younger SMEs and bank financing as well as between these enterprises and profitability in a sample of 79,723 SMEs in various industries in 15 Central and Eastern European economies in transition for the year 1999. SMEs had emerged from the break-up and/or privatization of SOEs in the wake of economic transition some 10 years back; they have also benefited considerably from international assistance programmes. As such, many SMEs in Central and Eastern Europe tend to have easier access to bank finance because of their dynamism and profitability.

being developed countries and Indonesia being the only ASEAN economy with some available estimates (APEC 2002, pp. 74-75).[23] By and large, suggestive evidence indicates that the SME sector may share only one-fifth or less of the institutional credit extended to all businesses in the late 1990s (APEC 2002, p. 74; Viloria 2001, pp. 142-143; and Berry, Rodriguez and Sandee 2001, p. 378). This relative stake, which may be subject to a margin of error both ways, is slightly lower than SME contribution to aggregate production. However, it is certainly much less than the relative importance of SMEs in domestic employment generation.

A number of implications can now be explored briefly. Firstly, Indonesia registers perhaps the fastest expansion in formal-sector financial services (especially branch banking) within the region.[24] Yet, only 12 per cent of SMEs are estimated to have access to bank finance in the country (APEC 2003, p. 5). Meanwhile, almost two-thirds of the surveyed SMEs in the garment industry have accounts at commercial banks in Indonesia but less than 20 per cent have ever applied for and actually obtained a bank loan. As regards SMEs in the wood furniture industry, the corresponding figures are 47 per cent and less than one-tenth (van Dierman and others 1998). These comparatively low ratios are, in part, reflected from the institutional side with a very low ratio of SME loans to deposits, implying thus some resource transfer to other borrowers.[25] Indeed, it has been colloquially remarked that bank

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[23] Further research is overdue on the whole subject matter. On the one hand, it is important to have a more informed estimate of the volume of funds (plus the associated terms and conditions) from different categories of financial institutions, (including private financial companies and DFIs) and the monetized incentives and BDS channeled to SMEs for start-up purposes, working capital as well as investment requirements. In addition, what are the major issues and bottlenecks which have been encountered from the supply side in the financing of SMEs? On the other hand, it is also of significant policy interest to have a clear picture of the main segments of the SME sectors which have been accorded with, or have failed to access, commercial bank and other sources of institutional finance. These segments may be looked at in terms of sectoral distribution, market sales orientation (local or external), technological profile, age structure, composition and origin of equity capital, and employment volume and workforce characteristics.

[24] For example, the number of private commercial banks (and their offices) jumped from 63 (and 559) in 1988 to 144 (and 4,150) a decade later. Foreign banks, including joint-venture banks, numbered 11 and 44 respectively during these two benchmark years. Meanwhile, state-owned commercial banks almost doubled their network over the same decade, from 815 offices in 1988 to 1,527 in 1997. Earlier, interest rate controls and credit ceiling fixed annually for commercial banks had been removed in 1983 (Simanjuntak 2001, pp. 31-32).

[25] In particular, Bank Rakyat Indonesia, the country's fourth largest bank, is widely regarded as a success story in small-scale lending. Currently, the bank has over 24 million deposits accounts but only 2.5 million borrowers, with an average loan size of US$300-350 and an average loan to deposit ratio of 35 per cent (McCawley 2003, p. 40).

credit is just a flower added to the brocade, instead of being charcoal in snowy weather (Asian Development Bank 2003, p. 110).

Secondly, SMEs have to pay a higher rate of interest and comply to more restrictive requirements on institutional credit obtained by them, compared to those imposed on their large-scale counterparts. For example, the interest premium in 33 completed World Bank projects on SME financing (mentioned earlier) averaged 4.9 points for small enterprises and 4.4 points in the case of medium-scale firms. In absolute terms, the rates on SME loans are as high as 24-33 per cent, reflecting in part the larger inducement for financial institutions to participate in SME lending (Aryeetey and others 1994, p. 32; and Webster 1991, pp. 37-38 and 58). Moreover, upwards of four-fifths of SME applicants are required to provide suitable collaterals and the preferred security of fixed real estate assets has imposed a difficult requirement on smaller enterprises. Loan terms are typically for 12 months although there is no comparable information on loan rollover rates.

However, it is access to finance (rather than the cost of finance as such) which has constrained SME development and competitiveness. Furthermore, because of location or sectoral specialization, many firms within the SME sector are growing beyond the size that informal sources of finance can support and institutional credit is the only feasible option for upward movement to them (Asian Development Bank 2003, p. 27-28; Hill 2002, p. 174; IFC 2000, pp. 32-33; and UNCTAD 1995, p. 6). Additionally, many firms will gladly accept and carry bank credit at double the going (institutional) rate because financial sector interest rates are still far below those from the curb or grey markets.[26] Rates from these markets may be up to 30 per cent per month on a “short-term” monthly loan, and between 5 and 10 per cent a month for “long-term” loans of a year’s maturity (UNCTAD 1995, p. 15; and Aryeetey and others 1994, p. 37). These sheer magnitudes illustrate the remarkable productivity of capital in the SME sector in many low-income countries.

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[26] In China, for example, commercial banks can vary the interest rate on one-year term loans (which stood at 5.31 per cent in February 2002) up to plus or minus 10 per cent for SOEs. The percentage variation can be up to 30 per cent for SMEs and 50 per cent for rural cooperatives. However, many banks still see the returns as inadequate to compensate them for the risks and costs incurred in lending to private firms (Asian Development Bank 2003, p. 29; and IFC 2000, p.53).

Thirdly, DFIs have played only a minor financing role: in Malaysia, for example, about 4 per cent each of SME credit for working capital and long-term investment respectively came from these institutional sources in 1999; the corresponding percentages were 4 and 2 per cent in the case of Thailand (Urata 2002, p. 4 and table 4; and Regnier 2000, p. 25). Indeed, the performance of public-sector institutions with a SME funding mandate often leaves much to be desired. A detailed review of the 33 World Bank projects (noted earlier) shows that the average loan size (US$130,330) and the average cost of job creation US$12,721) from DFIs were respectively four times and three times larger than the overall average. Yet, the repayment rate achieved by these institutions was only 62 per cent, compared 80 per cent overall (Webster 1991, pp. 24-25 and 35).

Fourthly and in the above context, the informal financial markets remain a major source of funds for SMEs in ASEAN; notably, these markets were also an important source of finance for many business firms in the Republic of Korea and Chinese Taipei up to the late 1980s. Grey market funds are highly flexible, respond speedily to varying or unexpected needs, and are revolving for the credible SME customers, notwithstanding the exorbitant rates of interest on them indicated above. As a matter of fact, these grey sources of fund have become even more important in the wake of the financial crisis in 1997-1998, providing SMEs with 13.6 (8.4) per cent of working capital, and 6 (5.1) per cent of investment requirements in Malaysia (Thailand) in 1999. These funding ratios were even larger than the combined share of credit extended to SMEs from private financial companies and DFIs in these two countries for the same period (Urata 2002, p. 4 and table 4; and Regnier 2000, p. 25).

Fifthly, the spread effects of macroeconomic stability and vibrant economic growth in the two decades before the 1997-1998 crisis offset considerably the adverse impact of the disproportionately low share of financial resources channelled to the SME sector (Hill 2002, p. 174; Urata 2002, p. 10; Berry, Rodriguez and Sandee 2001, p. 378; Tecson 2001, p. 74; and Regnier 2000, pp. 25-26). On the other hand, large segments of SMEs will be pushed to the to the forefront of the domestic economic recession with any serious reversal of macroeconomic economic and financial fortune.[27] There is, in particular, considerable evidence of a sharp decline in business loans to SMEs, and their greater reliance on grey-market funds, during the crisis period of 1997-1998. The falling or negative rate of growth in credit persisted in the later part of the 1990s due partly to the high level of non-performance loans within the financial system and the banks' preoccupation with troublesome, large borrowers (APEC 2002, p.73; Urata 2002, pp. 7-10; and Regnier 2000, pp. 39-48). For example, the seven state-owned banks and specialized financial institutions in Thailand disbursed only 52 per cent of the allocated resources for SME financing totalling 70 billion baht (US$ 1.6 billion) during 1999 and the rate of disbursement for the first half of 2000 was largely at the same (slow) rate as that in the previous year.[28]

B. Supply- and Demand-side Constraints on SME Financing

The unsatisfactory outcomes as regards SME financing, as reviewed above, are due to a variety of adverse factors of both a systemic and institutional nature. Firstly, most financial institutions have not been able to operate profitably with SMEs as their sole or major debt clientele, despite the interest premium based on higher risk and transaction cost. Even in developed countries such as the United States, small-business loans are regarded as opaque assets, constituting thus the main component of credit risk (Carey 2001, p. 48; and Moody's Investors Service 2000, p. 10). In addition, commercial bank funds are essentially short-term while long-term lending to SMEs can be sourced from DFIs which are set up by government to provide finance to new entrants and for investment purposes. However, DFIs' lending resources

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[27] In particular, the SME sector in ASEAN was hard hit through the direct and spill-over effects of a sudden collapse of demand and high inflation, a hike in input costs (due to steep currency depreciation) and in the prices of goods with a sizable import content, and the even more acute shortage of finance and the very high cost of loan funds. However, the nature and magnitude of the crisis impact on firms depends on the degree of their export orientation, the sectoral concentration of production, ownership structure (such as joint venture firms), the extent of exposure to formal-sector financing, and operational scale or size itself. Generally, survey data indicate that around 70-80 per cent of SMEs in the manufacturing sector were adversely affected by the unexpected sharp drop in demand in many crisis-hit or affected countries in East and South-East Asia. For example, about three-fifths of SMEs in Thailand experienced a serious liquidity problem, compared to one-half in the Republic of Korea and 30 per cent in Malaysia. For more details, see Abdullah (2002); Harvie and Lee (2002); Urata (2002 and 2000); Berry, Rodriguez and Sandee (2001), Tecson (2001), Regnier (2000), Tambunan (2000) and van Dierman and others (1998).

[28] Disbursement under the New Entrepreneur Fund in Malaysia averaged around 53 per cent of the annual allocation of 1.25 billion ringgit (or US$ 328 million) for 1998 and 1999. However, the rate of approved lending under the Fund for Small and Medium Industries went up from 29 per cent of the allocation of 1.85 billion ringgit (US$ 487 million) in 1998 (a crisis year) to 88 per cent in the following (recovery) year. See Urata (2002, tables 8 and 9).

(from local and donor funding) are much more limited than those from commercial banks due to their typical lack of an adequate and independent resource base.[29] Besides, most DFIs do not have an extensive branch structure, and a diversified range of institutional products and services on offer in many ASEAN and other developing countries (UNCTAD 1995, pp. 8-9; and Webster 1991, pp. 35-37). As a result, many commercial banks and DFIs are reluctant to implement SME-related lending programmes initiated by government and aid donors; they also tend to concentrate their services on the most obviously creditworthy businesses and large-scale enterprises, as discussed previously (Asian Development Bank 2003, pp. 29-31; UNCTAD 1995, pp. 7-8; Levy 1993, pp. 73-74; and Webster 1991, p. 19).

Secondly, for various reasons, many SMEs avoid using commercial banks for payroll management and other day-today working accounts (of incoming and outgoing transactions), thus precluding the formation and cementing of bank-client relationships which are an integral part of the so-called reputation collateral on the SME side. Thus, most commercial banks and DFIs do not have sufficient information on, among other things, the likely cash flows in business performance (and hence the capacity for loan repayments internal to the enterprises under consideration) plus the credit histories of the concerned SME entrepreneurs themselves, including their personal characters and business commitment. As a result, the paperwork and documentation required by banks can often takes 24 work-days to complete, compared to the 14-day gestation time on credit applications from large firms and less than two weeks in micro-lending (Aryeetey and others 1994, p. 32; and Webster 1991, p. 58). Furthermore, the high operating costs in SME lending and contract enforcement remain a persistent problem even at low default rates (Otero and Lopez 2001, p. 20).[30] However, delays in the loan appraisal and approval process have caused missed opportunities, cost overruns and leakages of commercial or trade

[29] For example, through the mobilization of domestic savings, equity investment and venture capital. This lack of a capital base has necessitated the continued reliance on government for refinance. However, public-sector resources are under severe constraints in many countries while market distortions arise in cases of subsidized credit and preferential allocations of funds and foreign exchange.

[30] In Indonesia, for example, the lending expenses may be as much as 26 per cent of the credit amounts of US$ 250 or less but they fall to less than 3 per cent for loan sizes larger than US$ 2,500 (Urata 2000, p. 30).

secrets, thus reducing further the motivation of small entrepreneurs to approach banks for finance.

Thirdly, bank lending decisions are traditionally based on the availability of fixed assets on offer as collateral, a sound business plan and, to a much lesser extent, a personal guarantor or mutual guarantee fund for loans, and machinery and equipment to be purchased by the loans under application being offered as partial security. Land and buildings are most often required (at least in 8 out of 10 cases, for instance) but few SME entrepreneurs have clear and good titles to real estates, especially those in low-income developing countries and economies in transition (Miller 2001, p. 41; and IFC 2000, p. 31 and 54).[31] In addition, real estate collaterals have become more problematique in ASEAN following the sharp decline in prices after the 1997-1998 crisis. However, the crisis-induced reforms have led to a better legal and regulatory framework in East and South-East Asia which has reduced somewhat the level of credit risks and improve the management of such risks. Nevertheless, there are still as significant difficulties and delays in the exercise of contract rights to possess collaterals and liquidate non-paying businesses, and persisting problems in contract enforcement and legal system overloads render the whole process unaffordably complex, costly and time consuming to all but the largest creditor firms.

Collateral requirements by commercial banks in developing countries have been a contentious issue in SME financing. However, 92 per cent of all small-business debt to financial institutions in the United States are secured (IFC 2000, p. 54). Even in some successful micro-loan schemes (with loan sizes averaging US$ 400) charging market interest rates, some collaterals are still required on top of an upfront (returnable) deposit as penalty for late repayment (Holtmann and others 2000, p. 2; and Webster 1991, pp. 57-58). Real-estate collaterals provide an incentive and a justification to lend and repay, as well as a means to offset losses in case of default (Otero and Lopez 2001, p. 20; and Aryeetey and others 1994, pp. 27-28). As

[31] Notably in this connection, current proposals under the new Basel capital accord entail a higher risk weight for retail bank lending secured by commercial real estate, with possible adverse implications for SME financing. The likely impact and implications of the so-called Basel II code on SME financing are examined by Carey (2001, pp. 47-50). The implementation of this new code was originally scheduled to take effect by the end of 2006 after the expected completion of the comment and revision process in November 2003. It is likely to be postponed by at least a year because of extensive criticisms of the proposed changes by numerous stakeholders around the world.

collateral, a business plan provides the roadmap and benchmarks for loan appraisal and the monitoring of business activities under implementation. This helps to minimize diversion and other misuses of borrowed funds which are a clear possibility without demonstrated financial discipline by SMEs and close supervision from banks (Asian Development Bank 2003, p. 29). As regards governance and succession, most SMEs are owned and operated by the (founding) entrepreneurs and their extended family members. As such, SME access to institutional finance is further constrained because of the excessive dependence on the founding groups, the understandable reluctance to go "public", the lack of clear managerial targets and succession plans, and the very high rate of defaults and insolvency, a problem attributable to SMEs' low capital base and limited internal reserves to meet unexpected adverse developments.[32]

Fourthly, supplementary financing or credit enhancement arrangements include credit guarantee, export and import bridging finance and refinance, venture capital, equipment leasing, inventory financing or factoring, and credit risk insurance.[33] They are clearly needed in developing countries, including ASEAN, to widen the investment base and funding opportunities for SMEs and other businesses. Their successful operation, however, is predicated on the existence of a relatively sophisticated financial system, efficient intermediation processes, and credit data registries and credit information analysis similar to those in the developed or high-income developing economies (Holtmann and others 2000, p. 6). Credit guarantee operates with reasonable success in developed countries and, among the various credit supplementary schemes, its utilization is comparatively more widespread among developing countries. Guarantee arrangements are especially important as a means of enhancing access to finance for SME entrepreneurs with viable projects but without adequate collateral requirements (Asian Development Bank 2003, p. 35). Nevertheless, a detailed review of 33 completed SME projects funded by the World

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[32] In Philippines during 1990-1995, for example, less than one half of SME start-ups were still operating after five years. The survival rates are lowest (around 20 per cent) for enterprises with 10 to 99 workers (Tecson 2001, p. 74). Other evidence indicates that 48 per cent of firms are between 1 and 5 years old, and about a quarter each survive for 6-10 years and for more than 10 years respectively (Rodriguez and Berry 2002, p. 154).

[33] For a concise discussion on the merits and disadvantages of credit enhancing arrangements and additional sources of finds in relation to SME financing, see Rodriguez (2002, pp. 12-18), Sahami-Malmberg (2000, pp. 119-122), Levitsky (2000, pp. 125-135) and UNCTAD (1995, pp. 12-14). Aylward (1988, pp. 2-21) presents the outcomes from a survey of about 410 investment projects made

Bank (noted previously) indicates the limited success of credit guarantee arrangements, and the consequent distrust among the involved stakeholders (including retail banks and entrepreneurs) in many developing economies. Partly as a result, commercial banks continue to require collaterals and guarantees on SME loans, among others (UNCTAD 1995, p. 20). These outcomes confirm an earlier finding by Levitsky and Prasad that there are certain conditions which have to be met for these schemes to achieve their design objectives.[34]

Lastly, several attempts have been made to establish an equity market dedicated to SMEs, although with limited success so far. The Philippine Stock Exchange, for example, started a nation-wide campaign in July 1998 for a SME capital market in favour of young companies with an outward orientation and/or high potential for growth. However, the subsequent response from SMEs has been less than enthusiastic due to the tight listing requirements.[35] Similarly, the Stock Exchange of Thailand was not able to open a second or alternative board for SMEs in 1999. Some 68 SMEs with capitalization from 40 million baht (just under one million United States dollars, or in upper segment of small firms) to 100 million baht (or about US$ 2.5 million, or in lower segment of medium-sized enterprises) had

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by 53 venture capital funds in 19 developing countries in Asia, and economies in transition in Central and Eastern Europe.

[34] Among the prerequisites and other international best practices are, firstly, that commercial banks participate in guarantee schemes so as to lower government liabilities in covering losses. Secondly, independent appraisal of guarantee requests are to be made to avoid the transfer by banks of riskier SME loan portfolios to the schemes. Thirdly, the percentage loan guarantee should preferably be between 70 and 80 per cent of face value, as a lower guarantee ratio may not justify the costs and efforts by banks to obtain the guarantee, and vice versa. Fourthly, there should be sufficient capitalization and refinancing of guarantee schemes and most successful schemes consider a 5 per cent default rate as rather high. A leverage rate of 5-10 should be a target to aim at after 5 years of operation. Fifthly, cost recovery and related administrative expenses are to be incorporated in guarantee fees although full cost recovery will add an additional burden on banks and hence on the SME borrowers. In addition, guarantee schemes should take whatever collateral available (e.g., cars, future revenues, and promissory notes) to provide the right signal as regards financial resource scarcity. Sixthly, it is essential to have in place efficient operational procedures to ensure transparency, simplicity and speediness in claim applications and settlements. This will also help to minimize moral hazard problems which will retard the development of a commercial credit culture, including the weakening of incentives for SMEs to prepare reliable financial accounts concerning their credit worthiness (Asian Development Bank 2003, pp. 28-31; IFC 2000, p. 69; Aryeetey and others 1994, p. 40; and Webster 1991, pp. 59-60).

[35] The requirements include (a) authorized capital of US$0.4-2 million with paid-up capital of at least one-quarter of the authorized amount; (b) two years of positive net operating income; (c) minimum offering size of one-fifth of the authorized capital; (d) lock-up period of three years; (e) existing owners to retain 51 per cent of equity holding; (f) the number of shareholders to be at least 50 persons. Additionally, SMEs must undergo a nomination and listing process before they can join the SME capital market. Considerations are now given to the establishment of a separate exchange for SMEs so as to better cater for the special needs of these enterprises (Viloria 2001, pp. 150-151).

originally expressed an interest in listing. They were subsequently deterred by disclosure requirements which were largely the same as those for companies listed in the main board (Regnier 2000, p. 82). Other more general reasons for the reluctance of SMEs to "go public" include the relatively tedious and costly procedures for regulatory issues of papers as well as the small number of underwriters for them, and the large fixed costs in underwriting and distribution (IFC 2000, p. 22). Taxes on initial share offerings and on share transactions are another disincentive. Lastly, it does not help that many equity markets are subject to a significant degree of speculation (Takagi 2002, pp. 74-75; and Viloria 2001, pp. 150-151).

III. FOUR PROPOSALS FOR ENHANCING SME FINANCING

It can be seen from the above review that SME financing problems cannot be resolved just through mere lending in most developing economies at present (Holtmann and others 2000, p. 7; and Levitsky 2000, p. 125). Indeed, the less formally organized SMEs are, the less access they will have to formal finance. Similarly, the less developed the financial markets are, the higher is the dependence of SMEs on their own and other informal sources of finance (UNCTAD 1995, p. 6). A well developed financial system will have many different types of (banking and non-bank) institutions and instruments (short- and long-term risk capital, equity stocks, and debt and asset-backed securities) to better match the different risk and return profiles and time preferences of domestic and external investors. These institutions and instruments will also serve more effectively the diverse needs, and cost-evaluation and risk-hedging behaviours of all borrowers and, other things being equal, ensure an acceptable level of systemic good governance in the process. Reputation collateral can be built up over time since financial institutions can be relied on by SMEs for both investment and operational purposes (including day-to-day working accounts and payroll management, as mentioned earlier).

Clearly, ways and means (especially capacity-building measures) have to be in place to foster gradually the most competitive allocation and utilization of scarce financial resources by all the stakeholders on both the demand and supply sides. The following proposals are made because there are few, if any, viable options in the long run. The financial sector has to be upgraded and become more sophisticated not just to enlarge and deepen investor interest and the investment base (Takagi 2002, p. 68-69). As noted earlier, financial sector development is an essential response to the impulses and imperatives from the increasing volume and complexity of business transactions as ASEAN economies and enterprises develop and integrate regionally and globally in the coming decades. Corporate governance is important in these contexts and the incidence of imperfect information, plus the related needs for due transparency and accountability, is directly addressed or implicitly embodied in the four proposals to be discussed below.[36] These suggestions can be regarded not just as a credit appraisal technique but also as a practical tool for financial management in the long term (Connelly 2001, p. 21). Two proposals each are related to the financial demand side (SMEs) and financial supply side (banking institutions), with the former being discussed first.

A. Financial Information Disclosure by SMEs

Inadequate financial record keeping, and the consequent failure to make good use of the available financial information, is characteristic of micro-enterprises and many small businesses in developing economies. Micro-enterprises are mostly sole proprietorships which tend to have a less distinct separation between the finances of the entrepreneur's business activities and those of his own personal household transactions (Holtmann and others 2000, p. 2). The absence of proper financial accounting among many small and even medium-scale firms may be due to various reasons, ranging from the reluctance to reveal critical information to competitors to

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[36] Corporate governance has become a matter of significant concern, especially against the backdrop of the 1997-1998 financial and economic crisis in East and South-East Asia. However, this matter is not a focal area of this paper and, as needed, will be discussed in the context of other issues under consideration. Briefly speaking, from the views of a shareholder, corporate governance is understood as the ways in which suppliers of finance to companies assure themselves of getting a return on their investment in an environment of asymmetric or imperfect information dissemination. A broader perspective and approach towards corporate governance encompasses the design of institutions that induce or force the internalization of the welfare of stakeholders in management decisions, thus ameliorating the problems in maintaining transparency and accountability. As such, corporate governance relates to those institutions which govern and regulate the agency problem associated with hidden action (the investors and stakeholders are not aware of all the actions taken by management) or hidden information (management has information that the investors and other stakeholders do not have), or the relationship between stakeholders and shareholders as mediated by corporate supervisory and non-executive boards, and the top management of the organizations concerned. See Shleifer and Vishny (1977, pp. 737-783) for a literature survey on corporate governance. A detailed examination of governance issues in the crisis-related, Asian context can be found in the collection of conference papers in UNESCAP (2001) and Zhuang and others (2000, two volumes).

non-transparent practices to minimize the tax burden. Nevertheless, it precludes the establishment of long-term bank-client relationships which are part and parcel of the reputation collateral. Furthermore, the availability of good information on enterprise finance and governance structure is a prerequisite for the preparation of a bankable business plan which, as indicated earlier, can be used as a partial substitute for fixed-asset collaterals on the financial supply side. Shortcomings in information disclosure can, therefore, be viewed as evidence of management weaknesses and financial indiscipline by institutional analysts and loan appraisers (Kao and Tan 2002, p. 55 and 157).

Adequate disclosure of useful financial information on financial accounts and enterprise ownership means the presentation, in a fair and transparent manner, of the firm's credit footprint as well as the track record on governance. It applies to both form (standardized format and timely availability) and substance (reliability, relevance, compatibility and understandability). Standard accounting rules and norms already contain sufficient disclosure to meet those criteria in the three main components of the firm's financial transactions during the budgetary period.[37] As such, financial accounting and control systems are very important for small businesses, especially at the start-up and development stages when SMEs' needs for investment and working capital are greatest. However, these are also the times when institutional credit is comparatively much more difficult to obtain by them, as was discussed earlier. But financial and accounting information is also useful for other purposes, including the diagnosis of possible problems or hidden advantages.[38]

Due diligence is an obligatory process for financial institutions and there is a larger issue in the context of disclosure. For practical reasons, the post-crisis reform in corporate governance has a primary focus on publicly listed companies; these

[37] Namely, the operating statement (or residual income statement), the balance sheet to show the anticipated or expected financial outcomes and position of the firm, and the cash-flow statement which plots cash movements associated with all transactions of the firm.

[38] Financial statements from an SME, for example, may reveal a low debt-to-equity ratio. In this case, either management is highly conservative or the benefits of leverage may not have been fully appreciated. On the other hand, operational expenditure may be relatively higher than the norm among business firms in the same industry. This may have implications (for remedial purposes) regarding the inadequate levels of operational efficiency and effectiveness of the SME concerned -- especially in the combination and utilization of inputs, the current application of technologies, or the implicit needs for

constitute just a very tiny fraction of the business world within ASEAN and elsewhere among most developing countries, however. Thus, parallel attempts will have to be made to foster adherence to the building blocks of good enterprise governance, even if such compliance is largely on a voluntary basis by sole proprietorships or family businesses (Simanjuntak 2001, pp. 56-57).[39] Financial institutions, and commercial banks in particular, can be a powerful proponent and enforcer of good governance as they, too, are also under great and constant pressures to comply with the principles and practices of good governance. For example, banking institutions can interface more strongly with borrowers, including SMEs, on the disclosure of the governance structure of their firms as well as on issues of good corporate governance. This consideration takes on special significance in well-supervised and governed banks, given the almost complete absence of capital markets for SME financing where much tougher requirements on financial and governance disclosure are attached to equity and bond issues, as indicated previously.

Regarding financial disclosure, the data and information required is not that extensive or onerous on SMEs, those of medium size or in the upper layer of the small-firm segment especially. In addition, good record keeping is an inexpensive proposition given the ready availability and affordability of electronic means for information storage, processing and retrieval as well as the ancillary, specialized computer software programmes.[40] Moreover, recent advances in information and communication technologies (ICTs) have led to the development of dedicated software on standard accounting programmes, manuals and exercises geared to the needs of small businesses. These programmes are widely available from SME-related stakeholders – including public support agencies, bilateral donor organizations, and

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skill-base and technological upgrading. Footnote 41 contains a definition of firm-level efficiency and effectiveness.

[39] As sole proprietorships or family firms, many SMEs have few principal-agent problems and the extent of financial disclosure is governed largely by tax laws and institutional funding requirements. However, many medium-sized enterprises (including closely held family firms) may be large or complex enough to have a separation between ownership and management – thus requiring some formal governance structure, information transparency and financial disclosure which, however, are much less complex to put in place and comply with than those associated with publicly traded corporations.

[40] There are integrated programs (such as those relating to enterprise resource planning) which allow the entrepreneurs to map out the whole business operations, and to simulate various scenarios or outcomes under different conditions or parameters governing business activities. Other software facilitates the extraction and presentation of critical information generally or in particular areas of business transactions deserving special attention from management.

private BDS providers. They can be encapsulated and distributed widely in CD-ROM format as an ICT-based system package of modular toolkits to ensure the most cost-effective dissemination and outreach as well as to promote self-reliant capacity building and trouble-shooting by the concerned SMEs themselves.

Such an active, demand-driven involvement helps to improve ownership and commitment by the concerned SME beneficiaries. Notably, most donor-funded technical assistance programs carried out by public-sector agencies fail to achieve their objectives, according to an extensive review of 33 SME projects funded by the World Bank (mentioned previously) because they are largely supply-driven. Besides, many programmes are too sophisticated for the local conditions and circumstances while many others are not sufficiently specific, relevant and useful in relation to the target beneficiaries' needs (Holtmann and others 2000, pp. 6-7; and Webster 1991, pp. 46-52). Moreover, the choice of suitable partner organizations to build up a coalition of cooperating stakeholders is an important matter. In this connection, there are significant opportunities for better synergies between the public sector (including SME-related agencies and donor programs) and private stakeholders (particularly financial institutions and BDS providers) in the dissemination of ICT-based system toolkits to build up the SME skills base in management and financial reporting, and in the internet-based provision of related mentoring and advisory services to SMEs.

B. Business Plan Preparations by SMEs

Another point of consensus is that SMEs must have better and more effective channels and modalities for communication with credit providers for funding purposes, including from venture capitalists and government program. Almost invariably, this takes the form of a plan for business start-up or development which, as mentioned earlier, can ease collateral requirements if loan financing is also based on commercial project feasibility. But a well-conceived business plan can serve also as a blueprint and roadmap for entrepreneurs in the operation of their business activities, and in the mobilization and allocation of the available resources (financial, technological and human) in an effective, efficient and flexible basis.[41] Additionally, an integral part of any business plan is the disclosure of information on enterprise finance and governance in such a way as to provide a sound basis for an informed assessment by all stakeholders of the feasibility of the proposed business project and the suitability of the associated corporate governance.

Substantively, a (full-dress) bankable business plan can go to hundreds of pages and, depending on the scope and technical complexity of the business activity or service under consideration, its preparation tends to be complicated, daunting and time-consuming. In particular, a large number of details and estimates will have to be given on a wide range of subject matters – from market surveys and projections pertinent to the particular industry or sector, elaboration on development and operational plans, to detailed specifications as regards management objectives and financing matters.[42] In addition, the plans itself has to address the needs of specific

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[41] Effectiveness refers to the extent to which the activities of the firm contribute to the realization of its strategic plans and business targets, whether explicit or otherwise. Efficiency relates to the degrees of optimality or cost-effectiveness with which the firm's inputs are transformed into outputs. Flexibility denotes the speed with which the firm's activities evolve competitively in response to changing market requirements and expectations, whether or not such changes are foreseen or unpredictable.

[42] Timmons (1990, pp. 377-397), and Kao and Tan (2002, pp. 57-85), for example, provide details of a typical business plan along with some practical exercises for illustration. Generally, the executive summary of such a plan contains a description of (a) the business concept or the business itself; (b) the opportunity and strategy; (c) the target market and market projections; (d) the comparative and competitive advantage; (e) the team; and (f) the ownership structure and/or stock offering, as appropriate. Market research and analysis may include (a) potential customers; (b) market size and trends; (c) current competition and potential new entries; (d) estimated gains in market shares and sales; and (e) means for on-going market evaluation. The marketing plan has to cover such parameters as (a) overall marketing strategy; (b) pricing; (c) sales tactics; (d) service and warranty policies; (e) advertising and promotion; and (f) distribution.

The next part of the business plan is normally devoted to production and productivity issues. The product design and development plan contains (a) development status, phases and tasks; (b) estimated difficulties and risks; (c) product improvements and differentiation; (d) costs; and (d) licensing and other proprietary matters. The manufacturing and operations plan provides information on (a) the operating cycle; (b) geographical location; (c) input suppliers and subcontractors; (d) utilities and facilities requirements; (e) equipment and buildings, and their scheduled improvements and maintenance; (f) manufacturing strategies and plans; and (g) regulatory and legal issues.

Another part of the business plan deals with management and financial matters. The management plan gives details concerning (a) the organization chart; (b) key management personnel; (c) management compensation and ownership; (d) ownership structure and external investors; (e) employment contract terms and, as available, other agreements as regards stock options and bonuses; (f) board of (executive and non-executive) directors; (g) shareholders rights and restrictions; and (h) outside professional advisors for support services. The financial plan contains (a) actual income statements and balance sheets; (b) proforma or estimated income statements and balance sheets; (c) proforma or estimated cash flow analysis; (d) breakeven charts and calculations; and (e) financial highlights. The company's proposed offering deals with matters relating to (a) the desired structure and terms of financing; (b) offering sequence; (c) capitalization details; (d) proposed uses of funds; and (e) the estimated investment returns.

users which, in most cases, are commercial bankers. Nevertheless, some variations and adaptation are necessary for the typically rare occasions when a business plan is used, for example, to raise venture capital or to bid for funding support from SME-related programmes from government or civil society organizations.

On the other hand, a dehydrated business plan (5-10 pages in length) can be drawn up largely within the firm to cover only the keys aspects of the proposed business activity or service. Such a plan is required for initial or exploratory funding discussions with potential investors or financiers and it may be adequate in the case of small loans or the SME entrepreneurs are reasonably well known to the lenders or investors. For bankers, it can emphasize financial safety, reasonable short-term earnings plus the possibilities of building up a long-term relationship (a key part of the reputation collateral). In SME-related programmes within the public sector, the business plan can show the full realization of programme objectives and the long-term contribution to government development and investment priorities (IFC 2003, p. 2; and Kao and Tan 2002, pp. 55-56). However, for venture capital, the plan has to indicate a high rate of returns plus the opportunities for a fast exit for the capital providers. A review of some 300 projects with venture capital in developing countries of Asia and Central and Eastern European economies in transition shows an expected average rate of returns of 39 per cent, and around 30 per cent for start-up and expansion business projects (Aylward 1998, p. 17).

Assuming a favourable outcome from the preliminary interaction with lenders and investors, a more detailed business plan is necessary for larger projects but with more simplification in structure, contents and focus as illustrated in the following (generic) format of a watered-down SME business plan of between 30-40 pages long.

- Executive summary (4 pages)
- Brief history and main characteristics of the industry concerned (2 pages).
- History of the company and its products, including mission statement and business philosophy (2 pages).
- Market research on the proposed activity, product or service, and a brief analysis of SWOT (strengths, weaknesses, opportunities and threats) (2 pages).

- The economic and financial aspects of the proposed business activity, product or service (2 pages).
- The marketing plan, including distribution and sales schedules (3 pages).
- Design and development plans (3 pages).
- Manufacturing and operations plans (3 pages).
- Management team -- including structure and personal profiles of the principal executives and managers, plus their responsibilities and targeted achievements (3 pages).
- Overall planning and production schedules (2 pages).
- Critical risks, problems and assumptions (2 pages).
- The financial plan (including ownership, equity structure and proposed company stock offering, as appropriate) (3 pages); and
- Attachments and appendices (as needed).

A good business plan is of critical importance for new, young or small firms because of their typical lack of real-asset collateral, equity capital and credit track record (Jappelli and Pagano 2000a, p. 8). However, the preparation of a plan to the bankable stage is also a learning exercise requiring considerable perseverance and as such, many SME entrepreneurs do not find business planning a congenial preoccupation while many others fail to plan altogether (Kao and Tan 2001, pp. 54-55). On the other hand, the kinds of plans taught in many business management schools may impart state-of-the-art know-how but they often have little to do with what is needed and practical for SMEs, especially those in the low-income, developing economies. Generally, therefore, the skills for designing and constructing a business plan are another important weakness in the SME sector and a large number of entrepreneurs will require assistance and coaching in the process. All these considerations account for the considerable emphasis under the IFC Private Enterprise Partnership on building up the skill base of both SMEs and DBS providers in financial analysis and modern business plan writing, among other focal thrusts in capacity building.[43]

[43] Established in May 2000, the Partnership is the technical assistance arm of IFC in the former Soviet Union. It is jointly funded by donor countries and the IFC (US$50 million during 2000-2003) and provides technical assistance in various areas of business enterprise financing, management, governance, linkage, regulation and development (IFC 2002, pp. 61-67).

In the above context, recent advances in ICTs have greatly facilitated the logistical aspects of business plan preparation; dedicated computer software can help generate and simulate business planning under varying economic circumstances and financial conditions. Again, the same system approach can be adopted in developing a multi-media set of modular toolkits for SME capacity building in business plan preparation. Ownership and commitment is also fostered through a demand-driven involvement of the SME beneficiaries. In these regards, there is again a significant scope for multi-dimensional collaboration among the same public-private SME stakeholders in the standardization of the structure, contents and focus of a SME-friendly business plan for starts-up, expansion and upgrading. In particular, close backstopping of financial-sector personnel and experts will have to be secured because such participation will greatly enhance the relevance and bankability of the SME business plans to the lending institutions. Indeed, experience from the 33 completed SME projects carried out by the World Bank (noted earlier) shows the critical importance of having such a linkage or bridge between the entrepreneurs and the credit components in the success of programme implementation (Webster 1991, p. 47).

C. Strengthening Institutional Capabilities in SME Credit Evaluation

Capacity building is also needed on the supply side, in particular, institutional facilities and expertise in applicant screening and loan project appraisal in the credit rating process.[44] Credit risk, the most common cause of bank and financial institution failures, has motivated financial regulators worldwide to prescribe minimum standards for risk management (Greuning and Bratanovic 2001, pp. 135-144). Thus, the integrity and credibility of bank lending depends greatly on an accurate, transparent and accountable assessment of an acceptable level of existing and

[44] Credit rating is the assessment of the credit worthiness of an individual or corporation. It normally involves the screening of the loan applicant's history of borrowings and repayments, assets and liabilities as well as the appraisal of the proposed business project. Any weakening (improvement) of the counter-party's finances will cause an impairment (enhancement) of credit status. Meanwhile, credit is usually understood as the borrowing capacity of a person or company, or as a contractual agreement in which the borrower receives something of value now and undertakes to repay the lender at some future date. Thus, credit risk is the possibility of a loss taking place because of the counter-party's failure (for whatever reasons) to meet contractual debt obligation. It is thus equivalent to a default risk to the lenders concerned.

potential risks in relation to the expected returns.[45] The sound management of credit risk, including that associated with SME lending, is critical to the performance of banking institutions which itself is monitored and rated by the supervisory authorities on a number of criteria, including the quality of assets and sensitivity to market risks.

Institutional due diligence means careful loan appraisal and credit history screening, processes which become even more complex when SMEs are involved. On the one hand, small-business loans are still regarded as an opaque asset class largely because of the lack of risk benchmarks with wide industry usage and acceptance within the financial sector, the main reason for the limited securitization of such loan portfolios. On the other hand, the margin between incoming and outgoing cash flow is typically so thin while the leverage, often so high in most financial institutions that small differences in asset quality can affect their solvency, and through the cascading (or contagion) effect, the stability of the financial system itself (Moody's Investors Service 2000, p. 14). Given adequate disclosure of financial and governance information in the SME business plan as suggested earlier, however, the risks internal to the firm can be assessed through (a) record of profitability, such as returns to assets and shareholders' capital (if already in operation) or expected returns after start-up; (b) capital and ownership structure; (c) liquidity and cash flows, and retained earnings (current or projected); (d) size; (e) activities; and (f) growth or start-up history. For assessment purposes, the first two parameters tend to be given greater weights (up to one-half of the total).[46] There is, however, no hard and fast rule for a

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[45] As can be seen from the 1997-1998 crisis in East and South-East Asia, the availability of credit rating facilities, and public credit registers and private credit bureaux will not eliminate actual loan defaults or default risks to lenders. However, the probabilities of non-repayment and loan delinquency can be lowered through the operations such facilities and systems. This is because, other things being equal, the likely loan defaulters and other bad credit cases will be "on-screen" statistically (as with credit risk scoring or Altman's Z-scoring technique, for example) or through their credit footprint. In this connection, an illustration of a variety of poor credit risks can be found in Greuning and Bratanovic (2001, p. 141) while the economic effects of credit information sharing are examined in some detail by Jappelli and Pagano (2000a, pp. 10-16).

[46] Bringing all the elements together, a typical file for loan appraisal contains the (a) SME borrower's names and contact addresses, and lines of business or industries or sectors; (b) date of credit or overdraft approval, and uses of the disbursed loans and overdrafts; (c) loan maturity date, amount, and applicable interest rates (and currency denomination); (d) principal sources and amounts of repayments; (e) nature and value of collateral or security (on a market valuation basis in the case of fixed assets); (f) total and current liabilities, including principal and interest due; (g) estimated real and contingent liabilities (in case the institutional lender is absorbing the credit risk); (h) record of delinquency, arrears or non-repayments, if any; (i) brief description of the monitoring activities carried out (within the organization) for the loans or overdrafts; (j) borrower's related financial information – including trends in the structure of assets and liabilities, retained earnings to current liabilities, and

typical SME loan to equity ratio; such a ratio has been a matter of significant concern in the wake of the 1997-1998 crisis.[47]

The screening of SME borrowers' characters and credit footprint becomes imperative in cases of insufficient disclosure of financial and governance information, and uncertainties or differences of opinions within the lending institution as regards project financial viability. Many lenders also screen applicants of projects which have already been rated as of low risk in the financial analysis stage. The small base of institutional credit information on SMEs can be enlarged through exchanges among finance providers although there are inter-institutional issues in this regard, including fears of giving away "white" or positive, and hence potentially valuable, information to competitors (Jappelli and Pagano 2000a, pp. 9-10). More frequently, however, credit information on borrowers is accessed via such formal mechanisms such as private credit bureaux (also known as credit reference agencies) and/or public credit registers.[48] In general, the availability and accessibility of credit information to funding institutions have several positive effects on financial markets.[49] Cross-sectional evidence also suggests that bank lending tends to be higher and credit risk,

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other financial ratios with total net assets as the denominator; and (h) notes on sources and uses of outside credit information and information referral services concerning the borrower (Greuning and Bratanovic 2001, p. 133).

[47] Indeed, there are lending schemes in Asia and Africa with a starting ratio of around 70/30. The amount of loan capital can then be raised to very close to 100 per cent along with the build-up of mutual knowledge and confidence between the pertinent firms and their credit providers over time (Levitsky 2000, p. 125).

[48] By and large, private credit bureaux are voluntary (as opposed to legally imposed), cooperative entities. They are basically information brokers which rely on the reciprocity principle in the collection, filing and dissemination of information supplied voluntarily by a coalition of lenders and bureau members. The information collected is largely consumer oriented. Public credit registers, on the other hand, are data banks created by government primarily for supervision purposes. They are mostly managed by the central banking authorities. Information is supplied by lenders who, in return, obtain the pooled data for use in their credit rating and lending decisions. Because of the reciprocity arrangement, public registries are less likely to provide access to their information than their private counterparts. More comparative details on these two credit information systems in a cross-country survey conducted by the World Bank can be found in Miller (2001, pp. 42-44).

[49] Credit information and information exchanges among institutional stakeholders, firstly, permit a more accurate prediction of repayment problems and default risks by improving lenders' knowledge of applicants' characters over time, thus speeding up the appraisal process; secondly, reduce the information "rents" that banks can extract from borrowers (superior knowledge entails lower interest charges), thus raising clients' net returns and incentives to perform better; thirdly, serve to discipline borrowers, thus strengthening the incentives to pay and perform, and reducing moral hazard problems in the process; and fourthly, discourage demand-side over-borrowing and excessive debt/equity leverage and financial over-commitments system-wide. For a more detailed discussion on these matters, and related implications, see (Jappelli and Pagano 2000a, pp. 10-14).

lower in countries where lenders have access to quality information on loan applicants (Jappelli and Pagano 2000b, pp. 21-26).

Several private credit bureaux operate in individual ASEAN members (including Malaysia, Philippines, Singapore and Thailand) although there are fewer public credit registers in the region (e.g., Indonesia, Malaysia and Viet Nam). Information from these registers is typically limited by the high reporting threshold and selective sectoral focus, thus leaving the middle-market segment, including SME lending, and various sources of consumer finance to credit bureaux. These credit reference agencies are comparatively a recent phenomenon (except notably in Singapore, since 1978, and Philippines, since 1982), and their data banks are understandably more oriented toward consumer (or household) credit rather than toward commercial lending, as is also the case in most other countries (Miller 2001, pp. 43-44). Moreover, the utility of credit bureau information for SME applicant screening in ASEAN is further limited by the very low proportion of small entrepreneurs with access to bank funding, and their heavy reliance on internal sources of funding and grey market loans, as discussed earlier.

The need for a sound, accessible and usable credit information and information referral system is pressingly apparent, especially for the middle- and small-market segments of commercial lending in the region and elsewhere in the developing world. Indeed, in many developed and high-income developing economies, credit information bureaux can often serve as credit scoring and rating agencies by virtue of their access to diverse and massive pools of information, and modern techniques and facilities in risk management.[50] In this context, the outstanding agenda for policy and operational attention is extensive in many parts of ASEAN. At one level, a balance has to be struck between personal privacy and creditor protection, and between economies of scale in information gathering and the

[50] In the Republic of Korea, for example, a relatively sophisticated and elaborate system of credit rating underpins credit guarantee schemes which are among the largest in the developing world, with an outstanding balance of US$28.3 billion as of June 2000. The system has earned substantial income from its rating of domestic applications for credit guarantees and of non-Korean firms wishing to do business or to establish inter-firm networks in the country. Meanwhile, the credit standing of SMEs and other firms not listed in any equity market in the Hong Kong economy can be vetted, on request, by an independent credit bureau (Kang 2002, pp. 194-195; UNESCAP and Asian Development Bank 2002, p. 8; and Levitsky 2000, p. 132).

prevention of anti-competition collusion in information sharing. There are then issues as regards the breadth of credit market coverage, the reporting threshold, the nature (black and white) and extent of information (personal, occupational, social etc.) to be on record, the duration of credit record memory and retention, and the on-going interface with credit providers, given the relatively unsophisticated personnel in banks in most developing countries.[51]

In the context of bank financing operations and procedures, lending functions are spread throughout the institution and the 1997-1998 crisis underlines the great importance of having appropriate systems in place to better monitor and coordinate (institution-wide) adherence to established procedures and guidelines, including those relating to due diligence and lending prudence. This is another area in financial corporate governance which has been of significant concern in the region. The required action in most instances, however, means better and timely enforcement of the laws and regulations that are already in existence. There are, thirdly, issues relating to insufficient institutional professionalism and initiatives as regards the range and competitiveness of financial products and services on offer within the banking system itself (Rodriguez 2002, pp. 12-15; UNESCAP and Asian Development Bank 2002, pp. 6-11; Urata 2002, pp. 7-10; and Hallberg 2001, 11-13). In particular, the lending process is less than innovative and sophisticated, and a number of options to push the institutional productivity frontier forward are examined next.

D. SME Credit Risk Scoring and Competitiveness Benchmarking

The availability and accessibility of credit information may induce financial institutions to shift gradually from a purely collateral-based lending to a largely information-based one, with a greater emphasis on the loan applicants' track record and project financial viability. In fact, a cross-country survey by the World Bank indicates the preference of many financial institutions to have access to good credit information over collateral because of the adverse publicity, and costly steps in possession and disposal in case of default (Miller 2001, p. 44). More immediately, however, operational efficiency and effectiveness (including better risk pricing and

[51] A more detailed consideration of all these issues can be found in Jappelli and Pagano (2000a, pp. 14-24) and the references cited therein.

lower transaction costs) can be further enhanced with the introduction of modern risk management techniques. Pertinent in this connection are the credit scoring system, based on credit and other information, and Altman's z-scoring, derived from selected financial ratios. Both systems facilitate process automation, provide meaningful benchmarks to both lenders and investors, permit more timely and consistent decision making, and have proved useful as a management tool. All these lead, in turn, to better service, higher asset quality, and increased productivity (Stein 2001, p.2).

As discussed previously, SME financing is characteristically a high-cost transaction because there are numerous applicants whose desired or feasible loan sizes are not sufficiently large. On the other hand, the institutional information base on applicants is often limited or non-existent while individual (or manual) credit risk assessment is a subjective process and financial interpretations tend to vary from analyst to analyst. However, the pooling of data from many credit information bureaux created a sufficiently large sample and standardized consumer scores appeared in the United States more than two decades ago. Credit risk scoring for consumer lending can now capture at least 90 per cent of the measurable risk, and credit bureau reports can be purchased for a few dollars each in developed countries.[52] Comparatively, credit scoring for commercial lending in the middle- and small-market segments has a much shorter history and is less widely utilized in these countries.[53] Generally, credit risk scoring remains to be developed in most Asian developing economies (Miller 2001, p. 41).

A credit scoring model assigns different weights to different characteristics (criteria) of a loan applicant to predict the likelihood of repayments (and arrears) over the loan duration. These weights vary in accordance with the influence or impact of specific subsets of these characteristics on the outcome; the weights and levels of influence are statistically pre-determined from large-sample testing and validation. The criteria are many, ranging from age groups, number of dependents, residence

[52] Such a high degree of confident inference is possible because of the very large sample sizes available, for example, in the several hundreds of thousands for bad credit card debts, and in the tens of millions of good ones. The low cost of reporting is due to process automation and the widespread usage involved (Jappelli and Pagano 2000b, p. 13; and Moody's Investors Service 2000, p. 10).

[53] The Small Business Scoring System, for example, comprises several models which are used by 350 institutional lenders in the United States to make some 900,000 lending decision a year (Jennings 2000, p. 6).

status, total assets, types of business and years in business, to negative file information (thus negative score). The overall score represents the sum of the applicable weight values (or rank orderings) given to the pertinent criteria. Continuous tracking of the scoring system and its performance will interactively provide further improvement to and validation of the criteria and their weights. In particular, credit scoring permit lenders (and investors) to trade off a higher accept rate (from 75 to 89 per cent taken from an actual scoring sample analysis) against a higher default level (from 1.7 to 2.3 per cent), and vice versa. This greatly facilitates the planning and management of a superior strategy in lending as a quick response to changing economic conditions or geared to specific categories of industries or clients, such as SMEs.[54]

Credit risk scoring depends on the quality of information on the applicant's personal credit footprint. Suitably developed, it can be a useful and efficient tool for SME lending and the system has, in fact, been introduced in several developing countries, including for micro-lending purposes (Otero and Lopez 2001, pp. 19-20). Altman's z-score model (1968, pp. 593-606), however, relies instead on the corporate financial profile extracted from financial statement data. The bounds for scoring applicability extends from around US$100,000 in asset size of manufacturing enterprises up to publicly traded or privately held large companies; the lower boundary is well within the upper layer of the small-firm category or the medium-enterprise segment in many ASEAN countries. The z-score is the sum of the (weighted) products of five ratios – namely working capital to total assets (X1), retained earnings to total assets (X2), earnings before interest and taxes to total assets (X3), market value of equity to book value of total liabilities (X4), and sales to total assets (X5). The original model has subsequently been revised to take account of privately held companies (with the book value replacing market value of equity in X4, and denoted as z'-score), and non-manufacturing firms (with X5 omitted). A second generation (and proprietary) Zeta model was jointly developed by Altman with other

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[54] By and large, any two identical loan applications will receive virtually the same score, another advantage over manual or subjective credit assessment which may differ among financial analysts in any given day as well as with the same analyst in different days. Credit risk scoring models can be set up for first-time loans, loan renewals and roll-overs, and portfolio operations and collections. For more details on credit scoring, and its design and applications, see Jennings (2001, pp. 5-10), Coffman (2001, pp. 13-17), and Otero and Lopez (2001, pp. 19-22).

collaborators in 1976 and in 1995, the original z-score system was collaboratively modified to create a scoring model for emerging market economies.[55]

The scoring operation is simplicity itself. The five variables (or four in case of non-manufacturing companies) are assigned with their relevant weights, or coefficients, which were previously estimated and validated statistically.[56] If the z-score exceeds (or is lower than) a certain value or cut-off point, such as 2.9 (1.81), then the publicly traded, manufacturing enterprise concerned falls into the financially healthy (bankrupt) zone; any z-score in between these two cut-off points is in the gray (or ignorance) area, requiring further analysis in loan decision making. Models based on z-scoring have correctly predicted 82-94 and 68-72 per cent of corporate defaults and bankruptcies one and two years respectively prior to the events in various sub-periods during 1969-1999. The accuracy of predictions can be improved by 15-20 per cent with a tighter or more conservative cut-off score (Altman 2000, pp.22-23).[57] Indeed, comparative surveys have consistently given an edge to these models despite the challenge of changing times and the parsimonious data requirements.

As a result, z-score models have assumed not only a benchmark status in the literature (including textbooks) on accounting and financial analysis (Moody's Investors Service 2000, p. 15). Scoring based on these models is now commonly used by auditors, courts of law, and management consultancy firms; z-scores also form an integral part of many data banks used for domestic and external loan pricing, lending decision and investment screening, particularly in developed countries. Its relevance and applicability deserves careful consideration by financial institutions in ASEAN, among other stakeholders concerned with corporate financing, including SME

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[55] The seminal work on z-score by Altman is based on the statistical technique of multiple discriminant analysis. For the more details and comparative evaluations on this model and its later variants, see Altman (1968, 2000), and Altman and others (1977, 1995).

[56] The five statistical coefficients for the z-score (the z'-score) are respectively 0.012 (0.717), 0.014 (0.847), 0.033 (3.107), 0.006 (0.420), and 0.999 (0.998). The four coefficients for non-manufacturing firms are respectively 6.56, 3.26, 6.72 and 1.05. The cut-off values in the z'-score of privately held firms and the non-manufacturing enterprise z-score are respectively 2.90 and 2.60 for the healthy zone, and 1.23 and 1.10 for the bankrupt area.

[57] Needless to say, there are several other models and empirical studies on corporate defaults and default risks in the literature and from financial institutions, including Moody's series of (proprietary) Risk-Calc models for private companies in different sectors as well as for different countries. It should also be noted that the outcomes of risk scoring are still far from uniform. Retail trade, for example, has the highest default rates in Moody's rating but one of the lowest among smaller companies according to

lending. However, credit risk and z-scoring indicates what is likely to happen over the loan duration but it does not provide the larger picture on the factors and forces, both inside and outside the firms, which have contributed to the scores so obtained. These factors and forces must also be imputed into (institutional) financial projections and analysis as they can affect asset quality, and market and systemic risks (Moody's Investors Service 2000, p. 41).

Thus, information and data banks will have to be set up by, or accessible to, financial institutions on such variables as (a) the nature, relative size, technological dynamism and competitiveness of the industries or markets of importance in terms of loan exposure; (b) the structure and characteristics of enterprises, and their profitability or loan default and bankruptcy rates in these industries or markets; (c) the dominance or concentration ratios plus enterprise structure and characteristics in complementary and/or competing industries or markets; and (d) exposure to, and linkages with, foreign industries and markets (on both the supply and demand sides). Currently, however, there are virtually no systematic and regular surveys of, let alone comparable and up-to-date data banks on, the evolving dynamism and competitive potential of the top layers of SMEs even in priority sectors and industries within ASEAN. Such an information-gathering exercise is overdue not just because, on the one hand, it helps to relieve somewhat the structurally chronic and acute shortage of data and information on SMEs in this region, as noted earlier. On the other hand, learning what a country and its enterprises are, or can be, good at producing is a key challenge to sound financial management and sustained economic growth (Rodrick 2002, p. 7a).

The periodic benchmarking of SME competitiveness is particularly relevant in the above context.[58] It permits the construction of best-practice standards (or scores) for the sectors or industries concerned, or for the best-in-class groups within a specific

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Dun and Bradstreet, another major credit rating agency in the United States (Moody's Investors Service 2000, p. 41).

[58] In business management, national competitiveness refers to the extent to which the overall domestic environment (policy, institutions and infrastructure) is conducive to entrepreneurship, innovation, and business initiatives. Industry-level competitiveness is to the extent to which an industry or sector has the potential for growth and/or to generate an attractive return to capital. At the firm's level, competitiveness is the effectiveness, flexibility and efficiency in the production and

sector or industry, against which the performance of individual or groups of SMEs (as current or potential borrowers) can be matched and evaluated. The observed performance deviations (whether progressive or regressive) over time may be due to differences in the evolving capabilities and competitiveness within the enterprises under considertion. Such deviations should thus be reflected by commensurate adjustments in credit scoring, loan pricing and lending conditions by financial institutions themselves. However, the revealed deviations may be attributable to changes (negative or otherwise) in the pertinent sector or industry, or in the local or international economic and financial environment. In this case, responsive action and remedial measures are needed from government and for other domestic and external stakeholders.

Competitiveness has a foundation at the micro-level, whether or not it is measured and benchmarked at the industry, sectoral or national level (Porter, Sachs and Mcarthur 2001, p. 21; and Meyer-Stamer 1995, pp. 143-146). To be credible, the data and information for monitoring and benchmarking purposes have to be obtained in an objective, systematic, periodic and (statistically) robust manner. Given the relatively large-scale requirements and the frequency (or periodicity) in information gathering and analysis, the proposed survey of SME capabilities and competitiveness should preferably be carried out as a joint undertaking by public-private stakeholders, including the financial institutions concerned, for resource pooling and cost-sharing purposes. The periodic results so obtained can be shared, processed and analyzed in accordance with the specific needs and interests of different partners in the exercise. The detailed proposal and framework for the measurement, comparison and benchmarking of SME capabilities and competitiveness over time, made by Wattanapruttipaisan (2002a, pp. 70-78 and 84-85), can be modified with reasonable ease to yield comprehensive information and data of direct relevance to institutional financial analysis and projections, including for SME credit risk scoring purposes.[59]

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delivery of goods and services at lower costs than those of the competitors, or at a price premium over those supplied by other enterprises.

[59] The survey framework is derived, firstly, from the constituent survey questionnaires for compiling the Current Competitiveness Index (CCI) and (since 2000) the Growth Competitiveness Index (GCI) from the World Economic Forum (WEF); secondly, from the common parameters and prerequisites for SME competitiveness and growth as discussed in Minoza-Gatchalian (2001, pp. 22-236), Raneses (2001, pp.197-213), Regnier (2000, pp. 150-165), Tambunan (2000, pp. 167-180) and Altenburg (1999, pp. 30-38); and thirdly, from various SMEs-related surveys and questionnaires available in APEC (2002, pp. 116-117), Momaya (2001, pp. 142-152), Tambunan (2000, pp. 95-109),

Briefly speaking, SME capabilities and competitiveness are conceptually grouped under seven categories with the overall environment in which SMEs operate being denoted as “Nature and readiness of firms” (with 12 questions and a proposed relative weight of 12.5 per cent of the total). “Entrepreneurial characteristics” (13 questions and 20 per-cent weight) are the driving force of firms, whether they are large businesses or SMEs. The two categories on “Capabilities” and “Competitiveness” (each with 10 questions and 12.5 per-cent weight) are indicative, by and large, of the initial conditions and circumstances of the SMEs concerned. In a way, these two groupings together represent an approximation of the CCI in the WEF Global Competitiveness Report (GCR). Meanwhile, matters included in “Production organization” (11 question and 15 per-cent weight) serve as a proxy of the potential for productivity upgrading and competitive growth of the pertinent SMEs. This category mirrors the GCI which has been introduced by WEF in the annual GCR from the 2000 issue. The last two categories in the proposed SME monitoring and benchmarking survey are “Finance” (with 11 questions and 15 per-cent weight) and “Human resource development” (with 11 questions and 12.5 per-cent weight).

IV. CONCLUDING REMARKS

The development of SMEs has long been restrained by a low share of institutional financing which is far from commensurate to their critical socio-economic importance in most developing countries, those in ASEAN included. Such an outcome reflects, in part, the various biases against the SME sector which are inherent or still remain in the domestic policy and institutional framework. There are a variety of systemic and institutional constraints on SME funding as well. But as was also discussed at length above, SME financing problems cannot be resolved just by lending not least because of the limited amount of financial resources available for development. These problems have to be viewed against a larger backdrop of financial sector growth and modernization as a response to the impulses and imperatives arising from the increasing complexity of business transactions associated

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and UNCTAD (1998, pp. 188-195). However, these surveys and questionnaires are both shorter in length and more limited in scope than the assessment framework being proposed for competitiveness benchmarking.

with economic development and global integration over time. However, such a response can be sped up and made more innovative by the adoption of a wide range of remedial measures, four of which are the focus of the analysis in the text.

The intractable difficulties in SME lending are due to both demand- and supply-side factors and forces. Generally, banks are the major source of SME financing within the formal financial sector in both developed and developing economies. However, SME loans are still regarded as opaque assets and this accounts for the lack of securitization of the related loan portfolios and the higher risk premium on such loans. In the absence of a credit and other track record, lending decisions from financial institutions necessarily have to be based on, among other considerations, the adequate and systematic disclosure of information on SME finance and governance, plus the availability of a credible or bankable SME business plan. Information disclosure and business planning have been among the major weaknesses of many SMEs, hence the two proposals, and the related provision of capacity building, on the loan demand side made in the text.

On the other hand, the lack of credit information and/or access to such information has also considerably hampered banks in the rating of credit and other risks from SME financing proposals. Notably in this connection, commercial banks in the developed countries used to focus heavily on meeting the operational and investment needs of large corporations, and of high- and upper middle-income borrowers. The widespread pooling of credit bureau information and the application of modern risk management techniques from the 1970s served to revolutionize consumer lending and, to a more gradual extent, commercial loans in the middle-and small-market segments. Thus, the two supply-side proposals relating to the need for greater and more systematic reliance by financial institutions on credit information and on credit risk scoring and z-score techniques are made against this backdrop. However, there are still risk factors both internal and external to the firms which are not factored in credit scoring but which can impact on institutional asset quality and risk exposure. Regular surveys of SME competitiveness for benchmarking (or scoring) purposes are another proposed option to provide additional, high quality information for institutional analysis and projection of SME credit risks, including those from financing proposals falling in the grey or review zones in scoring exercises.

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