

CODE of Best SME Finance Practices in South Eastern Europe



Center for Economic Development

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The Code includes country case studies for Albania, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia, and a chapter with regional conclusions and recommendations. The Code aims at highlighting the most effective SME finance practices and programs in South East Europe, and at facilitating the development of new SME financing instruments.



Center for International Private Enterprise



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PREFACE

Small and Medium-sized Enterprises in South-East Europe (SEE) are playing an increasingly important role as engines for economic growth and employment. Consequently, policies and initiatives to develop SMEs and to increase their competitiveness are a priority for the countries in the region. Nevertheless, in all of the countries in the region, as well as in other transition countries, the access to financing is a leading obstacle to SME growth. By minimizing the barriers to SME finance and facilitating the adoption of new financing vehicles, this initiative will improve the business environment in the region. A sound business environment is a prerequisite for regional economic growth and, crucial for the SME sector to become not only a source of employment but also a source of innovation and productivity.

The Code of Best SME Finance Practices in South Eastern Europe has been developed by experts from Albania, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia, under the project “South East Europe Small and Medium sized Enterprise Finance Initiative”, funded by the Center for International Private Enterprise – Washington.

The main goals of the Code are:

- To highlight the most effective SME finance practices and programs in South East Europe, and to inform both private and public sector institutions about the impact of these policies and practices.
- To formulate and implement innovative SME finance policies and vehicles in the region;
- To identify mechanisms to solve common SME finance obstacles in the region and encourage SME development.

The Code consists of seven country case studies and a chapter with regional conclusions and recommendations.

The case studies include a general overview of the SME sector, current status of SME financing, recommended financial instruments for the development of the SME sector and conclusions and policy recommendations.

The Code is based on country specific surveys, comparative analyses and on the recommendations of research institutions from the region. The Code is designed to inform both private and public sector institutions on the impact of the SME finance policies and practices, to serve as a guide for the formulation and implementation of innovative SME finance policies and vehicles in the region.

THE CASE OF ALBANIA

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1. GENERAL OVERVIEW OF THE SME SECTOR

Albania's economy environment has been steadily improving since the second half of the 1990's. The vigorous campaign of privatization and tax-reform undertaken by the Albanian Government has led to an expanding economic foundation. The Albanian Government has passed laws providing for private ownership, entrepreneurial activity, open competition, bankruptcy, foreign investment, and protection of consumers, privatization of small, medium and large enterprises, and many other elements of a modern economic regime. The steady growth of domestic and foreign investment was a vote of confidence by the private sector in Albania's commercial law reforms.

Trade liberalization is one of the guiding forces of economic stabilization and reform. Along with price liberalization, exchange liberalization, fiscal control, monetary restraint and rapid privatization of agricultural land and small enterprises. The principal objectives of privatization in Albania were to provide long-term economic development, improved economic efficiency, increased effectiveness of market efficiency through the promotion of competition and continued deregulation. Within this framework Albania has sought to attract foreign investment to important sectors of the Albanian economy, including the strategic sectors (e.g. oil and gas, banking, telecommunications, utilities, mining and transport). The privatization of strategic enterprises was accomplished in three stages, a preparatory stage, a promotional stage, and a decision making stage. Since privatization is conducted on a case-by-case strategy, the enterprises were at different stages in the process.

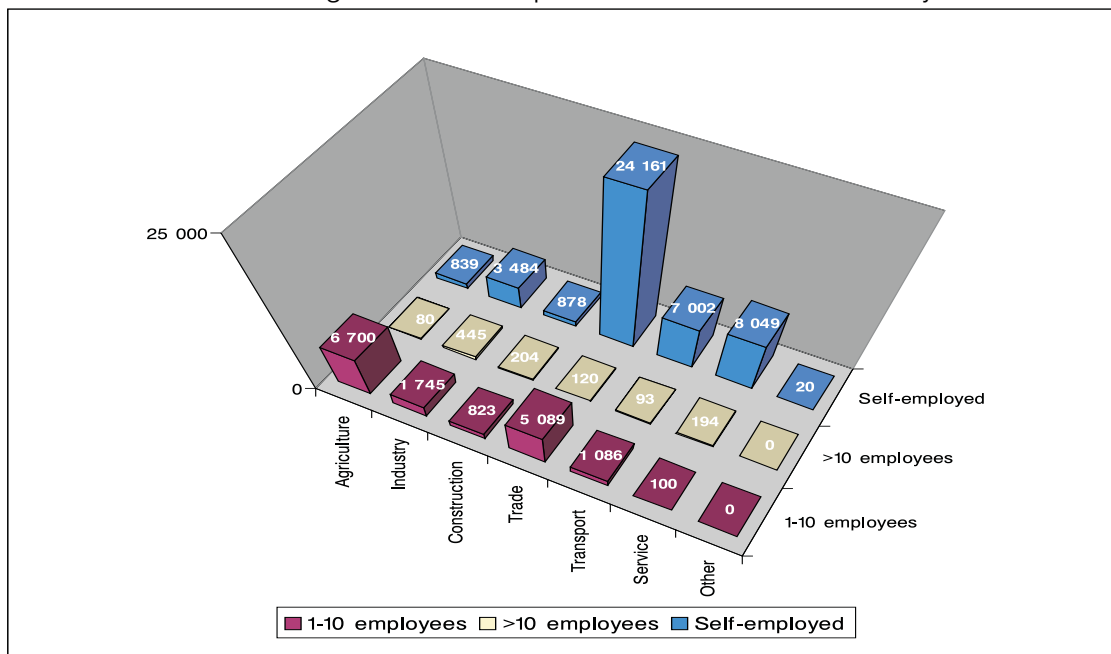
Significant progress has been made in privatization in 2000. This renewal of impetus in privatization, the recent stability of the Lek, continued strong GDP growth and almost zero inflation should make privatization more attractive to foreign investors. The Government intends to capitalize on those favorable conditions in order to maintain the substantial inflow of external resources, in particular by sale or lease in the banking sector, telecommunications, the electricity utility and the extractive industries.

1.1. IMPORTANCE OF THE SME SECTOR FOR THE NATIONAL ECONOMY

The development of a strong and dynamic private sector in Albania, especially the SMEs, both those, which have been established since the fundamental political changes and those, which are the results of the privatization process, has been considered by Government as a priority since the beginning of the reforms. Before 1990, initiatives and private enterprises were entirely absent in Albania. Privatization process in Albania compared to Eastern European Countries, started under the conditions of a paralyzed economy, mainly based on an obsolete and inefficient technology, where huge subsidies were keeping unprofitable enterprises work.

As the first step of economic reform was needed the deepened and fast privatization of economy, starting from transport network and wholesalers

Figure 1. SME Repartition in Albania's Economy

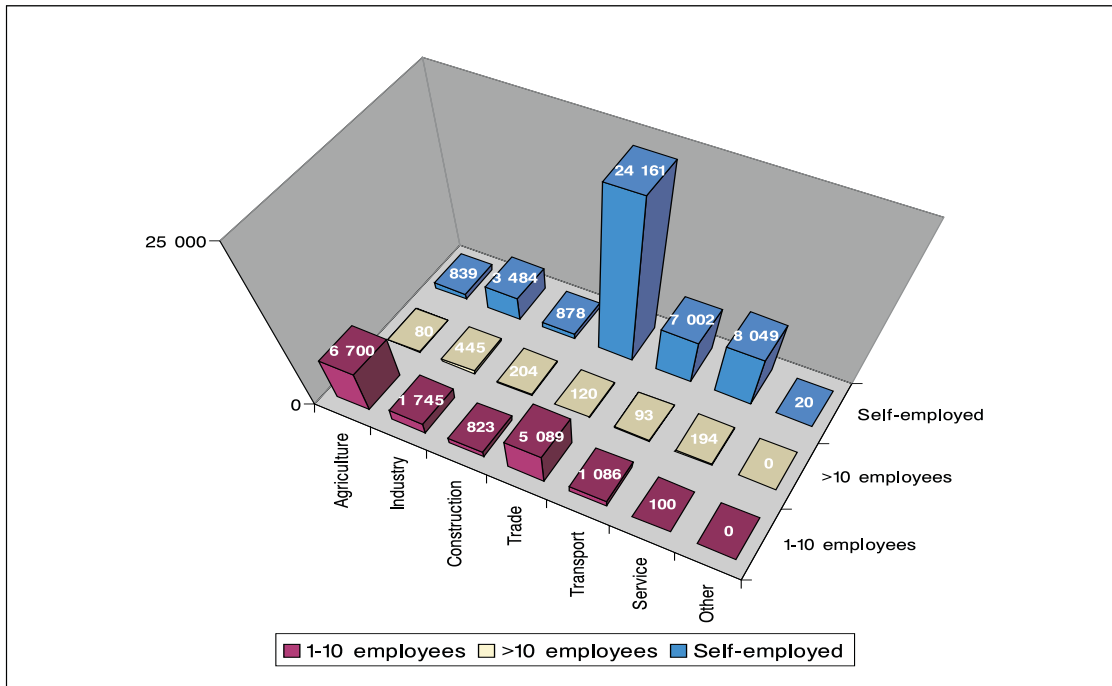


and retailers of small and medium enterprises and ending to big enterprises.

Almost all enterprises in Albania fall into the category of small and medium-sized enterprises, as defined by the EU. The Albanian statistical office however utilizes a different definition for each size category of enterprises. Small enterprises correspond to the EU self-employed; medium-sized enterprises have up to 10 employees (this corresponds to the EU micro enterprises).

Even adopting this very narrow definition of SMEs, about 98 % of Albanian enterprises can be classified as small or medium-sized, i.e. micro-enterprises by EU standards. As the most of enterprises in Albania are considered as SMEs (only 0.2 % of companies have more than 100 employees) meaning that Government policy towards the development of the private sector is by definition SME policy.

Figure 2. Employment by Albanian SMEs



In terms of employment, SME sector accounts for about 40 % of total employment in the public sector. Again, most of this employment is generated in the trade sector, followed by the service sector for the self-employed and the industrial sector for medium-sized companies. Larger firms (>10 employees), on the other hand, generated most employment in industry, followed by the transport sector.

Regional differences in the density of private enterprises appear to be the result of urban-rural differentiation. Thus the region of Tirana-Durres has a higher concentration of private enterprises than the other regions. Heavy industry is concentrated mainly in Elbasan (about 30 miles southeast of Tirana), while trade opportunities are mainly found in the southern border regions.

In 1996, around 53% of the total number of joint ventures were set-up with Italian capital (but their percentage in value of capital invested was weaker, about 35%), some 27% were Greek, some 6% were German and around 2.6 % were American. Other important investors were France, United Kingdom, Turkey and Luxembourg. FDI from other Balkan Countries is very low, but small enterprises or individuals from the Yugoslav province of Kosovo and from Romania have invested in Albania. The fact that 80% of foreign and joint venture enterprises are Italian or Greek shows the importance of proximity factors. The Italian capital is mainly concentrated in the Western areas of Albania, particularly in towns like Tirana, Durresi, Elbasani, Shkodra, Vlora, etc. While the Greek investments are mainly concentrated in Southern and South-Eastern part of Albania, in towns like Korza, Gjirokastra, Delvina, Saranda, etc. The same tendency is evidenced also during the last few years. So, during 1998, Italian investments accounted for 61% of the total while those of Greek origin accounted for 30%.

Under the circumstances in Albania and general statistics, SME are not

only dominant in economy, but also they have the capabilities to be dynamic firms in economic development. However, they often face economic, institutional and legal obstacles. Such restraints include limited ability of crediting the circulating capital and provision of long term credits, inappropriate infrastructure, high transaction costs, limited managerial and technical know-how, etc. Despite of this obstacles , which are mostly inter-dependent, the general opinion on which SME supporting policies are based, stems in the fact that lack of finance makes up the principal restraint in their growth and intensification.

This obstacle has come as a consequence of some factors. Among them we could mention the following:

- Low efficiency of financial intermediaries system.
- Lack of instruments against the risk makes banks be more careful in loan issuance and adopt higher interest rates, because SME are considered highly risky and generally, they are unable to offer suitable collateral. Decrease of interest rates on long-term deposits is not accompanied simultaneously with the same reduction of interest rates on credits over the last years, but with the increase of marginal profits in favor of banks. Accomplished studies show that total bank loans to SME occupy a very small share in credit portfolio.
- Existence of a complex borrowing procedure accompanied with a high cost.
- Financial crisis of 1997 after the bankruptcy of pyramidal schemes impeded further the borrowing abilities of SME. This crisis influenced policy development and involvement of resources in economic reform process, complicating creation and normal functioning of SMEs. Around 21,000 enterprises are counted to have been closed due to this crisis. Moreover, after 1997 credit issuance from two state-owned banks of two-tier was cut due to high level of default loans.

Historically, new SME registrations grew from just under 2000 in 1991 to 9000 in 1993; 16,400 in 1994 and subsequently declined to just less than 3000 in 1997. They then went up again to 4800 in 1998. This downward movement coincided with negative GDP growth until 1993, a collapse to 7% in 1997, followed by positive growth again in 1998 (INSTAT). In terms of employment and sectoral distribution, 70% of employment (but only 2% of enterprises) in 1998 was in agriculture, about 3% of employment was located in trade and retailing, and about 8% in extracting, processing and electricity production (according to the official classifications). This has remained the same as it was since 1994, with a slight increase in agriculture and a decline in extracting, processing and electricity production. This reveals a relatively static situation as an agricultural economy, where new enterprises are starting up predominantly in trade, maybe lasting only for a short time on average, and having little effect on employment and on the production sector.

Considering the importance of SME development, Albanian government has been assisted by international institutions over the last few years. There was a major policy report on the SME strategy conducted in 1996, funded

by the European Commission that threw light on a range of policy recommendations for SME sector development. At that time there was a comprehensive and significant technical assistance and credit lines program for SME support from EU Phare. Other donors have been involved in SME development, too, but the PHARE initiative included: i) the establishment of a central agency - the "SME Foundation" - along with the establishment of seven Regional Business Agencies (RBAs) that nowadays are called Regional Development Agencies (RDAs) and ii) the introduction of a major SME credit line.

1.2. GOVERNMENT SUPPORT TO THE SME SECTOR

Albania, like some other Central and Eastern European Countries, started the privatization under the conditions of almost a complete lack of capital and without management expertise, which led to a grave economic crisis. This was reflected in the drastic decrease of production, high deficits and high level of unemployment and inflation. Under these circumstances, the Albanian Government faces not only difficulties but also contradictory situations. Knowing that developing private property is the only way to economic progress, the privatization process is considered as a cornerstone apart from the serious barriers to immediate privatization. For this reason, Albania gave the green light to privatization and placed at the foundation of a privatization strategy not only to accelerate procedures but also reach what was hoped to be an optimum between efficiency and social justice.

Institutionally, the privatization process has been administered by two different Bureaus established by legislation: the Preparatory Commission for the Privatization Process (PCPP) which was an inter-ministerial body responsible for the preparation of privatization deals and the National Agency for Privatization (NAP) under the control of the Council of Ministers. The NAP was given regulatory and administrative functions, including the approval of privatization transactions. Both bodies established offices in each district of the country.

The privatization process was carried out in two phases:

- 1) first phase – from the middle of 1991 up to May 1993 and
- 2) second phase - from May 1995 and on, after entering into force the Decision No. 248¹ which provided specific instruction concerning the privatization of enterprises whose value was up to 500,000 US\$. The main provisions of this decision were:
 - decentralization of the privatization process by setting up of Districts' Privatization Body fully responsible for the implementation of procedures and decisions;
 - identification of special cases of auction exemption (for specific social groups or specific assets) on the basis of District Board decision;
 - preemption right accorded to the ex-owners of the land on which the enterprises were built up;
 - setting up a mechanism aimed at advantaging the workers of enterprises along with the national and international investors.

Structural Policies and Privatization

With regard to foreign investors, the Decision stated that they had to pay three times the price that national investors ought to pay for purchasing an enterprise.

The process of privatization of state properties, notwithstanding the modifications brought about by as per the Law mentioned above, has been characterized by the following:

- strong centralization of the decision making process as well as of the implementing procedures;
- selling procedures theoretically based on auctions and evaluation procedures based on the residual value (book value less amortization) multiplied by the inflation coefficient;
- promulgation of decisions which exempted many assets from auctions and application of the inflation coefficient.

The methods applied in privatizing SMEs are characterized by the following:

- Effective evaluation of privatization alternatives and implementation of those most suitable to the local social and economic conditions (auctions, donations, tenders, free or direct sale, buy-out by public enterprise employees, leasing or partitioning of large enterprises);
- Thorough orientation of people that managed the privatization process and those that directly participated in privatization;
- Establishing in a most convenient and efficient manner the stages of privatization for each enterprise put under privatization;

The First Stage of privatization was called Small Enterprises Privatization (or Massive Privatization). The main characteristic of this stage was that it enabled faster privatization and provided to the public proof of the social justice of privatization. During this stage were privatized most of the: i) urban services, ii) shops, iii) agricultural and construction machinery, iv) small mechanization workshops, v) handcraft activities, vi) means of transport and automotive parks, vii) small rural processing plants. A brief description of the properties which have been privatized and of respective privatization methods are depicted as follows:

Agricultural Land: through donation, considering the incapability of peasants worn out from cooperative regime to buy land at any price. The social justice has been guaranteed by giving to each peasant families approximately the same area of land. Applying this method brought partitioning of agriculture land; it often was controversial because of dissatisfied former landowners that made claims to take back the same land their families had used to own previously to 1946;

Land has been privatized according to the Land Law No. 7501 dated 19 July 1991 being supported by Decision No. 452 and Decision No. 161 dated 8 April 1993.

Non-Agricultural Land: in April 1993 a law (Law No. 7698 dated 1 April 1993) was passed with the intention of compensating the inefficient practices of the past and of avoiding release of the public support for privatization. This

law on restitution gave former owners of nonagricultural land the right to purchase the buildings situated on their former property. If the buildings situated on that land had already been privatized, the law created co-ownership between the landowner and the building new owner. The building owner leased the land for two years from the former owner at a rate set by the law, term by which the owners were expected to mutually convene on commercial basis.

Housing Units: using partially the method of donating and partially the method of purchasing with the aim of maintaining social justice as a priority in the context of economic reform and privatization efficiency. This method minimized the great increase in value of housing under privatization and at the same time secured significant funding for the state budget. Furthermore, there was a need to differentiate buildings' prices according to owners' incomes or to the potential value of the property considering amortization, quality and location.

Service Enterprises and Shops: were privatized by giving priority to employee "buy-out" with alternatives of "free selling" and "rent" providing second options. Such combined method facilitated the social justice while accelerating privatization of such objects. This made possible the normal functioning of services and trading markets.

The Second Stage has been called Privatization of Small and Medium Enterprises. It was not so massive and fast like the first one and has been characterized by economic efficiency over the social justice when speaking in terms of privatization objectives. Auction was considered and perceived as the method enabling the government and potential buyers to know the real value and price of the property under privatization. This made the auction the most transparent approach, which included competition, efficiency and speed.

Joint Ventures were another method of privatization, which came in force during this phase; tens of such firms have been established in the field of Industry, Agriculture, banking and construction.

The Third Stage has been called Privatization of Large Scale Enterprises. Besides the methods of privatization mentioned above, during this stage the method "through shares" has been used which was seen as useful, rapid and efficient from socio-economic viewpoint. The free distribution of shares increased the amount of personal savings of population and enabled participation of retired persons and other strata of the population that were not any more active in the nation's economic life.

Other privatization methods such as auctions, joint ventures or free sale were not so much applied due to the fact that:

- Albanian businessmen lacked capital and managerial skills to privatize and manage such large firms;
- The high internal debt of such enterprises made the potential investors withdraw;
- Old technology of such enterprise did not promise high efficiency and financial return;

Implementing privatization process was an act of State Administration. In Albania, all state enterprises were classified, as municipality owned enterprises and national enterprises. In all national enterprises, the ownership was exercised by relevant line ministries, whilst the privatization generally was undertaken by NAP and its 37 District Agencies.

Policies related to the Restructuring of Former State Enterprises

With the Decision of the Council of Ministers No. 300 dated 15 July 1992 an Agency of Restructuring and Privatization of Agricultural State Farms (ARPASF) was established within the Ministry of Agriculture and Food. This agency set up its branches in all districts and had a separate special bank account. Its objectives were related to the stages of privatization, so during the first stage the main objective of this agency was restructuring the agricultural enterprises and in the second stage the objective was the privatization of 297 agricultural enterprises (including livestock complexes) managed by that agency.

During the first stage of privatization, the agency paid the salaries of 150.000 workers and gradually through restructuring critical funding for industrial enterprises of poultry and pigs, food factories and houses were maintained. In these cases, the agency provided assistance to the retrenched staff, mainly guards. During this stage these enterprises were dissolved so that they could more easily be transferred to private sector.

The second stage of privatization process started in May 1993 and concerned all State Farms. The privatization was seen in two aspects:

- Land privatization according the Land Law No. 7501 and Decision No. 452 dated 19 July 1993 and that No. 161 dated 8 April 1993.
- Privatization of other assets of state farms under the Decision No. 282 dated 25 June 1992, No. 161 dated 8 April 1993 and No. 195 dated 16 April 1993.

The total book value of all State-Farms' assets (construction, equipment, space and infrastructure) was estimated round to 21.6 million US\$. On March 1996, Directorate of Agricultural Policies and Privatization of MoAF reports that Lek 16.5 million have been divested (through cash or installment sales or auctions). The remaining number of 1200 assets or so called "privatization units" at an estimated value of US\$ 4.1 million are mainly worthless assets or possessed illegally, or those having a certain value have been stolen (majority during the turmoil of spring 1997).

The Land of State Farms which was privatized was given to the employees of these enterprises to own or use it according to whether the land had been an asset of any former Cooperative or the State. State Farms owned about 145.000 ha of land out of which 10.000 ha have been included in Joint Ventures. The rest of State Farm assets have been privatized by selling them to constituent employees. The latter was realized by former employees paying the value of properties to the branches of ARPASF.

Ten thousand of State Enterprises were privatized and another 1000 agricultural state enterprises entered privatization after 1 January 1994.

Concerning other agricultural enterprises, 93 agricultural mechanization enterprises out of 102 ones in total, have been privatized. Regarding 29 Water Enterprises, these have not been included in privatization and continue to be State Property.

When considering the agro-processing industry and agro-food sector (local milling enterprises dairies, producers of beverages, canned food and companies from tinned industry), they can be summarized as follows:

- about 500 small processing plants (mainly cheese processing, mills and bakeries);
- about 300 units of medium scale enterprises quite homogeneously widespread in the capital of districts.

It results that round to 95% of these enterprises have been privatizable under the Decision No. 248 since their value was under 500.000 US\$.

The main structural constraints that have affected the privatization of agro-industry sector can be summarized as follows:

- very obsolete technology which could not be put into function again, with few exceptions
- fragmentation, lack of standardization, uncertainty and poor intercession in supply of agricultural raw materials;
- very poor support industry especially in packaging sub-sector;
- lack of financial resources and management skills;
- lack of consultant services for management and technology restructuring and preparation of business-plans to be submitted for credit and /or joint ventures.

Obviously the poor results obtained in privatization have been mainly due to overvaluation of the assets in relation to the old and inefficient technology as well as the prevailing market conditions.

Policies and Strategies for the SME Sector Development

In view of the SME sector's vital importance to the national economy, the Government of Albania since the change to a free market system, has always been very attentive to the development of the SMEs. They have been growing steadily during the first years. However this process was interrupted by two crises: the Pyramid Scheme in 1997 and the Kosovo Crisis in 1999. The Government is committed to promote the development of SMEs and to use SME development as a catalyst for obtaining rapid increases in local production and employment. Rapid and sustainable SME promotion and development will need considerable resources.

Over the years a number of donors have been supporting the SME sector such as UNDP and GTZ. As a result, in order to establish the factual basis for the Government concerning clearly identified needs of the SME sector and the available business support resources, a new SME development strategy has been formulated and some actions are in progress right now.

Such a strategy has been perceived as a part of the Government's global strategic goals for the social and economic development of the population including employment, economic growth as well as more regional and sector balanced development all over the country.

Creating a positive business development climate to allow for sustainable SME growth is the strategy's global objective. Its specific objectives include: encouraging the expansion of existing businesses and the creation of new ones (start-ups), including the transformation of traders into investors in production, while simultaneously supporting production for export and promoting SME joint-ventures.

In order to reach those objectives a number of policy highlights are designed and hopefully will be taken soon, such as:

- Institutional strengthening and development on 3 levels:
 - Policy/program decisions by a strong SME Department at the MoECT on behalf of Government;
 - Program development and quality supervision by the Small Business Development Agency (SBDA);
 - Program delivery (i.e. SME support services etc.) by regional intermediary institutions, such as the network of RDAs/Business Centers, the Chambers of Commerce-CCIs, other business associations or consulting firms.
- Creating a positive predictable legal and fiscal framework, conducive to SME development. This will consist of keeping a database on laws and fiscal measures affecting SMEs; scrutinising draft legislation and making proposals for new ones, including a comprehensive SME law. These tasks are to be done jointly by the MoECT SME Department, by other Ministries related with private sector and by the SBDA.
- Improving the operational management of the SMEs, via a comprehensive training program, comprising training-of-trainers/staff from the regional intermediaries; increasing the capability of SME managers of existing enterprises and training of start-ups.
- Improving the SME credit system through taking the appropriate steps to alleviate present gaps and lending problems and/or initiating new credit tools;
- Promote SME development in order to obtain more balanced regional and sector development through making use of fiscal incentives for SME creation in poor areas and studies on regional SME investment opportunities.

Current Status of Government support to the SME sector

Albanian Government in its economic development program intends to compile an extended program with concrete projects in order to promote the strengthening and development of the SME mainly focused on export-oriented production and also promoting the FDI in production sector. Promotion of domestic production is a long process that requires time and it is costly, too.

According to the studies and analyses, not all the sectors of the economy dispose with comparative advantages in export-oriented production. Sectors

that have to be treated with priority in export-oriented production are: wood processing, textile, leather and shoes. Collaboration with foreign firms is the most important factor in export promotion.

The Government is working in developing an export promotion strategy. The small domestic market in Albania is insufficient to drive development. An export promotion strategy challenges Albanian enterprises to compete. The approach must be enterprise-driven and industry-specific because the arena in which competition takes place is the industry and its market sector. Government has to work in two directions: promote Albanian exports and build up the capability of Albanian industry.

Since October 1999, according to the asymmetrical agreement provided in favor of Albania, EU has given preferences to Albanian products on European market. EU has stimulated in this way the exemptions from custom duties as well as elimination of limitations on quantity for industrial products, for some special concessions in agricultural products, fish, etc. About 90% of all Albanian exports to EU countries are duty-free customs.

Within the frame of Stability Pact Investment Compact is functioning as an integral part of it. This document focuses on presenting the current situation of policies with respect to private sector development, presenting specific commitments and measures to be taken by the Government of Albania for creating a friendly environment for business development and foreign investment promotion.

In its future program for business development, Government will concentrate in:

- Improving the operational management of enterprises, via a comprehensive training program, comprising training-of-trainers/staff from the regional intermediaries; increasing the capability of SME managers of existing enterprises and training of start-ups.
- Using SME promotion to obtain more balanced regional and sector development. Using fiscal incentives for SME creation in poor areas; studies on regional SME investment opportunities; creation of SME Industrial Estates/Business Incubators in collaboration with local governments etc. could do this. Also providing the right incentives to promote production instead of trade.

Government therefore will work closely with its two preferential partners: private sector institutions and the donors' community. Government could try to keep some control over possible unbalances of the market. It may thus be able to fulfill the demand of the society for a more balanced distribution of the national income among groups of people and among regions.

A regional network of Regional Development Agencies (RDAs) operates in 9 regions of the country as private agencies, offering different services to the business sector, including business plan development, counseling, training courses, etc. RDAs collaborate with the local authorities in preparing different economic studies and analyses of projects for the region's economic development.

The network of the Chambers of Commerce is also broad. There are 35 chambers of commerce across the country, but there is a lack of quality and quantity of services offered in response to the needs of their members. They provide information on markets, technology and products, as well as on training possibilities and, trade fairs and exhibitions.

The Union of CCI's also has co-operation agreements with other chambers in Europe. This results in the exchange of trade directories and other practical information, as well as in regional co-operation (e.g. with the Balkan Chambers, related to markets, investments and joint-ventures).

There is a number of public and private institutions that do provide support to the SME sector development.

1.3. INSTITUTIONS SUPPORTING THE SME SECTOR

Public Regulatory/ Promotional Institutions

This involves governmental institutions whose organisational structure contains either departments responsible for the preparation of legislation and the regulatory framework for the private sector or units dealing with the implementation of the regulatory framework.

A rough assessment of the present circumstances indicates that legislative improvements are required in order to support SME development. It is generally agreed that business associations have a weak effect on legislation. The most important difficulties in starting up and running a business were reported to be finance, unfair competition, and administrative bureaucracy. However, the registration and licensing procedures were not difficult or expensive.

There are only a few SME's promoting institutions in Albania. Albanian Economic Development Agency can be considered as the leading promoting institution. But, at present even AEDA is focused on a limited number of activities and it is not an adequate organizational structure capable of developing all the needed promoting activities. Other departments in charge of International Relations in some of the Line Ministries can indirectly be considered as business promoting ones since they are involved in identifying projects of business development and negotiating with donors to attract funds. The market information and the financial management advice are considered as the most important areas of SME' s promotion.

The collection of information regarding SME' s sector development is done by INSTAT within the framework of information on Private Enterprise Sector. It is based on a limited number of indicators on national level. Actually, what is being lacked is a specialized monitoring unit on SME' s sector to collect periodically full information and on its basis then propose to the decision-makers appropriate policies and strategies.

Formal Financial Institutions: Banking Institutions

Formal financial institutions include those institutions that are subject to monetary regulation, rules and laws of central bank. They have an important impact on economic development where the need for financial services is being increased. Formal sector includes institutions such as "Commercial Banks, Development Banks, Cooperative Financial Institutions, Insurance

institutions, etc". In Albania development process of formal financial institutions can be divided into two periods:

- Period 1990–1996 or the period of creation of judicial and institutional framework of banking system. At this period double level of banking system was established where apart from state owned banks, first joint ventures and private banks were established. End of this period coincides with flourish of pyramid schemes that showed that banking system reformation was slow.
- Period 1997-2000 or restructuring and expansion period of banking system. During this period RCB liquidation, NCB privatization and preparation of judicial framework as well as the approval of privatization strategy of SB were achieved. Along with this process, during the last two-three years the number of private banks operating in our country has increased substantially. Based on capital ownership, banking system in Albania is presented in respective table:

Table 1. Albanian Banking System (December 2000)

No	Kind of Banks	No of branches	No of agencies	Market share (in %)
I State Owned Banks				
1	<i>Savings Bank</i>	26	197	62.6
II Joint-Venture Banks				
2	<i>Italian-Albanian Bank</i>	1	1	5.2
3	<i>Albanian Arabic Islamic Bank</i>			0.8
III Private Banks				
4	<i>National Commercial Bank</i>	10		12.5
5	<i>Dardania Bank</i>			0.7
6	<i>Tirana Bank</i>	3		5.0
7	<i>The Branch of National Bank of Greece</i>		2	2.5
8	<i>International Commercial Bank</i>			0.6
9	<i>The Branch of Alpha Bank</i>	2		2.9
10	<i>American Bank of Albania</i>		1	4.2
11	<i>FEFAD Bank</i>	4	1	1.6
12	<i>The Branch of the First Investment Bank</i>			0.8
13	<i>Inter-Commercial Bank²</i>			0.8

Source: Bank of Albania, *Economic Bulletin*; 2001

Banks generally work according to universal rules except for Arab Albanian Islamic Bank, which operates on the basis of Islamic banking principles not accepting term deposits and issuing loans.

Albanian banking system is characterized by market segmentation. So, SB possesses still the greatest share of deposits (about 80 % of them) and it is the only bank that has branches in all districts. On the other hand it is a fact that private banks are making progress. They are quickly attracting deposits in foreign currency and ALL. That has been achieved through a contemporary payment system offered to clients resulting in deposit increase and the increase of term deposits fixed by savers.

When the SB was exempted from the right of credit limit use, crediting of the economy, despite the deficiencies observed, was channeled through private banks. Now they have formed their credit portfolio that increases the room for short-term credits, circulating the same funds. Last abolition from the BoA of credit limit and base on indicators of supervisors only for those activities, make greater chances for banks to increase credit volume extended to the economy.

External Financial Institutions/ Assistance

Co-operation agreements with the government that support the SME development in Albania are signed up with 13 main investors. Some NGOs also contribute to SME development, but not through any agreement with the state. These contributions are considered to be modest and they are not being monitored by any state institution.

Ten investors finance credit lines for SME development. Most of them consider their programs successful. They believe that the credit lines they do provide are attractive to SMEs, but they point out problems caused by the weak banking system, political instability and public disorder as the main constraints in implementation. Most of the investors are of the opinion that a more liberal credit policy should be developed. They also are of the opinion that new institutions are necessary for SME development through a bottom-up approach.

There is a need for an SME development strategy to promote economic growth. Almost all investors have regular co-operation with the government and three-quarters attend regular investors' co-ordination meetings. Although, co-ordination must be improved, in order to avoid duplication, and that there ought to be a strengthening of the SME Unit in the Ministry.

A short characterization of the main investors in Albania follows downsides.

WORLD BANK AND IDA

Albania joined the World Bank and IDA in October 1991. The Bank's central lending objective has been to alleviate poverty, and to promote economic growth and private sector-development in the country. IDA's lending to Albania since 1992 amounts to \$481.75 million for the support of 33 projects.

IDA's Country Assistance Strategy, adopted in 1998, focuses on the following strategic priorities:

- government and institution-building
- promoting a sustainable private sector (restoring macroeconomic stability in conjunction with the IMF); financial sector reform; enterprise privatization
- sustainable agriculture growth; improving infrastructure and promoting environmental stability
- promoting human development and alleviating poverty

Another project under development is trade and transport facilitation in the Southeast. This project is a part of a Regional Program of Trade and

Transport Facilitation in SEE. The project has three development objectives: to reduce non-tariff costs to trade and transport; to reduce smuggling and corruption at border crossings; to develop regional trade partnerships. The project addresses customs reform as a major element in the reduction of costs to trade in a regional context.

IFC

Albania became a member of IFC in 1991. IFC's strategy for Albania consists of:

- Provision of financial and technical assistance to small-and medium-sized enterprises in the post-privatization stage.
- Encouragement of regional investment in Albania's nascent private sector.
- Improvement of the financial sector through the development and strengthening of commercial banks and micro-enterprise banks.
- Rehabilitation of key industrial sectors (such as oil, gas and mining) as well as the industrial infrastructure.

To date, the IFC has approved approximately US\$ 50 million in financing, with US\$ 1.2 million allocated for a cement terminal, and the remaining US\$48.5 million for the rehabilitation of the Patos Marinza Oil Field.

IFC's activities in the financial sector include strengthening the financial system through the establishment of new financial institutions; helping with bank privatization; and reaching SMEs by lending through local, and perhaps new, financial intermediaries. The latter would support SMEs in industries and/or economic sectors where Albania has a comparative advantage, such as agribusiness, construction materials, and mining.

IFC establishes a business advisory unit, with the financial support of donor governments, to assist entrepreneurs in preparing bankable projects, and to help them through the initial phase of development. Further, IFC has begun a survey of the agribusiness sector to be followed by studies of the mining and health sectors. IFC has raised funds and identified an international consultant who will prepare a survey of the agribusiness sector, and identify companies with strong manufacturing potential to support the increased demand for food supply in the country. IFC is in the process of raising other trust funds to carry out sector studies for the small chrome private mining sector and the health sector.

As a part of this program, IFC established its field office in Tirana in December 1997, and began to support small-and medium-sized enterprises (SMEs). So far, IFC has approved two projects, for a total of US\$ 2.2 million: one in the financial sector, and the second in the production of construction materials. In addition, IFC has developed a sound pipeline of projects in sectors ranging from construction materials to agribusiness. Although undeveloped at this point, light manufacturing exports such as textiles, fishing, and tourism along the Adriatic Sea, have potential if developed with the strong involvement of EU-based partners.

EBRD FINANCING

Another financing agency of the SME development is the European Bank for Reconstruction and Development. The EBRD intends to continue playing a leading role in promoting, screening and financing private investment projects, focusing in particular on the manufacturing and tourism sectors. The EBRD is also assessing several private sector investment proposals in a variety of sectors, such as agro-industry, energy and construction materials. The financial support of EBRD is provided through:

SME Recovery Credit Line: The EBRD has established a credit line facility with BIA and the Tirana Bank (TB) for a total amount of US\$ 10 million. This facility consists of two five-year bank-to-bank loans: US\$ 6 million to BIA and US\$ 4 million to TB. The operation will enable both banks to lend in hard currency to SMEs, which in their turn would be able to increase working capital and investment financing, thus supporting the recovery of the private sector in Albania. The credit facility is complemented by the Albanian Guarantee Agency (AGA), which will provide guarantees to private sector entities to cover political risk in Albania.

Albania Reconstruction Equity Fund: The EBRD contributes US\$ 7 million to the Albania Reconstruction Equity Fund established to assist business development in the local private sector in Albania. The Fund, totaling US\$ 14 million, will provide equity financing to support SMEs, helping to restore confidence in the economy. The Italian Government also participates in the Fund with US\$ 7 million.

FEFAD Bank: In July 1999 the EBRD became a shareholder in FEFAD Bank, which took over from the previous FEFAD Foundation, specializing in micro credit lending. The EBRD investment amounts up to ?1.2 million. Other shareholders are: KfW, a German institution; the International Finance Corporation; and IMI, a German investment fund. FEFAD Bank will support the emergence of the private sector in Albania by ensuring that micro and small entrepreneurs have permanent access to formal sector financing. It plays a very important role within the Albanian financial sector since no other financial institutions currently supply credit to micro and small businesses.

Private Business Associations and Consulting Agencies

The Chamber of Commerce and other business associations are mainly focused in Tirana and other big cities. They operate on the basis of membership and the main income comes from the contribution of private sector members. The kinds of services they offer to SME-s are mainly activities linked with trade promotion, general business counselling and information facilities. The relations of the Business Associations with central and local government are estimated as normal ones, but the representation on different meetings is the main activity of such cooperation.

Generally the opinion of the business community is not taken into consideration at all by the government when the problems of SMEs are being discussed, mainly because of the low interest of the Government to have their opinion.

The national structure of the Chambers of Commerce consists of the Union of Chambers of Commerce and 35 operational Chambers in the various districts of the country, which make up the Union. Membership in a Chamber is obligatory for registered businesses. Registered physical persons with a turnover of less than 250,000 Lek are not required to join. There is some doubt that all those required to join have done so, since the figures in some areas demonstrate significant under-representation. Some reports suggest that there are only a few Chambers operating at a reasonable level. The Ministry of Economic Cooperation and Trade supervises the Chambers with respect to legal provisions regulating their activity, regulations concerning elections of the General Assembly and its president, as well as the President of the Chamber and the President of the Union of Chambers. There is also a Chairman of the Union of Chambers and a Secretary General, the latter appointed by the Ministry.

Other business associations include the Union of Albanian Businessmen, the Union of Investors, the Foreign Investors Association, the Agricultural Association, the Italian Entrepreneurs Association, the Greek Entrepreneurs Association, as well as several joint associations between Albania and other countries.

The business associations offer a range of services including trade promotion, counselling, and library/information facilities as the most common ones. Some also provide workshops, seminars and conferences, newsletters and other publications, as well as some training programs. None of them provide finance. 65% felt that they took an active part in SME development (83% in Tirana), while 27% felt that they did not. This may once again reflect geographical constraints (i.e. the need for a better regional distribution of initiatives and support) and possibly inadequate relationship with government.

The majority (60%) report relations with government (both central and local) as 'normal'. Whereas half of them believe their opinions are taken into account by government, another half (46%) think their opinion is not considered at all. Of this group, 90% attribute this to a lack of interest by government, and just fewer than 40% - to conflicts between the associations and government.

Concerning the problems facing business development, access to financial resources was mentioned as the highest constraint by the majority, with unfair competition, and administrative bureaucracy, coming a close second and third. But other constraints were also seen as serious ones, such as taxes and contributions, business initiatives and information, regional location, finding qualified staff and premises, and business registration procedures. Legal changes were said to be necessary in taxation and customs regulations, and, once again, the enforcement of competition law. They suggested a decrease in customs duties and VAT, as well as removal of customs duties on production equipment and machinery.

Private consulting agencies are relatively few and other institutions giving advice on private sector are a new experience to the Albanian reality. Their actual stage of development reflects the development of the private sector, which is still not consolidated. They range from small local companies to

some foreign companies. Most of them operate only in Tirana, because of the lack of financial means and because most of the clients are located in Tirana. The number of clients they have is small, on average 105 people, and the tariffs on various services do not change more often than once in a year. The tax and legal services and training activities seem to be the most frequent services provided by the private consulting.

Informal financial institutions

Informal financial institutions are those that stay out of the impact of rules of Central Bank. They usually include moneylenders, merchants, friends, family members as well as Saving and Crediting Associations (SCA). Informal institutions are still important in many developing countries. In rural areas they might be more important than in formal sector.

Agricultural private producers after 1990 unable to get loans from commercial banks have used as an extra financial source credit from moneylenders, friends or relatives.

According to a survey conducted in 1993-1995, only 2% of farmers have used credit from the banking system in around 648 farms in 25 districts out of 36. Among difficulties stressed by them regarding crediting from banks are high interest rates, bureaucracy of procedures and short maturity. Another part has used credits from relatives or merchants. The largest portion of credits was borne by moneylenders and merchants.

Another survey, undertaken in districts where rural credit projects has applied Rural Finance Funds (RFF) in 89 farmers, points out that household loans received from banks occupy a small place.

Small credits have been mainly used to finance husbandry activities and animal purchase. Credits from ACB have been used for farm mechanization with heavy equipments.

Table 2. Nature of financed activities in compliance with received credit

Type of financed activities	Credits from RFF	Credits from others (banks)	Credits from particular people (relatives)
Urgent household needs	0	0	37 %
Agricultural	2 %	0	5 %
Husbandry	67 %	40 %	21 %
Animals for ploughing up	14 %	0	0
Trade	5 %	0	0
Crafts	2 %	0	0
Mechanization	2 %	60 %	0
Others	8 %	0	37 %

Borrowings of particular individuals have contributed up to 21 % of livestock finance and specific household needs (sickness, feasts).

During the last two or three years the judicial foundations are laid and efforts for establishment of rural financial institutions on group basis have started. During this period, the following laws have been approved:

- The Law on “associations of mutual cooperation” provides a legal framework for relatively loose groups and cooperatives with few obligations for its members. The model may also apply to associations in financing sector although no bank supervision is foreseen. Some professionals for the rural banking sector favor the model as outside control would be kept to a minimum. This law constitutes judicial foundation of cooperation in agriculture.
- The Law on “savings and credit associations - SCA” is the latter case in above but is directed toward financial issues. This law constitutes the judicial form for establishment of financial institutions specialized in rural areas. Nowadays in Albania the first saving and crediting associations have been set up but have not started yet their entire activities. Different projects financed by donors make efforts in establishing such institutions. Among important projects focused on rural sector are: Rural Finance Component; The Albanian Credit Union Development Project; GTZ (German Agency for Technical Cooperation), IFDC (International Fertilizer Development Center).

By assisting the project for credit unions development, up to now the first 6 SCA have been established based on Irish experience. The amount of contribution from members is still modest (a capital of US\$ 7,000) and their operation is at initial phase. The number of members is still small (on average 15-25 members per one SCA). These 6 associations have set up their union.

Creation of a SCA of merchants of fertilizers is also an ambitious task, which is supported by IFDC project. Among main constraints to establishment, expansion and operation of SCA are the following two:

- Old mentality of farmers regarding cooperatives of former socialist system, organizations that failed in fulfillment of planned objectives.
- Impact of pyramid schemes bankruptcy that apart from loss of farmers' savings increases the lack of trust in cooperation.

2. CURRENT STATUS OF SME FINANCING

Financial support to SMEs after 1990 is provided from donors' project as well as from bank loans. According to the statistical data, around 62% of the total funds allocated from donors' community for Albania are given as soft loans for Albanian government.

These financing types, the so-called "Development Projects", are mainly used to finance credit lines to SMEs accompanied with technical assistance. This constitutes 79% of funds, out of which only 45% are spent. Another component of foreign aid is "Technical Assistance" that includes institutional support and support to enterprises in various forms.

Credit line funds are given from donors as soft loans and the government allocates them to banks to be used as commercial loans without harming banking practice and the use of own bank capitals. As a consequence, the greater part of financial crediting sources is converted into commercial funds.

The Albanian banking sector provides minor loans only to SMEs as finance dedicated to credit lines. We could classify the financial support to SME in two periods.

The period 1992-1997, over which along with the financing from three state-owned banks, SME sector was supported by various donors' funds, too. Total finance of SME over this period amounts up to US\$ 150 million, out of which US\$ 105 million are internal funds and US\$ 45 million are foreign funds. The loan proportion within business sector is as follows: 44.6% or US\$ 46.8 million - in trade, 33% or US\$ 49.3 million - in manufacturing, and 25% or US\$ 33.7 million - in service sector.

Table 3. SMEs Loans According to the Economic Sector

Years	Albanian funds for SMEs			Total '000 ALL	Total US\$
	Trade	Service	Manufacture		
1992	312,045	134,508	268,129	714,682	9,777,271
1993	1,464,140	688,330	534,795	2,687,265	26,339,452
1994	1,392,821	411,681	362,961	2,167,463	22,932,949
1995	1,000,209	408,700	800,498	2,209,407	23,829,763
1996	314,542	593,967	995,325	1,903,834	18,185,401
1997	90,398	71,161	413,813	575,372	3,874,960
Total ALL	4,574,155	2,308,347	3,375,521	10,258,023	104,939,796
Total US\$	46,793,704	23,614,439	34,531,652	104,939,796	
%	44.59 %	22.50 %	32.91 %	100.00 %	

Source: Report on SMEFoundation - Albania, May 1998

Assuming that during 1992-1997 the total of 46,049 enterprises (in trade, manufacture and service) have been financed by the banks with a total finance of US\$ 150 million, we could draw the conclusion that every enterprise has taken about US\$ 3,200 on average.

1997 and the period to date pertains to the situation, which has emerged after the bankruptcy of pyramidal schemes and which gave its negative effects on SME activities. Over the year 1997 many small and medium businesses were closed. Moreover, worsening of macroeconomic indicators and in particular the high inflation level caused a breakdown of credit issuance and increase in the cost of credits. Interest rate of bank credits in ALL increased from 18-20 % in 1997 to 45-48 % in 1998. Along with the restricted monetary policy of BoA through credit limit, state-owned banks were prevented to issue loans. This measure was taken because the level of default loans was very high.

Continuation of reforms in banking system, increase of private banks' number and improvement of macroeconomic indicators over the last two years created the circumstances of SME financing increase.

Actually, the main local banks either independently or through credit lines have built up a SME portfolio. It is wealthy to mention here Italian-Albanian Bank, Tirana Bank, American Bank of Albania, FEFAD Bank

Difficulty in restoring confidence in the state-owned banking sector following the pyramid crisis of 1997, is a serious impediment to developing loan finance in the enterprise sector. In the early 1990s the Albanian banks used to intermediate most of the large flows of remittances that Albanian migrants sent home from abroad. Later on the pyramid schemes, with the promise of very high returns, diverted these flows away from banking system. The collapse of these schemes resulted in the loss of lifelong savings for most Albanian families and in the loss of (the already low level of) confidence in the banking sector. As a result of stabilization of macroeconomic indicators, establishment of new joint-venture banks and privatization of National Commercial Bank the public trust in banking system has returned. Saving Bank that is the only state-owned bank is now at the privatization process. High level of default loans as well as capitalization issues has stopped the bank to credit the economy. The Bank of Albania has forbidden Saving Bank to issue any loan within a 3-year period.

Non-banking sector SMEs lending, represented by BESA Foundation, Credit Union or Saving and Credit Associations (SCA), as they are defined in Albanian legislation Rural Development Fund, Rural financial institutions are already operating in Albania, but a limited number of SMEs are concerned.

Commercial banks have been expanding their activities, but they mainly involve big import operations that supply with consumption and industrial goods the major part of Albanian market. When SMEs receive official loans, banking interest rates are higher as compared to activity cost of import/local trade. Unofficial credit issuance is considerable and constitutes the major part of start-up capital for SMEs in Albania. Albania as an agricultural country has not even a single specialized bank in financing of rural sector since 1997.

As a result, government in its SME development strategy has to take into account the sources of business development in this field as well as the necessary financial instruments for their realization. Here we have in mind building of supporting structures that would coordinate the cooperation between the business community and local and central government bodies.

2.1. EXISTING FINANCIAL INSTRUMENTS

ADD

Following the information from banks and other credit providers and investors, the following areas will be items for the government to consider and address where it is possible. There are opinions from the financial sector that demand for SME credits is low while businesses reveals significant demand for credits/loans. There also appears a low disbursement rate for credit schemes as opposed to high levels for technical assistance and other areas not directly providing cash for business development.

There may be something in the range of US\$ 80 million available in Albania for SME finance, most of it seeking a similar and high level of commercial return. What might be called "development finance" for productive investment hardly exists. The funds are either micro-credit schemes or large venture capital investment funds. Demand may be low for a number of reasons. Some suggest that people do not want to enter in formal economy, not necessarily because they do not wish to register for tax and other purposes, but because this would make them uncompetitive.

Interest rates are too high and collateral requirements - too onerous. The government will give consideration to any form of a preferential finance scheme using the tax system that will help address these problems. Alternatively, there may be a lack of finance available or sought in the middle range because of security/collateral problems or fears of unfair competition from entering in the formal sector of the economy, especially in the productive sectors.

Following this, the opinion of many professionals in the financial sector is that the application of pure commercial principles will not develop Albania. Of course, a properly functioning, competitive financial sector is necessary, along with adequate commercial demand, which will expand banking business into productive and profitable sectors.

The question to consider is how to promote economic development in the process. The provision of adequate finance for economic development may be required more quickly than the financial sector can be reformed.

There are various options of supporting SME sector including here the guarantee funds, grant aids, low interest finance operated by special institutions etc. and the Government has been currently analysing these options in view of finding the most appropriate one and implementing it.

Table 4. Support for SME Development through Development Projects

Nr	Project Name	Country/ Donor	Total commit.	Starting Date	Project Description
1	FEFAD Bank	KfW, IFC, IMI (Internationale Micro Investicione AG), EBRD (not yet signed)	EUR 5 m	1996	Provisions of Finance to micro-enterprises via a dedicated Greenfield financial institution
2	Albanian Recovery SME Credit Line	EBRD	USD 10 m	July 1998	Support recovery of private sector, develop lending activities of private banks (operates through Tirana Bank and Banca Italo-Albaneze)
3	Political Risk Guarantee Facility	World Bank	USD 10- 15 m	1998	Support implementation of the SME Recovery Credit line, by covering the political risk. Managed by the Albanian Guarantee Agency
4	Albanian Reconstruction SME Fund	EBRD, Italian Government	USD 14 m	1998	Equity Fund contributing to modernization, expansion, restructuring and development of SMEs in Albania
5	Credit Line for SME start-ups	DEG+ GTZ	DEM 19.5 m		To finance Albanian Migrants returning from Germany and wanting to start-up a business. Administered by Banca Italo-Albanese
6	Private Sector Support	Greek Government	USD 17.012 m	1998	Credit Line administered via Tirana Bank
7	American Albanian Enterprises Fund	US government, USAID	USD 22.6 m	1995	Equity Fund for small enterprises. Able to take majority stakes.
8	Rural micro-credit Program	World Bank, IFAD, Irland			RFF (W. Bank), IFAD 3, Irish League
9	BESA Foundation	World Bank, Soros Foundation	USD 3,4 m	1994 (as Albanian Development Fund)	Provides micro-finance to all sectors of the economy, builds up trust in entrepreneurship and business activity.
10	Partner in micro-credit	USAID	USD 5m	1999	

2.2. GENERAL ACCESS TO FINANCING

The access of SMEs to different sources of finance is rather difficult. Most SMEs have applied for a bank loan at some stage since their establishment and a great number of them have not succeeded in getting it. 10 of them have withdrawn their application before a decision has been taken. This is mostly due to the high interest rates quoted by the banks. Generally, the banks need between two and four weeks to make a decision and rarely it takes more than four weeks before a decision is made. Out of the 24 enterprises that were offered a loan, only two refused it. Out of the companies that were offered a loan, 13 were in manufacturing, six - in agribusiness, two - in trade and three - in catering. All the 18 enterprises that were refused

a loan were told that the reason for refusal was the inability of the bank to offer a loan at the requested maturity.

The fact that the bank did not have knowledge of the entrepreneur was another frequently cited factor. There is a tendency that large firms are more likely to apply for loans than small firms. However, two issues are worth exploring further. First, are large firms more likely than small firms to be successful in their applications? Second, does the association between size and loan application hold even when other factors such as location and sector are controlled for?

The results show that the association between application and size remains positive and statistically significant, even when location and sector are included. However, among those firms who do apply for loan, there is no evidence that size matters for success.

2.3. EFFECTIVENESS OF THE EXISTING FINANCIAL INSTRUMENTS

The IFIs operating in Albania seem to agree on the following issues connected to the effectiveness of the financial instruments currently available in Albania:

- In the vast majority of cases local enterprises require very small loans (\$10,000-\$100,000).
- Local enterprises are indifferent to what currency finance is available in.
- State owned banks have network branches but no skill or commitment to lend to SMEs.
- There are large inflows of remittances, which are only partly intermediated by the banking system. Although part of this fund finances start-up capital requirements, most of it directly finances consumption.
- The micro-credit bank seems to be very successful.
- There is a low disbursement rate of existing credit lines targeting larger firms, which could be explained with the mismatch in size of loan supply and requirements—although sponsors indicate that the overpricing of the credit lines might have an important role.
- Some IFI credit lines are not competitive due to the availability of cheaper funds from other donors in the past. Currently, the pricing of some credit lines is unrealistically high, with low disbursement rate as a result.
- Finance is available mostly in Tirana.

The Political risk is currently low, thus there is very little use for political risk guarantee funds.

3. DEVELOPING SME SECTOR: RECOMMENDED FINANCIAL INSTRUMENTS

Strengthening the financial sector is the most important issue for enabling Albanian SMEs to perform successfully. The Albanian financial sector is still at an early stage of development. It has already been strengthened by the arrival of several foreign banks. There are some foreign financial institutions such as EBRD, the World Bank etc. that participated in the creation of the private banks of Albania. EBRD participated in the establishment of the first private bank in Albania, Banca Italo-Albanese, which started operating in 1993. The EBRD will continue to strengthen the financial sector by encouraging strategic investors to invest in Albania. In particular, the EBRD:

- participates in the capital of the Albania Reconstruction Equity Fund;
- has extended a credit line to two private banks to support the development of small and medium-sized enterprises (SMEs);
- has made an equity investment in FEFAD Bank;
- cooperates with the Government and a strategic investor to participate in the privatization of the National Commercial Bank;
- considers the assistance it may provide, along with other international financial institutions, for the restructuring and eventual privatization of the Savings Bank.

3.1. SUGGESTED TYPES OF INSTRUMENTS

Other Governments of Eastern European Countries have applied the mechanism of SME Guarantee Fund. They have analyzed and implemented such a mechanism with the help and advice from donors or International Finance Institutions (IFIs). The intention here was to alleviate the perceived high risk problem in investments through introducing a targeted "SME Loan Guarantee Scheme".

Commercial banks in Albania could be reluctant to provide loans from own banking funds to SMEs. In this case, the investment will be used mainly by SMEs for short-term working capital at high interest rates and predominantly to the trade sector. Actually, commercial banks in Albania are not so interested to provide long-term investment loans to SMEs, because of perceived high risks and also high overhead costs for monitoring these loans.

The main consideration is simply that by reducing the credit risk, the participating commercial banks could be induced to become actively involved in providing long-term investment credits from their own funds to the SME sector.

This has long-term benefits for the banks, as well as for the SME beneficiaries

and for the country's economy as a whole: the banks get new clients, the SMEs get long-term credit at normal market rates, the economy gets new investments in productive activities.

Basically the mechanism consists of setting up a kind of special insurance scheme. The fund is established mostly from a grant from Government, from a Donor – sometimes with contributions from local financial institutions – or a combination of all these.

This fund is put often at the country's Central Bank, as the technical and moral guardian for the good use of the fund.

The fund is not supposed to cover 100% of the risks. The coverage is often limited to around 70%. The reason is that the participating banks should share a part of the risks. Otherwise they might wrongly be encouraged to lend haphazardly and not to follow sound banking lending practices.

Suitable commercial banks are then invited to participate at the scheme by signing a special agreement with the Guarantee Fund managing institution (e.g. the Central Bank) concerning acceptance of the Fund's special rules and regulations and the payment of an agreed insurance fee. They could also be encouraged to take a small share in the Fund's capital, eventually.

In case of bad loans, which could not be recovered in full – after normal and proven efforts by the bank itself, the latter may start proceedings with the Fund's management to be reimbursed for the agreed percentage of risk covered by the Fund.

It has been observed that the multiplier factor is usually around 4, so that the multiplication effect related to actual credit disbursement is quite high. A US\$ 5 M Fund might thus result in around US\$ 20 M loans disbursement over a few years of time.

The Fund's mechanisms, rules and regulations, although being basically the same in most countries, may have to be redesigned in some cases. This is to take into account special local economic and financial circumstances. Still, there is a need to take into account some other conceptual elements like: i) Objectives of the fund, ii) Administration and fees' structure, iii) Lending Terms and credit disbursement schedule, iv) Criteria for project evaluation and v) Guarantees/claims mechanism and other special conditions.

Government will take steps to alleviate present gaps and lending problems by expanding present (micro-banks/development fund) and/or initiating new credit tools, such as SME Loan Guarantee Fund/seed capital/leasing etc. All these actions will make possible the improving of the SME credit system.

There is a need for SME promotion in order to obtain a more balanced regional and sector development. This could be done by: using fiscal incentives for SME creation in poor areas; studies on regional SME investment opportunities; the creation of SME Industrial Estates/Business Incubators in collaboration with local governments etc. Also by providing the right incentives to promote production instead of trade and thus kick-start once again processing of local agro-production, wood and other raw materials.

3.2. IMPLEMENTING NEW FINANCIAL INSTRUMENTS

Implementing the Loan Guarantee Fund means setting up a special insurance scheme. The fund is established from a grant from the Government, from a Donor—sometimes with contributions from local financial institutions—or a combination of all these.

The Fund is often deposited at the country's Central Bank, as the technical and moral guardian for the good use of the fund. This fund is not supposed to cover the risk 100%. The cover is often limited to around 70%. The reason is that the participating banks should share a part of the risks; otherwise they might wrongly be encouraged to lend haphazardly and not follow sound bank lending practices.

Suitable commercial banks are then invited to participate at the scheme by signing a special agreement with the Guarantee Fund managing institution (e.g. the Central Bank) concerning the acceptance of the Fund's special rules and regulations and the payment of an agreed insurance fee.

In case of bad loans, which could not be recovered in full—after normal and proven efforts by the bank itself—the latter may start proceedings with the Funds management to be reimbursed for the agreed percentage of risk covered by the Fund.

The Funds mechanisms, rules and regulations, although being basically the same in most countries, may have to be redesigned in some cases. This is done in order to take into consideration special economic and financial circumstances.

On the other hand, in order to establish a proper Incubator/Estate program, special funds have to be reserved. There is need of capital resources for establishing the incubator in order to build new premises or to transform an existing building, to install or upgrade utilities, to purchase common office equipment and some basic machinery. Operating funds are needed to pay for staff, utilities and other operating costs for the initial 3 years starting up period – later to be covered progressively by increasing tenants' rent on fee-based services. Renting out machine-time from the beginning however, should cover the use of common machinery. Seed money may be required for some tenants to cover initial working/investment capital needs.

This could be covered partly by special credit schemes and by normal commercial credit from the banks. Funding may be dependent on the objectives of each center. Non-profit incubators may receive funding from the state, from the local community, from donors, community groups, NGOs or foundations who take shares in the venture. The State or the municipality could also contribute by providing rent-free buildings, while the local higher institutes or research centres could assist by in kind support services, staff expertise and students help.

3.3. THE POTENTIAL INFLUENCE OF THE SUGGESTED INSTRUMENTS TO THE SME SECTOR

The implementation of the financial instruments explained in the two above sections is expected to have long-term positive influence on the developments of the SME sector.

The implementation of the Loan Guarantee Scheme is expected to have long-term benefits on banks, SMEs and the country as a whole:

- The banks get new clients.
- The SMEs get long term credit at normal market rates.
- The economy gets new investments in productive activities.

It has been observed that the multiplier factor is usually around 4, so that the multiplication effect related to actual credit disbursement is quite high. A US\$ 5 million might thus result in around US\$ 20 million loans disbursed over a few years time.

Whereas the implementation of the Estate/Incubator scheme would have positive results in that it would:

- Promote mostly the entrepreneurs that have most possibilities for success because all prospective tenants will be carefully selected.
- The candidates are going to be assisted in preparing business plans and in assessing the need for seed capital.
- They are going to be trained in business skills.

These two schemes visibly facilitate the process of creation and operation of small and medium-sized business. If the right incentives to promote production are added to the effects of these schemes instead of trade, the desired effect of kick-starting once again the processing of local agro-production, wood and raw materials would be achieved in a short period of time.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

4.1. PROPOSED CHANGES IN CURRENT POLICIES

The globalisation and internationalisation are the most important processes for our economy. The globalisation rules and structures of the business reflected in the adaptation and acclimatization of government policies to the international capital demands and standards of global market.

Fiscal options to be considered include certain preferential provisions for start-ups, perhaps linked to credit schemes, reinvestment allowances, and/or depreciation allowances. The Government have also to include "a review of VAT levels and exemptions as part of the fiscal policy for SME development. It is possible that the introduction of legal provisions for incentives, followed by their subsequent removal has itself driven enterprises out of the formal sector, thereby having the contradictory effect of reducing the future tax base of the economy.

Indeed, the problem with the frequency of legislative changes still standsq as well as the perception that there is no overall strategy or consistent basis for changes and new provisions. Data on fiscal provisions show that the Laws "On Income Tax" and "On Profit Tax" have been changed five times since 1993, the Law "On Small Business Tax" has been changed 4 times since 1993, the Law "On Social Insurance" has changed 20 times since 1993 and VAT exemptions 16 times since 1995.

It is necessary to keep a comprehensive review and summary of all legislation as well as to monitor the effect on enterprises through cooperation with private sector organizations and to report back to the SME Unit in the Ministry. Consideration will also be given to the establishment of a consistent definition of SMEs in order to simplify administration and provide a clear profile of government policy among different ministries. The definition is needed for the implementation of sector priorities and any associated fiscal policies. It would distinguish between SME development and private sector development more generally.

In addition, the Government's SME policy has to be seen as part of the more general development of industrial, sector regional policies and legislation. The government could consider the relationship between these policies because they are all parts of the reform process.

What has happened, especially since 1996 is that parts of the reform process, including SME development, have not progressed simultaneously. Banking reform, privatization, measures to increase formal economy, policies for agriculture and production are all parts of the reform process. There are still major problems with many of these areas but SME policy has become less apparent.

SME development is an important part of all these elements of the reform process and should not be considered in this broader context as something separate. It is integral, not additional. This means that SME policy implementation must have the support of a number of Ministries and must be considered in the framing of a wide range of legislation, which could have implications for SME development. The strategy is being finalized in the Ministry of Economic Co-operation and Trade. But it must have the endorsement and final agreement by the inter-ministerial Committee or Council of Ministers.

Apart from the policy decision there should also be a clear specification by the government of the inputs from different Ministries and the appropriate executive responsibilities. The establishment of a new Agency, or the development of an existing one, with broad ministerial involvement at Board level, and better coordination with the private sector and local agencies could considerably clarify this input and the intention of the government to prioritise SME policy program development and program implementation in all its various activities and legislative work.

The economic development will not be considered as a separate process apart from the international development phenomena of capital flow towards the countries and markets where there are lower cost and bigger profits. Albania is situated in the South Eastern Europe and like other countries such as FYROM, Montenegro, Bulgaria and Greece has been interested to develop a foreign capital expansion policy. Such a process is to be carried out through an assessment and re-elaboration of the present policies as well as through formulating new ones. The proposed changes in the current policies are briefly summarized as follows.

- Promotion of legal and regulatory environment that:
 - Allows export-oriented production to flourish;
 - Provides for policy leadership, guidance on strategy, and sustained commitment to mobilizing necessary resources to achieve strategic goals;
 - Promotes competitiveness in Albanian industry mainly in the field of quality, cost, productivity, responsiveness, design and delivery.
 - Improve the information quality/quantity/dissemination;
- Continuing the pro-privatization and encouraging the privatization of the state owned portion of joint ventures.
- Promotional export policy has to be addressed in those economic sectors that are making use of domestic resources.
- Reforming banking system in order to:
 - create credit facilities for export-oriented businesses as well as
 - create financial mechanism for Albanian export guarantee.
- Developing an export-promotion industry that will generate economic growth;
- Support Albanian ownership of productive economic activities;
 - widen market for Albanian producers;
 - generate investment in technology and processes;
- Improve competitiveness of private sector by:

- lowering costs and spurring investment;
 - fostering industry rivalry and
 - increasing innovation;
 - raising productivity levels and improving quality;
 - generate foreign exchange earnings;
 - improve Albania's international standing and relationship with other countries.
- Strengthen links with other governmental and non-governmental institutions involved in export.
 - Encouraging the production of highly processed products by establishing an appropriate industrial policy in the regions with the highest potential for production and development of competitive export products.
 - Creating and carrying out a well-grounded and efficient policy in the field of agriculture, and developing the food and light industries based on the availability of local high-quality raw materials.
 - Developing high-tech export-oriented products by attracting foreign capital, investing in local human resources and monitoring a more efficient utilization of the existing scientific and research infrastructure.

4.2. PROPOSED CHANGES IN CURRENT LEGISLATION

As early as 1992, Albania embarked on a gradual alignment of its legislation with that of the EC, but results have been rather uneven and clear priorities have not been established within the legislative committee in charge. In addition to high turnover in the ministries and administration, and the unreliability of the judiciary system, there is a lack of awareness of law and its enforcement.

A Permanent Office for the Reform and Alignment of Legislation was established in early 1999. As a result, in the future the government may begin operating in a more systematic manner. It is obvious that alignment with EC legal standards will have to be a gradual process. A future SAA would have to contain specific provisions, not only for the implementation of the alignment of legislation, but also for appropriate law awareness and enforcement.

Improving the regulatory acts related to improving risk-assessment in compliance with EU standards will be possible to achieve by encouraging the credit activity of commercial banks. This could be done through removing or limiting the risk of accumulating bad loans through i) creating a credit register jointly with the commercial banks and ii) creating a collateral register for committed funds.

Legislation framework and especially that part which regulates legal connections between Government and business, procedures establishment, taxes, charges, duties and business incentives and facilities have to be in the function of development objectives and will pave progressively the way to a steady and sound economic changes.

Considering the revision of the business laws as an organizational goal to centralize the large volume of work of business laws developments in the specialized qualified public structures, the government will work to avoid the interference and influence of different administrative organizational structures in the process of Business Law Development. On the contrary, the government development strategy of private sector has to be better provided and monitored..

The role and functional strategies of the specialized business law structures will materialize the private sector development strategy with the required and desired norms, rules and regulations. The main objectives are to analyse the development policy and identification of the business laws demands and evaluation of the outputs.

The private sector is developed through the new emerging companies, which as mentioned above, in the most times are SMEs. The importance and the need to support efficiently those SMEs, makes imperative the definition and distinction of them in the business law subject. The Government needs to draft a special law for the SMEs and to define precisely clear authorization and responsibilities.

The legislation development process should provide that the implementing responsible institutions are adequate, provided with their own distinctive roles, duties and functions that have become complementary and integral part of the core objectives in the overall structure.

4.3. PROPOSED CHANGES IN CURRENT PROCEDURES

Perhaps the most striking result is the fact that Albanian enterprises are more concerned about unfair competition from the unofficial economy than about other, more obvious constraints. This concern outweighs even the lack of finance as the most binding constraint they face, either in establishing or expanding a business. For many registered businesses, competition by the informal sector is a problem because of the high level of taxation, whereas for others, such competition is a problem independent of the tax burden.

Nevertheless, lack of finance is also a major issue and it prevents undoubtedly many potentially sound businesses from getting off the ground. Our survey reveals that remittance flows and other funds provided by family/friends tend to make up for the scarcity of available bank finance.

Some results suggest that action to help the SME sector can and should be taken by the Albanian authorities in two main areas.

First, the government should make a vigorous and sustained effort to reduce the size of the informal economy. Not only would this help improve macroeconomic imbalances (through higher tax revenues) but it would also reduce the importance of an unfair obstacle faced by legitimate businesses. The positive experience of some Western countries in reducing the size of the gray economy through selective tax incentives can be a useful guide for Albania.

Second, the role of business advisory services could be expanded. Many companies in our sample reported that they would benefit from support in areas such as marketing techniques, cost management, and ways to improve output quality, but very few had received such help from business support groups. A better targeting of the provision of services and linking them to complementary forms of business support (e.g. provide assistance to prepare a business plan only to enterprises that intend to apply for a loan) would also be desirable. Furthermore, an effective business support system, perhaps through the Chamber of Commerce, could provide an incentive for firms in the informal economy to become registered, thus helping to alleviate the main problem identified in this paper.

Some of the current procedures have to be adjusted to better reflect the newly economic and environment conditions as well as the stage of development of Albanian SME sector. Among them could be dealing with the creation of a competitive financial market through:

- Expanding non-bank funding for the enterprises – and for this purpose, developing the stock exchange.
- Developing capital markets by increasing their role in the redistribution of resources in the economy and complementing traditional banking procedures and instruments for accumulating capital and loans for municipal infrastructure development.
- Encouraging the credit activity of commercial banks by removing or limiting the risk on accumulating bad loans through:
 - Creating a credit register jointly with the commercial banks.
 - Creating a collateral register for committed funds.
- Improving the regulatory acts related to improving risk-assessment in compliance with EU standards.

There is a fair challenge for the commercial banks that will be lending to agricultural businesses and at a low risk and cost. Some ways of reducing risk could be the proper adoption of lending technology, financing of several activities, allocation of loans according to borrower's repayment capacity, better monitoring of contracts, etc. In addition to that, ways of cost reducing could be the use of scale economies, simplification of lending procedures, etc.

Another challenge faced by banks is teaching clients contractual task accomplishment. That is a particularly very important issue since it takes into account the fact that a lot of people in Albania think that they can and should not pay the loan received (perhaps that's the reason why some loans issued by government have never been collected). Donors' finances have primarily supported agriculture and agro-food processing industry mechanism. Currently there are five guidelines supported by the World Bank. They are: ASAC project, rehabilitation and drainage project, rural development project, agro-processing project; forest project. Financing has been made by FAO, IFAD, the European Union through PHARE program as well as countries like US, Germany, Netherlands, Switzerland and Italy.

Semi formal institutions are not regulated through banking authorities. For instance “Credit Unions” and NGOs sometimes considered as part of semi formal sector often prevail as legally registered and are subject of some control forms or reports of some inquiries.

Semi-formal institutions provide goods and services that are to some extent between those offered by formal sector and institutions of informal sector. The purpose of their credits and products offered has often a common feature from both sectors.

Table 5. Characterization of Banks and other Financial Institutions

Name of the Bank	Year of Establishment	Legal Status	Credit Line Fund (000)	Max. Credit amount per client (000)	Terms of credit		
					Collateral requirement	Annual interest rate	Grace Period
1. National Commercial Bank	1995	Public	Variable	2,000 USD	100%	35% for C in Leks 13% for C in USD	Up to one year
2. Savings Bank	1992	Public	Quarterly 200,000 Lek	70 ECU 172,000 Lek	100-120%	41-43% (Lek) 9.5% USD	Max 6 months
3. Italian-Albanian Bank	1998	Joint Venture	Variable	Variable	150-200 %	14.5% in It. Lira	6 months
4. Dardania Bank	1993	Private	Not available	-	-	-	-
5. Islamic Bank	1992	Private	Not available	-	-	-	-
6. Tirana Bank	1997	Private	Variable	500USD 78,000 Lek 120,000GRD	Negotiable on 150% of Real Property	10% in USD 33% in Lek	Negotiable
7. National Bank of Greece	1996	Private	Variable	120 DEM 10,000 Lek	150% of credit	12% DEM 34% Lek	Up to 6 months
8. International Commercial Bank	1997	Private	Confidential information	200 USD	150%	10% in USD 29% in Lek	-
9. Alpha Credit Bank	1998	Private	Confidential information	-	-	-	-
10. American Bank of Albania	1998	Private	Confidential information	-	-	-	-
11. FEFAD Bank	1999	Private	120 DEM 10,000 Lek	7,000DEM 1,100 USD	150% of Credit	12% in DEM 34-36% in Lek	Up to 6 months
12. First Investment Bank	1999	Private					
13. Albanian Development Fund	1993	Foundation	Grand from donors	2 USD 500 Lek	House, cattle solidarity	18-24 %	1-2 months
14. International Finance Co-operation	-	Project Management Unit	Unlimited	Up to 2,500 USD	Negotiable	LIBOR + 3-5%	1-3 Years
15. Albanian American Enterprise Fund	1996	Enterprise Fund	20,000 USD	250 up to 1,500	Minimum 100% of credit	Not less than 15%	6 Months

They often receive donations or government support through technical assistance or subsidies on their activities. As we can notice from Tab. 1, those NGOs have financed both urban and rural areas businesses. The size of their credits has been relatively low or medium varying from USD 350 to USD 5,000. Larger part of them has covered northern and central parts of the country and only some of them have been focused on northeast of cities.

Those who invest in rural areas have a tendency to invest in livestock.

Moreover, in different cases we can observe that NGOs have used in-group lending technology. That means that loans have been given to individuals who set up a group as their guarantee.

Table 6. External Financial Support to Private Enterprise Development

DONOR /PROJECT	Grants, Loans, Soft loans	Aid type	Year of Commitment (starting from.)	Total Budget	Total disbursement	Intermediary Institution
USA, USAID						
1. SME Development	G	TA	1995	5,050	5,050	
2. TA to enterprises	G	TA	1992	655	655	
3. Enterprise Fund	G	D	1995	22,600	21,600	Albanian American Enterprise Fund
4. Commercial Law	G	TA	1992	2,565	2,440	
WORLD BANK						
1. Private Industry Recovery	SL	D	1998	10,250	2,020	Tirana Bank (4,100 USD)
2. Rural and Urban Micro Credit Programs	SL	D	1993	24,548	11,415	FEFAD (4,100 USD) and ADF
EIB						
1. Credit Lines for Private Enterprise Investment	CL	D	1995	5,521	2,807	Italian Albanian Bank
EBRD						
1. Durres Industrial Park	G	D	1998	167	115	
2. SME Recovery Credit Line	CL	D	1998	4,000	-	Tirana Bank and Italian Albanian Bank
ISLAMIC DEVELOPMENT BANK						
1. Rural and Urban Micro-credit Programs	SL	D	1996	6,155	1,063	
EC Phare						
1. Support for Private Sector Development	G	TA	1992	5,103	5,067	
2. Credit Lines for SME	G	D	1993	4,750	2,000	
3. Rural and Urban Micro-Credit Programs	G	D	1994	3,000	3,000	
4. Durres Industrial Park	G	D	1995	1,213	29	
5. Southern Cost Tourism Study	G	TA	1996	1,103	-	
UNDP						
1. Computer Aided Design Center	G	TA	1994	317	317	
2. Promoting Foreign Investments in Albania	G	TA	1994	413	390	
3. Private Sector Development and Job Opportunities in Albania	G	TA	1996	477	400	
4. Enterprise Restr. & Development of Competitive Conditions	G	TA	1998	983	-	
IFAD						
1. Rural and Urban Micro-Credit Programs	SL	D	1994	13,110	6,985	
ITALY						
1. Constitutional support to SME	G	TA	1998	1,138	-	
2. TA for SME	G	TA	1993	569	-	
3. Credit Line to SME	SL	D	1993	2,846	-	
4. Commodity Aid	SL	CA	1998	9,108	-	
AUSTRIA						
1. Regional Tourism Master-plan	G	TA	1995	208	208	
GERMANY						
1. Credit lines	SL	D	1995	17,620	11,789	FEFAD(7 000 DEM)
2. Commodity Aid	SL	CA	1993	3,746	3,746	National Commercial Bank
3. Promotion of SME creation	G	TA	1993	5,377	2,970	National Commercial Bank
4. Support to Private Initiatives in Rural Areas	G	TA	1999	545	-	
5. Promotion of SME-s	SL	D	1993	6,042	2,098	
JAPAN						
1. Private Industry Recovery	G	D	1997	455	226	
2. Micro credit	G	D	1998	400	190	ADF
GREECE						
1. Private Sector Support	SL	D	1998	17,012	-	Tirana Bank (5 million GDR)
TOTAL			177,241	86,725		

SME FINANCING IN BULGARIA

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INTRODUCTION

International experience in the development of each particular national economy proves in practice the priority importance of the sector of small and medium-sized enterprises (SMEs) for the emergence and existence of competitive market economy and the achievement of optimum diversification in terms of the size of enterprises. SMEs are a source of new employment opportunities, they stimulate the development of entrepreneurial skills, contribute to strengthening of competition and reduction in regional discrepancies related to economic efficiency. Since economic development depends primarily on private initiative of individual persons or groups of various motivations, the state shall only establish, impose and provide favourable framework conditions for its free development.

1. A GENERAL OVERVIEW OF THE SME SECTOR

1.1 IMPORTANCE OF THE SECTOR OF SMALL AND MEDIUM-SIZED ENTERPRISES (SMES) FOR THE BULGARIAN ECONOMY

The 1998 NSI data shows that 92.4% of the enterprises (total number 205 643, without the private agricultural farms which do not have the status of an enterprise) are micro-enterprises, 5.41% - small and 1.05% medium-sized, i.e. about 98.5% of all enterprises come within the SME sector. For the sake of comparison, 99.8% of all enterprises in the European Union are SMEs and provide 66% of the total employment.

The biggest share of SME, by economy branches, belongs to healthcare, trade, education, hotels and public catering - from 99.78% to 99.9%, and the smallest - to production and distribution of electricity, gas, and water and the mining industry - between 65.44% and 68.32%¹. The sector of small and medium enterprises in Bulgaria generates 48% of the total income and holds 22,8% of the long-term tangible assets of all enterprises. The increase in the number of employees in SMEs in 1998 is by 51 742 people and represents 88.74% of the reported reduction in unemployment rate for the country (58 305 p.) That fact shows that small and medium-sized businesses are getting a firm position as the major factor to reduce unemployment and generate new employment opportunities².

In 1998 SME account for 46.2% of the turnover of all enterprises. Their contribution to the gross value added for the same year is as follows: micro-enterprises - 9.08%, small - 9.94%, medium-sized - 6.36%, SMEs total - 25,38%³

The achieved net profitability (expressed as a ratio of the net profit to sales revenues) for the entire economy in 1998 is 0.69%, for micro-enterprises - 3.21%, for small enterprises - 0.03%, and for medium-sized enterprises - 0.05%. It should be noted that in the period 1996 - 1998 only micro-enterprises have reported positive net profitability for all three years, while the for the entire economy in 1996 companies report negative profitability - -0.85%, and the biggest companies (with over 250 employees) report negative profitability of - -0.25% even in 1998. Generally, the data show that SMEs exhibit higher flexibility and recover much quicker after a crisis period.

The SME share in 1998 employment rate totals 44.1% (in 1996 it is 36.7%, and in 1997 - 41%) out of which: - micro - 20.5%, small - 14.5%, medium-sized - 9.1%). Considering that in 1998 an average Bulgarian enterprise employed 8 people, it can be inferred that SME own considerable potential for additional employment if the conditions for the development of their business are favourable, and can help to reduce the comparatively high unemployment rate at regional and national level.

The SME share in 1998 imports is 38.52% (micro enterprises - 15.13%, small - 17.7%, medium-sized - 5.69%), and in exports - 22.12% (micro enterprises - 9.53%, small - 7.85%, medium-sized - 4.74%).⁴

1 Report on SME for 1996 -1999 - Bulgaria, SME Agency - FED, CED, 2000.

2 1999 Annual Report of the SME Agency.

3 SMEs in the Republic of Bulgaria in 1998, NSI, 1999.

4 Report on SME for 1996 -1999 - Bulgaria, SME Agency - FED, CED, 2000.

Analysis of the NSI information for 1998 by economic sectors and industry groups shows that SMEs in the technology sectors comprise 98.8% of all enterprises in those sectors (Table 1). The SME total for the industry branch is 95.4%, and the highest relative share of 96.8% belongs to production of medical equipment, precision apparatuses and instruments, where obviously the highest diversification in the size of enterprises has been achieved, while the lowest - 89.9% - belongs to production of cars, trailers, semi-trailers, spare parts and accessories for them. The highest is the share of micro-enterprises in production of transportation vehicles, excluding cars - 90.3%, of small and medium-sized enterprises in production of cars, trailers, semi-trailers, spare parts and accessories for them - respectively 24.6% and 5.1%. The SMEs total 99.7% in services, featuring the highest relative share in businesses providing designs and programs and related services - 99.9%, and lowest - in scientific research - 93.1%.

The share of technology sector related SMEs in employment totals 44%, in the "Industry" branch - 36%, in the "Services" branch - 66.3% (Table 2). The share of technology sector related SMEs in turnover is on the average 46.2%, in the "Industry" branch - 18.6%, while in production of office and electronic and computing technical equipment it reaches 59.2%, in the "Services" branch - 69.6%, and in businesses providing designs and programs and related services - 86.2% (Table 3). The average turnover per employee (as a measure of clear labour productivity) at 100 average index per each branch group (Table 4), in the "Industry" branch is the highest for micro-enterprises and medium-sized enterprises in production of office and electronic and computing technical equipment - 424 and 257 respectively (where the greatest deviation of 168.4% can be observed), in small enterprises for production of cars, trailers, semi-trailers, spare parts and accessories for them - 206. Generally, average turnover per employee at big enterprises, in most technology sectors in the branch is below 100, being the lowest in production of office and electronic and computing technical equipment - 53. That proves the relatively high efficiency achieved by SME following that indicator. Services feature the highest average turnover per employee in medium-sized enterprises providing designs and programs and related services - 253, but generally it is 100 or slightly over for the big enterprises in the sectors of the branch.

The analysis of the data for operational profitability (expressed as a ratio between /operational revenues – operational expenses/ : sales revenues x 100) of technological SMEs in 1998 (Table 6) shows that for the "Industry" branch it is the highest - 8.6% - in micro-enterprises (and in the production of electric machinery and apparatuses it reaches 14.9%), 2.9% for small enterprises (production of medical equipment, precision apparatuses and instruments - 8.6%), 2.85 for medium-sized enterprises (production of cars, trailers, semi-trailers, spare parts and accessories for them - 7.8%) and 4.9% for big enterprises (production of transportation vehicles, excluding cars - 10.5%). Operational profitability is the lowest in medium-sized enterprises for production of transportation vehicles, excluding cars - -39.5%. The services feature operational profitability of 4.3% in micro-enterprises, 2.2% in small enterprises, and 1.2% in medium-sized enterprises, while in big enterprises it is 5.7%. If only SMEs are considered by sector in the industry, the lowest

operational profitability is shown by micro-enterprises for scientific research - - 16.4% (where only big enterprises show positive operational profitability of 6.1%), and the highest belongs to micro- enterprises providing designs and programs and related services - 10.7%.

1.2. SWOT OF THE SME SECTOR

To create favourable conditions for the development of the sector is among the priorities in the policy of the Government⁵. The importance of the sector for the successful restructuring of the economy accounts for the increase of public attention toward the problems and prospects for development of the entrepreneurship, a result of which are the research and analysis of the SME sector that have been carried out recently. On the basis of the findings and the recommendations some of its most important advantages can be pointed out. The SMEs are:

- generator of higher competitiveness on the market;
- source of new employment opportunities;
- more flexible in crisis periods;
- more flexible in terms of internal organisational structure and are able to adopt more rapidly and readily innovations and new technologies;
- a favourable environment for development of entrepreneurial skills and business culture;
- closer to the ultimate consumers and can respond to their demands more rapidly and efficiently.

At the same time, some of the SME weaknesses shall also be pointed out, namely:

- due to difficult access to financing, a great part of the SMEs are engaged with activities which are characterised by higher labour intensity than invested capital;
- a substantial part of the entrepreneurs do not have sufficient marketing, financial and accounting and legal knowledge, which hinders their business and reduces the efficiency of the enterprises;
- low access level and disregard of the real needs for information and consultation;
- underestimating of the quality requirements for the manufactured goods and services, especially in export oriented industries;
- most entrepreneurs are not well acquainted with the current effective international agreements and requirements and their influence on the liberalisation of the market.

The importance of SME for the national economy could also be outlined in terms of the opportunities for further strengthening and development of the sector and its impact on the economy toward:

- reduction of the unemployment rate;
- increase of economic competition;
- development of new high-technology industries;
- reduction of regional economic discrepancies;
- possibility to loop the production cycle and achieve higher efficiency by setting up clusters (related production) on regional or branch principle;
- enhancement of the economic growth rate at regional and national level;
- increase of the welfare of the nation.

The potential threats for the successful development of the SME sector are mainly in the following directions:

- impossibility to extend an individual enterprise by modernisation, expansion of activities and employment of new workers because of the adverse external (macroeconomic) environment - high taxation and insurance liability, difficult access to financing, administrative barriers etc. - and also due to the inability of the entrepreneurs to deal with its challenges;
- insufficient managerial skills of the entrepreneurs, inability to react adequately to liberalised markets and reshaping the manufactured produce and provided services in compliance with the European standard requirements.

1.3. POLITICAL ENVIRONMENT - SMALL AND MEDIUM-SIZED ENTERPRISES

The legal framework for development of small and medium enterprises in Bulgaria is characterised by a number of laws and bye-laws, regulating various aspects of their activities, as well as various spheres of business activities in the country. One of the reasons for this is also the comparatively late adoption of the Small And Medium Enterprises Act (SMEA) - late September 1999, by contrast with other legislative documents related to the economic development in Bulgaria. That predetermined the necessity to synchronise it with the already acting norms so that contradictions and repetitions with them be avoided. The major achievements of the SMEA are: the comprehensive definition of the notions for "micro-", "small" and "medium" enterprises; definition of the status of the SME Agency and its major functions; establishment of a Consultative council for small and medium enterprises as a consultative state-public body at the SMEA; definition of the status of the "Encouragement Bank" AD as an institution granting credits to SME⁶ ; preferences for SME when participating in the privatisation and renting of state and municipal properties; establishment of a special Fund for partial guaranteeing of the credit risk; establishment of a SME register; information and training provision in the sphere of SME. At the same time, the predominant opinion is that by now no real effect from the enforcement of the act has been noticeable.

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The latest amendments in the SMEA of November 2000, which shall enter into force as of early 2001 provide for the "Encouragement Bank" to grant credits not "only to SME", as was the case under the current law, but "with priority to SME" - a too general wording, lacking concrete dimensions.

For example, by now no concrete cases for use of the above mentioned preferences have been known.

However, some concrete recommendations can be made in what respects the SMEA needs to be streamlined:

- Privatisation preferences - Articles 21 - 23 in the SMEA define the set of preferences for participation in the privatisation of detached parts of state or municipal enterprises (rescheduled payment of the price in a 3-year period, and payment of initial installment of 50 per cent of the price) or unfinished construction sites (rescheduled payment of the price in a 5-year period, and payment of initial installment of 30 per cent of the price). The difference between the preference schemes for privatisation participation provided to Employee-management companies and defined in TPSMEA (Transformation and Privatisation of State and Municipal Enterprises Act) , in this case the period for rescheduled payment and the initial installment are fixed precisely and cannot be negotiated. The preference is used by already selected purchasers, but it is not said whether in the process of selecting of the best offer discounting can or cannot be applied because of the scheme for rescheduled payment. It is not clear also whether rescheduled payment installments shall be equal or not, and whether interest shall be due on the unpaid portion of the price or not. Consequently, there is too much freedom to negotiate, which may in practice give rise to suspicions in bias and even corruption. The restriction that the right to preferences only in cases of privatisation of unfinished construction sites shall not be applied under the provisions of §9b of the Rules for the Application of TPSMEA (but not in the privatisation of detached parts, as stipulated in the text of the same §9b), allowing for the income to remain in the company itself, is not justified, since in both cases a rescheduled payment would influence unfavourably the company that would have to manage the means from privatisation (pursuant to §9b).

Article 24 of the SMEA defines the preferences to which SME are subject when participating in the privatisation of stocks and shares owned by the state, and that shall be performed in compliance with the provisions of Article 25, para 3 of the TPSMEA, if they are the only bidder. In other words, they use the preferences of an EMC, which until recently were: rescheduled payment up to 10 years with one year grace period, initial installment of 10 per cent of the price and 50 per cent of the BIR on the unpaid portion ⁷. Since the reference is only to Article 25, para 3 of the TPSMEA, and not to the other articles in the act which define the overall set of preferences for participation of EMCs in enterprises, it follows that the remaining conditions and restrictions shall not be valid - there shall be no sanction if in the course of payment of the price, the respective SME loses its status of being such any more, as per the definition in the SMEA; no issuance of collateral, mortgage or any other security that can guarantee the payment of the rescheduled portion of the price is envisaged. These unclear issues have been hindering the practical application of the preferences provided in the

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The latest amendments in the TPSMEA of December 5th, 2000, provide for rescheduling of up to 5 years, without grace period, initial installment of 25 per cent of the price and BIT interest on the unpaid portion.

SMEA⁸ . Probably that is the explanation for the lack of information about concrete cases in which the preferences provided in Article 24 of the SMEA have been applied.

- Preferences for renting properties - Articles 25- 27 of the SMEA sets out the preferences for renting properties - private municipal ownership, by SME. A definition is given of properties which shall be subject to renting only to SME for a period not less than 2 years, or following a tender procedure for renting, when the only bidder is a SME, the initial rent price is 60 per cent of the initial bid-price, or of the previous bid-price, if the bid is repeated, while the term of the rent-contract shall not be less than 2 years. In both cases there are bans for re-renting or joint use under contract with third-parties, and the sanctions in case of violation are fiscal and are stated in articles 27 and 28 of the SMEA respectively. It is striking that the size of the penalties is too low (BGN 50 to 200 , and BGN 500 to 2000 respectively) and in a number of cases would be negligibly small compared with the eventual profit ensuing from the violation of the ban, and that there is no express requirement for the contract to be terminated should a violation be established. Thus a possibility for embezzlement with the preference defined in the SMEA is created. On the other hand, provisions for these preferences shall be included in municipal budgets, but there are no data that this has been done in any municipality for the current 2000, or that has been envisaged for the next year. given of properties which shall be subject to renting only to SME for a period not less than 2 years, or following a tender procedure for renting, when the only bidder is a SME, the initial rent price is 60 per cent of the initial bid-price, or of the previous bid-price, if the bid is repeated, while the term of the rent-contract shall not be less than 2 years. In both cases there are bans for re-renting or joint use under contract with third-parties, and the sanctions in case of violation are fiscal and are stated in articles 27 and 28 of the SMEA respectively. It is striking that the size of the penalties is too low (BGN 50 to 200 , and BGN 500 to 2000 respectively) and in a number of cases would be negligibly small compared with the eventual profit ensuing from the violation of the ban, and that there is no express requirement for the contract to be terminated should a violation be established. Thus a possibility for embezzlement with the preference defined in the SMEA is created. On the other hand, provisions for these preferences shall be included in municipal budgets, but there are no data that this has been done in any municipality for the current 2000, or that has been envisaged for the next year.
- Public companies, which are not SME as per the definition of the SMEA - article 4 of the SMEA stipulates that public companies in the meaning of Article 43a of the SSEICA (Securities, Stock Exchanges and Investment Companies Act) shall not be considered as SME. Since meanwhile the new Public Offering of Securities Act (POSA) entered into force and repealed the SSEICA, the definition of a public company is laid out in Article 110. The limitation for public companies to be considered SME in the meaning of the SMEA would influence adversely mainly enterprises which otherwise meet the requirements for medium and small enterprises,

dealing for example with innovations and high-technology manufacturing, which need to raise capital and do that via emission of stocks that can be traded at the regulated securities markets. Even companies that wish to provide additional financing through emission of bonds would be more attractive for investors if they are public, because of the more stringent requirements under the POSA for a number of the activities related to management of public companies and the provision of greater transparency of that management. At the same time, Art. 17, item 6 of the SMEA states the obligation of ministries to provide measures in their branch programs, to increase the number of high-technology SME, which are given priority for encouragement in compliance with Art. 14, item 2 of the SMEA. Probably, that restriction is related to the requirement for independence of SME, but it will be appropriate to consider its advantages and disadvantages again and possibly cancel it.

- Requirements for independence of SMEs - the definition of “an independent enterprise” is given in Article 4 of the Additional Provisions to the SMEA. Pursuant to that, an EOOD company or a company in which the partners or stockholders are physical persons shall not be considered a SME. For comparison, the definition of the European Commission of a SME makes use of the broader notion of a “single business”. If, however, a holding is, for example, a medium enterprise, then its subsidiaries shall be considered independent. The same shall be valid for a company in which partners or stockholders are only sole traders. In case the partners are sole traders, the physical persons shall use their trading properties but are not entitled to a new legal status. Obviously, it is necessary to amend the definition of “an independent enterprise” in order to abolish this unjustified inequality.
- Cumulative criteria for SME definition - Article 3 of the SMEA gives definition of small and medium enterprises on the grounds of cumulative requirements - upper threshold of the average pay-roll number of employees, annual turnover or value of long-term assets, independence. A question arises: What type of an enterprise or company which, for example, in terms of “number of employees meets the requirements for a small enterprise, in terms of turn-over - for a medium enterprise, in terms of LTA - for a big enterprise? Or if in that case the employee number is up to 10, but the turn-over and the LTA are of a big enterprise, then it should be deemed a micro-enterprise, as the only requirement for such is the average pay-roll number of employees, and should it then be entitled to the privileges under the SMEA?
- Informative role of the Register - as per Article 9 of the SMEA, the SME Agency shall keep a Register of the SMEs, which shall be public. The role of that Register is conclusive, i.e. it does not change the legal status of the listed enterprises and does not assign new properties to them. It is informative by nature. In compliance with §1, item 1, of the Additional Provisions to the SMEA, an “enterprise” shall be any person - trader as per Art.1 of the Commercial Act. Consequently it becomes such at the moment of its entry in the Trade Register of the competent district court. From that time on it can demand use of the legally provided privileges, while the judgment whether it is a SME case shall be made by the body

to whom the application for use of the respective privilege has been submitted (a privatising body, commissioner of a public order, municipality-lessor, "Encouragement Bank" AD). In addition, it is envisaged to refresh the register biannually, and in the mean time checks whether the circumstances concerning a given registered enterprise have changed and whether it still meets the requirements for a SME as per the SMEA are impossible, since the number of enterprises in Bulgaria that would meet the requirements for a SME registration is very big. Consequently, the register would facilitate the implementation of the state policy for support of SMEs, but the mere fact of being registered is not an irrefutable proof that the registered enterprise continues to be small or medium in the meaning of the SMEA. Then the question arises: What would be the incentive for the SMEs themselves to be included in the register, and consequently whether the database would contain information on all (or nearly all) SMEs in Bulgaria and when will that be achieved? Moreover that the Rules for Application of the SMEA and the List of Tariffs to be levied by the SME Agency (Council of Ministers Decree No 64 of April 25th, 2000) define the list of required documentation, terms and charges for registration, i.e. the procedure implies some bureaucracy, waste of time and means (though not considerable). In addition, the BGN 2 charge to be written off the register - something that brings no benefit whatever to the respective SME - is the height of absurdity. The practice related to the application of the Public Orders Act has recently exhibited single attempts to assign to the SME Register some constitutive role, since the procedures for commissioning of public orders define registration as one of the compulsory conditions for SME to be entitled to privileges. Such a requirement is contrary to the effective legal framework and may be treated as some kind of administrative arbitrariness.

Finally, the overall regulatory framework related to the SME sector is characterised by certain inconsistency, instability and controversy; the procedures defined in it are long and complicated; licensing and permit provisions are too many; there are gaps in the law; there are no concrete mechanisms to encourage SMEs; the lack of a special unified legislative framework for development of SME is impeding the activities of the SME; there is no tax relief and financial schemes apart from Banking legislation; it does not stimulate enough the development of SME and their stability. In future the efforts shall be focused on overcoming the existing shortcomings and achievement of better harmony among various legal regulations. The regulatory framework for the development of SME is basically already available. Within the framework of the overall legislation, however, a certain inconsistency and instability can be observed, and their impact on the SME development is ambiguous and contradictory. Apparently, amendments and supplements to the current regulatory framework are needed, as well as mastering of the practices related to its application, so as to create a general favourable environment for the development of the entrepreneurship and achieve compliance with European Union Law. Moreover, in the 2000⁹ Regular report from the European Commission on Bulgaria's progress towards accession it is recommended to adopt the SME definition of the

European Commission in Bulgarian legislation, particularly in terms of the size of micro-, small and medium enterprises.

1.4. THE STATE POLICY RELATED TO SMEs.

In the first years of transition towards market economy in Bulgaria practically there was no state policy to encourage the development of SME. Random activities to this end have been implemented throughout the years, but they were not subordinated to an overall strategy and their efficiency was very low. The availability of a state policy related to SME at present is an indisputable fact. It is necessary to enhance it further, especially in some aspects such as financing and crediting, taxation and insurance (in terms of both the size and complexity of the procedures for collection of taxes and insurance) as well as to simplify administrative procedures. These aspects are considered in detail in other sections of this paper. Additional efforts shall be made to reduce the relative share of the “grey” economy and to stop disloyal competition. It is necessary to facilitate the access to information -both macroeconomic and specific, related to the SME sector or to individual groups of its representatives. Good co-ordination is particularly important in formulating of concrete objectives, tasks and priorities for implementation, in accordance with changes in the economic situation in the country, as well as with their due implementation. Thus the necessary flexibility will be achieved, the apparent tendencies toward fragmentation and discord in certain spheres will be overcome and the achieved final result will be better.

2. CURRENT STATUS OF SME FINANCING IN BULGARIA

2.1. EXISTING INSTRUMENTS FOR SME FINANCING

Programme of the German Credit Institution “KfW” for Funding of the Small Business in Bulgaria

According to the Agreement for financial cooperation between the Governments of the Federal Republic of Germany and the Republic of Bulgaria, and the signed “Contract for Loans, Funding and Projects” between the Bulgarian National Bank and the German credit institution “KfW”, funds at a value of DEM 10 million have been contracted under this credit line, from which:

- a loan of DEM 8.5 million for the project “Encouragement of SMEs”;
- DEM 1.5 million for funding the necessary related expenses on the project realization.

The first payment under the credit line is at a value of DEM 4.5 million and has been already transferred. The allocation and operating management of the funds shall be performed by the commercial banks, appointed by the BNB (APEX) and KfW. They, on their behalf, offer long-term financial support to reliable Bulgarian enterprises. The micro- and small enterprises from all the sectors - trade, services and production - may apply for credits, since investment projects and long-term assets, as well as working capital shall be funded under this programme. The technical support for the banks, as a part of the Programme, shall be performed for two years (starting January 1999). The period of action of the programme has not been limited. Eligible companies to receive credit under this Programme shall be Bulgarian legal persons and sole traders, who are private and at least 51% of their capital is Bulgarian. The companies shall have 50 full-time employees, at most. The conditions on the credits for the SMEs include:

- efficient projects with good technical and economic proposals;
- size of the credit - from DEM 1 000 to 50 000 (or the BGN equivalent);
- term of the credit - up to 24 months;
- interest rate - 12-16% annually (for credits in DEM);
- 14-18% annually (for credits in BGN);
- collateral - flexible schemes, but corresponding to the Banks Act;
- technological time - simpler and faster procedure for allocating the credits;
- eligible companies shall have had a successful performance for at least 6 months.

Guarantee Schemes of United Bulgarian Bank (UBB)

According to agreements between United States Agency for International Development and United Bulgarian Bank, USAID guarantees the credit portfolio of UBB in its part for: funding of SMEs and funding of energy effective projects.

- 50% of the credit risk that has arisen in the process of funding shall be covered (only of the value of the principal). The annual interest rate shall be in the range of 14 and 16%;
- The size of the guarantee scheme for SMEs shall be USD 6 million. The size of the credits shall be within the range of:
 - up to USD 5 000 for micro-enterprises with a personnel of up to 5 people;
 - USD 150 000 for SMEs, whose assets, less the value of the real estate property, do not exceed USD 250 000,

The size of the guarantee scheme is USD 6 million with validity until November 2004.

The conditions are:

- covering 50% of the credit risk (only of the value of the principal), which has arisen in the process of crediting SME projects;
- size of the credit: up to USD 5 000 for micro-enterprises with no more than 5 employees;
- up to USD 150 000 for SMEs, whose assets less the value of real estate property do not exceed USD 250 000;
- annual interest rate - 14-16%;
- collateral - according to the common banking practice;
- SMEs-potential beneficiaries, shall be 100% Bulgarian private companies, registered under the Commercial Code and without capital or equity participation of foreign companies.

United Nations Development Programme and the International Labour Organisation

Business centres in Razlog, Vidin, Blagoevgrad and a business incubator in Gotze Deltchev shall be established. These structures support the small and medium-sized enterprises in the respective regions through training, information and consultations. The business centres offer as well financial aid through a micro-credit scheme in the city of Vidin and a leasing line in Gotze Deltchev. The project offers training for the start-up of own private business, applying the methodology and the training materials of the International Organisation of Labour. The local small and medium-sized enterprises, potential entrepreneurs and the unemployed, who want to start their own private business, can apply for it, too.

Programmes of the Ministry of Labour and Social Policy

PROGRAMME "START YOUR OWN BUSINESS". Training and financial support for a successful start in the business of unemployed, registered in the Bureaus of labour. The Programme shall be accomplished jointly by the National Employment Service and the BARDA Regional Business Centres in the municipalities of: Blagoevgrad, Gotze Delchev, Razlog, Dupnica, Haskovo, Stara Zagora, Karjali, Svilengrad, Kazanlak, Assenovgrad,

Velingrad, Zlatograd, Karlovo, Madan, Pazardjik, Panagjurishte, Plovdiv, Berkovitz, Biala Slatina, Vidin, Vratza, Lom, Montana, Rousse, Razgrad, Silistra, Targovishte and Varna.

PROGRAMME "FROM SOCIAL CARE TO REAL EMPLOYMENT". The programme is directed to unemployed people, who are receiving social care or have the alternative to go under social care, lonely mothers and other persons unequally positioned on the market of labour social groups.

PROGRAMME "ENSURING EMPLOYMENT OF UNEMPLOYED PEOPLE THROUGH EMPLOYMENT ORGANISATIONS". The target of the Programme is to reduce the unemployment in the municipalities through providing opportunities for temporary and alternative employment of staff from industries under reconstruction and supporting the local authorities in the process of restructuring and preparation of enterprises for privatisation.

SAPARD Programme

The specialised programme for the agriculture is to start this year within the framework of the allocated by the EC about EURO 52 million annually.

Priority sectors under the programme shall be:

- Improvement of the conditions for production, processing and marketing of agricultural production, forest and fish products, as per the European norms and standards;
- Integrated development of the rural regions for protection of their economic and resource potential and decreasing the rate of depopulation of these regions;
- Development of ecological agriculture and improvement of the environmental protection activities;
- Qualification and training of the workers in the process of production and processing of agricultural, forest and fish production.

Under this programme projects of private companies shall be funded up to 50% of their project value, and the remaining part shall be covered by credits by the State Fund 'Agriculture' (which shall function under this programme as "Payment Agency") and by co-funding of the beneficiary.

Investment Programmes of State Fund "AGRICULTURE"

Programme "Agricultural Start"

The programme funds investment projects in certain directions sized up to BGN 15,000.

Programme "Bulgarian Farm"

The programme shall support the agricultural manufacturers in the accomplishment of their investment projects with loans of up to BGN 10 000 under the condition of minimum 10% own participation and maximum size of the credit of BGN 90 000.

Programme "Development"

Enhances the realization of investment projects of the value up to BGN 260 000 with own participation of minimum 30% of the total value of the project

and maximum value of the credit of up to BGN 182 000.

Programme 'Mountain Agriculture'

The programme supports investment projects in certain directions and the size of the credit is up to BGN 15 000.

Programme "Eco-agriculture"

Submits credits up to BGN 60 000 for realization of investment projects with a value of up to BGN 80 000 with own participation of the agricultural manufacturer minimum 25% of the project value.

Programme "Young Agricultural Worker"

Provides financial aid to agricultural manufacturers - physical persons aged up to 35 years, by investment credits of up to BGN 15 000.

Programme "Greenhouses"

The programme funds investment projects for new construction of greenhouses or purchase of ready ones of a value up to BGN 1 000 000 with own participation minimum 35% of the value and credit size of BGN 650 000 .

**Programme
of "FAEL"
Foundation
Through
United Bulgarian
Bank for
Encouraging
of SMEs**

In 1995 government of Switzerland accepted a programme for support of small and medium businesses in the Republic in Bulgaria, whose realization shall be accomplished by the Swiss foundation "FAEL". The foundation supports the development of independent private small and medium-sized enterprises in processing and services, going along with the production process and the market realization of agricultural products.

Within the framework of this programme and the contract signed between the Swiss Agency for Development and Cooperation and the United Bulgarian Bank a credit line shall be started under the project for support of the small and medium-sized enterprises in the semi-mountainous regions of the Central Balkan mountain - the regions of Lovetch, Gabrovo and Veliko Tarnovo.

Supports the development of independent private small and medium-sized enterprises in the processing of agricultural products and services, related to the production and the market realization through:

- Consultancy - consultancy support and training in corporate management and enhancing the quality of management;
- Credit support - preparation and presenting projects before the credit commission and monitoring the funds allocated;
- Technical assistance - providing information and consultations about technologies and innovations, organizing training and exchange of experience.

The size of the credit line is CHF 1 000 000 for the first three years from the start of the project.

Eligible companies under this credit line shall be SMEs, which are:

- situated in the northern part of Central Balkan Mountain - semi-mountainous regions of Lovetch, Gabrovo and Veliko Tarnovo;
- have at least two years of business history;
- create new jobs;
- enhance the recovering and preserving the core business in the respective region;
- the project is in compliance with the requirements for environmental protection.

**Programmes
of the Dutch
Government -
“PSO” and
“PSO+” for
Economic
Development**

PSO Programme contributes to the development of the commercial relations and cooperation between Dutch and Bulgarian companies and represents a pool of activities, containing the following elements:

- technical support, which shall be expressed in restructuring, training and learning the methods of the modern management, marketing and production;
- investments in procurement and hardware, necessary for improving the production process;
- creating closer relations between Bulgarian and Dutch companies with the aim of starting joint business.

“PSO+” Programme is an alternative to “PSO” Programme and is orientated towards companies from consortia of Dutch and Bulgarian companies, which have prepared joint projects. PSO+ Programme and the projects shall be connected with the investment of Dutch companies in Bulgaria or some other forms of sustainable cooperation with the aim of:

- promotion of innovations;
- establishing of long-term commercial relations;
- supporting the start up of new business activities;
- supporting the initiatives of Dutch-Bulgarian joint-ventures;
- supporting the “know-how” transfer and capital goods.

Beneficiaries under the Programme shall be companies from the following sectors: Agriculture, Transport, Energy and Environment, Industry.

The entrepreneurs, who have interest towards investments and joint activities, shall have a Dutch partner company, in order to apply for participation.

**Credit Line
for SMEs
Under
the PHARE
Programme**

The funds under this programme are granted from the EC under the Financial Memorandum between the European Union and the Ministry of Industry. Bulgarian National Bank. BNB (APEX institution) accumulates the funds and according to the contracts for their management the credits shall be submitted by the commercial banks: “EXPRESSBANK”, “POST BANK”, “CENTRAL COOPERATIVE BANK”

Under this credit line funding is allocated for projects, which:

- are export orientated;
- create new jobs;
- develop the transport, industry, processing of agricultural production and tourism.

Not eligible for funding are projects in the sectors of agriculture, trade, and real estate property business.

Eligible for funding can be only investment projects of SMEs covering the following conditions:

- Size of the credit - up to EURO 100 000;
- Possibility of the beneficiary to co-finance not less than 25% of the value of the project;
- Maximum term of the credit shall be 5 years with an optional grace period up to 2 years;
- Interest rate - the trimestrial EURO LIBOR plus added value.

National Network for Micro-Funding

According to an agreement between the State Savings Bank and the Bulgarian Industrial Association, SMEs shall be funded. The credits submitted shall be in the range of BGN 5 000 to 50 000, with grace period of up to 3 years and an option for a negotiable grace period, annual interest rate of 14.5%. The credits shall be extended only for production purposes, on the condition of minimum 30% own participation of the SMEs.

Under the programme an expert support shall be provided for the development of a business plan and a credit reasoned statement.

Minimum 30% own participation is required. The credit shall be extended only for production purposes.

Micro-Financing Programme from CRS/Bulgaria

The programme supports entrepreneurs from the small and medium-sized businesses in the sectors of trade, services and the small-scale production to get a permanent access to financial aid.

Sole traders and small family businesses who need between BGN 900 and 3 600 may have access to loans without collateral by establishing self-managed co-operatives. There are no specific restrictions to small enterprises.. The programme acts in the region of Vidin and Sliven, and shall enlarge its action throughout the country. The first amount to be applied for by an enterprise is BGN 900; no collateral is required.

2.2. GENERAL ACCESS TO FINANCING – BASIC PROBLEMS

Financing Bulgarian SMEs is one of the key prerequisites for the future development of the national economy and the achievement of economic growth. It would require special commercial bank financing targeted at the SME sector, as to implement it. Currently, commercial banks apply a

conservative policy in lending to SMEs. Most banks prefer to hold mostly risk-free and low-income generating assets, and SME lending is unattractive due to a range of objective and subjective factors. These include high transaction costs involved in extending small loans, inability to set up the collateral required, etc. Naturally, the SME sector is not homogeneous and, therefore, the attractiveness of an enterprise to financial institutions varies with SME size, maturity, industry, etc

Bulgarian small and medium-sized enterprises run into many difficulties when they apply for a bank loan, the main reasons being as follows:

They have no personal credit history.

Among the main criteria for loan disbursement in the country, is the sound financial condition of the company and its economic history. These criteria are in effect an insurmountable barrier to all small and medium-sized enterprises (SMEs) that have been recently set up in business and are not in a position to satisfy such conditions. Even the ones that were set up a couple of years ago and have good economic indicators find it difficult to meet these requirements. One additional circumstance that entrepreneurs admit quite frankly is the underreporting or non-reporting of the profit because of the heavy tax burden. For that reason, most of the small and medium-sized enterprises applying for loans cannot submit to the commercial banks reliable information about their operations. More often than not, the companies do not have any business plans or accounting records, which they need to attest their turnover.

The size and type of required loan securities.

When seeking medium or long-term loans, SMEs are often not in a position to offer the loan securities, which fulfill the requirements of the banks. The equipment they have is frequently obsolete or functionally depreciated. The newly established companies are particularly sensitive to this problem. The banks normally require collateral ranging between 160% and 200%, which makes the borrowings unachievable and more often than not economically unprofitable. They tend to have a preference to mortgaged real estate in compliance with the provisions of Regulation No 9 of the Bulgarian National Bank (BNB). There is a single Bulgarian bank, i.e. Eurobank AD, which accepts in security warehouse receipts.

The interest rate levels.

The average lending rate ranges between 14% and 18%. According to entrepreneurs and representatives of the branch associations, most SMEs cannot afford this rate, since their average profit is somewhere between 10% and 15%. This also applies to the Encouragement Bank, which was specially set up to assist the development of such enterprises. The banks on the other hand claim that given the market set-up, this should be the normal rate, furthermore that the international financial institutions impose explicit conditions concerning the market interest rate levels. Regardless of the high interest rate spread (approximately between 9.5% and 10%), the banks also assert that they are going to have difficulty covering the lending risk, their expenses and taxes at lower rate levels. For a long time, the banking system has not been in a position to cope with a very serious problem, i.e. the level of operating expenses. According to BNB data, the

ratio between the operating expenses and the total income in 1999 was about 65.1% - a fairly high level with respect to these expenses.

Bulgarian SMEs cannot make long-term financial projections, nor can they guarantee any stable income.

The lack of long-term corporate strategies and the resulting absence of financial planning are mostly due to the unstable economic environment. Sometimes they also result from the small entrepreneurs' underestimation of the necessity to have their businesses managed on a scientific basis.

The expenses and the cumbersome loan disbursement procedure, as well as the unhurried decision-making process, which causes uncertainty and puts SMEs to additional expense.

For the small and medium-sized enterprises, the disbursement of loans is associated with significant expenses and often these enterprises cannot afford such expenses. SMEs incur expenses for having their business plans mapped out, for banking charges on the loans, etc. SME-borrowers often apply to more than one bank for loans, which involves a couple of business plans that have to satisfy the requirements of individual banks. The small enterprises cannot afford to hire business advisors for financial reasons.

The minimum turnover requirements or requirements for a high minimum value for the amount of the loan.

In actual fact, the commercial banks do not make much difference between the expenses that they incur for the disbursement and servicing of large-scale or small loans. Given this fact, and especially in situations where the demand for loans surpasses the supply, it would be much more profitable for a bank to attract a small number of large customers than a large number of small borrowers.

The additional conditions imposed by the banks.

Quite often, loan disbursement is coupled with some additional requirements. A typical example would be the condition where the borrower should open an account with the bank that is going to extend the loan. Thus, if several loans are to be disbursed to a single borrower by a couple of financial institutions, the borrower will have to open an account with each of these institutions, which will cost him a lot of money.

The commercial banks' reluctance to extend investment loans to SMEs.

Looking for such loans is associated with the general technological and economic condition of the small and medium-sized enterprises in the country. The priority significance of investment loans is conditioned by the need of the newly established enterprises for financial resources, as well as by the necessity to modernize the obsolescent equipment in the privatised companies, to upgrade the quality of production, and to enhance SMEs competitiveness. On the other hand, it is the obsolescence and functional depreciation of the equipment that makes it unsuitable to be used as collateral for long-term loans.

Other circumstances in the way of SMEs to bank loans.

Among these are the violations of the banking confidentiality and the usual emphasis that is placed on the loan security when making decisions on the

disbursement of loans, rather than on the future generation of cash flows, on the companies' management characteristics, on their ability to repay the debt, etc.

The basic problems encountered by the commercial banks in lending to SMEs are:

The bank capital adequacy requirements, assessment of the risk-bearing exposures and making risk-covering provisions.

From the point of view of the commercial banks, the Bulgarian Banking Act is too restrictive. It was enacted at a time quite different from today and has to be amended, as the banking system is much more stable at present and some of the provisions of the act have to be brought in line with some other statutory documents. Bankers usually account for the behaviour of the banks by referring primarily to the statutory regulation of their operations. In this context, they claim that the shortage of free lending resource should be considered to be the major obstacle to the development of investment lending.

For example, BNB Regulation No 9 stipulates that a loan against mortgaged real property in a housing building is to be preferred to a loan guaranteed with production buildings, machines and equipment, which the Bulgarian companies can offer for the making of provisions. As the provisions are an expense for the banks, they affect their financial results. This is the reason why every bank endeavors to have as little provisions made as possible, which results in fewer expenses for the bank and in a better financial result.

Some BNB acts and decisions that cannot be appealed through the court and the requirement for a formal authorization by BNB for a number of operations that are typical of the business of banking.

The criminal liability for officer who have advanced unsecured loans that have not been repaid.

There are still some discrepancies between somewhat moderate provisions of the Bank Act concerning the requirement that the whole loan should be secured by a specific form of collateral and the still restrictive requirements for loan securities provided for in the Penal Code (Art. 220, Para 3).

The inconsistency between the National Accounting Standards and the International Accounting Standards with respect to lending.

The National Accounting Standards comprise strict rules, which often fail to take into account the loan-related circumstances and leave no room for any judgment.

The frequent amendments to tax legislation and the customs arrangements.

They make the business environment quite complex and unpredictable.

The problematic debt collections for the lenders.

This problem is associated with both the actual liquidity of the security and with the public collections. Since the Government has precedence over all other creditors, the public collections become an irremovable obstruction to obtaining a loan. Furthermore, the period needed to collect a security is too long (in case of any legal proceedings instituted by the debtor, the lawsuit may take years to complete).

There is no secondary market for the security in the country and the legal proceedings are sluggish and ineffective.

The prohibition against selling or pledging the assets of privatised companies up to 10 years following the company's acquisition.

This applies to transactions where the buyers have to meet serious post-privatisation commitments, such as rescheduled payments, repayment of the privatised company's debts, implementation of investment programs, etc.). In the majority of cases this prohibition is not absolute and allows permission by the privatising authority, wherever the dispositive act is in relation to assets, which are above the minimum percentage stipulated in the privatisation contract. Anyway, such a prohibition exists.

3. RECOMMENDED FINANCIAL INSTRUMENTS FOR THE DEVELOPMENT OF THE SME SECTOR IN BULGARIA

The specific characteristics of lending to SMEs has led to the development of a number of financial instruments especially designed for SMEs such as:

- Micro-lending facilities;
- Equity financing;
- Credit guarantee facilities, etc.

The policies of international financial institutions such as EBRD as regards SME financing usually focus on offering products directly addressing SMEs, or aim at strengthening the banking system in order to ensure access to banking services for small businesses. The most common formats to do that include:

- Participation in venture capital funds;
- Equity participation in local banks in order to increase their capital base and strengthen corporate governance;
- Extension of interbank loans;
- Co-financing for local projects in cooperation with local and international banks;
- Offering apex credit lines secured by government guarantees.

There are several financial instruments that could prove valuable in SME financing.

National Credit Guarantee Fund

The necessity of setting up a National guarantee fund arises from the conservative bank credit policy and higher risk in financing SMEs. The fund could be established with financial resources from the pre-accession funds of the EU and the state budget. During the first stage of its development the guarantee could be 50% of the principal of loans extended to SMEs by the commercial banks. A research made by the Center for Economic Development and Vitosha Research Agency in May 2001 shows that 68% of the commercial banks in Bulgaria consider the development of a national guarantee fund as very important measure for improving the access to credit for SMEs. Such guarantee funds operate in many developing and transition countries and play a significant role for the development of the SME sector as a whole.

**Regional
Guarantee
Funds**

The basic principles of functioning of regional funds are similar to the national guarantee fund. The differences are in the sources of capital of the funds. Regional guarantee funds could be set up with financial recourses of the municipalities and the different programs and initiatives for regional development. The creation of guarantee funds in regions with high rate of unemployment and weak economic structure can give opportunity to the entrepreneurs to get external financing much easier.

Credit Unions

Credit unions, or savings and credit cooperatives are the base-level financial institutions that provide savings and credit services to individual members. They are legally constituted financial institutions – chartered and supervised under the cooperative legislation. The development of the legal framework (Act for the credit unions) is the first step in creating a system of credit unions in Bulgaria. Credit unions provide micro- and small credits to their members and require little collateral. Most loans are limited to a multiple of the member's savings so that the savings balance guarantees a part of the loan. The use of other members as cosigners is the other principle mechanism used in credit unions.

**Special Loan
Programmes
for SMEs**

The programs provide loans to small businesses unable to secure financing on reasonable terms through normal lending channels. The programs operate through private-sector lenders that provide loans, which are, in turn, guaranteed by the National guarantee fund.

Repayment ability from the cash flow of the business is a primary consideration in the loan decision process, but good reputation, management capability, collateral, and owner's equity contribution are also important considerations.

Some of the principal lines along which the conditions for SME financing can be improved include:

- support for entrepreneurs in preparing the documents required to apply with financial institutions;
- setting up credit line facilities and lending schemes with international donors that share the risk with Bulgarian banks;
- risk sharing arrangements with insurance companies;
- introduction of a system for standardized SME loan extension and loan management with commercial banks;
- convergence of interests between banks and industry associations in order to attain more favorable conditions for lending to SMEs;
- improving the legal framework regulating the leasing and changes in tax regime;
- creating an Act for venture capital funds and developing a friendly business environment for the international risk capital.

4. CONCLUSIONS AND RECOMMENDATIONS

During the initial years of transition to a market oriented economy in Bulgaria actually there was no state policy stimulating SMEs' development. Sporadic actions have been undertaken over the years, which, however were not subordinated to a global strategy and their efficiency was rather low. At present the existence of a state policy with regard of SMEs is an accomplished fact. However, it is necessary to further improve it in certain aspects such as finances, loans and taxation, as well as in the simplification of administrative procedures. Of utmost importance is the proper co-ordination in the formulation of specific objectives, goals and priorities for the policy implementation in line with the changes occurring in the economic situation in the country, and also their achieving in due time. Thus the required flexibility will be attained, the tendencies for fragmentation and the lack of a uniform focus in certain spheres will be overcome, and consequently the end result will be much better.

- Elaboration of a sectoral policy of the government in support to SMEs' sustainable development and competitiveness;
- Setting up special departments in large Bulgarian banks (or boosting the activities of the existing ones) to help credit disbursement to SMEs;
- Regulatory changes guaranteeing to commercial banks rapid court procedures on the execution of mortgages or property pledged. In the area of small and medium business lending, courts of arbitration are particularly appropriate, since possible disputes could be resolved speedily at minimum expense to the parties;
- Facilitated access to information from public institutions - Central Depository, Special Pledges Register and the commercial departments of courts;
- Elaboration of special programmes together with the branch organisations of small and medium business, under which SMEs will receive free consultations in the preparation of business plans, financial statements, etc. to enable commercial banks in the lending process.

THE CASE STUDY OF CROATIA

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1. THE IMPORTANCE OF THE SME SECTOR IN CROATIA

Croatia economy is characterized by a very large SME sector. Around 96% of all business entities are small and medium enterprises.

SME sector employs about 62% of the labor force and has been showing positive results in employment trends with an average growth in employment of 5% while in large companies this percentage was negative. Raise of employment is especially evident in the subgroup consisting of small enterprises and crafts. We should take into account that the high expectations for the SME sector to absorb the jobs lost through the processes of privatization and restructuring of the ex- social sector have not been fulfilled. The growth of the small firm sector has not been enough to reduce the rate of unemployment, which has continued to increase, to 21% by the end of 1999.

SMEs in Croatia are mostly concentrated in retail trade and various services. In 1996, 51% of small firms were engaged in various trade activities. These firms accounted for only 38% percent of employment in the small firm sector. A further 15% are engaged in various business services, such as real estate, accounting for 13% of employment in small firms. Manufacturing firms are on the whole somewhat larger, representing 13% of the sector, but with an employment share of 22%.

The share of exports coming from the SME sector is 11 % indicating that most of SME production is directed primarily to the domestic market.

At present, small and medium enterprises represent a share of 34% of Croatian GDP.

Source of statistics: Croatian Ministry for Crafts and SME, Croatian Chamber of Commerce, Croatian Chamber of Crafts, National Bureau of Statistics

a) LEGAL DEFINITION OF SME IN CROATIA

Small enterprises are defined by The Law on Accountancy through the following conditions:

- a) profit balance upon deduction of losses carried forward in the equivalent value of DM 2, 000,000;
- b) profit during 12 months before balance sheet preparation in the equivalent value of DM 4, 000,000;

c) annual average 1/4 of the total number of employees on 31st of March, 30th of June, 30th of September , and 31st of December (employees abroad included)) – below 100.

Medium-sized enterprises are defined by The Law on Accountancy through the following conditions:

- a) profit balance upon deduction of losses carried forward in the equivalent value of DM 8,000,000;
- b) profit during 12 months before balance sheet preparation in the equivalent value of DM 16,000,000;
- c) annual average number of employees bellow 250.

SME related infrastructure

The Ministry of Crafts and SMEs established itself as the center of policy articulation, organization and co-ordination in Croatia. Local authorities are entitled to analyze the situation in small business, to formulate programs of SME support, and to decide on allocating funds towards these programs from their budgets. Currently there are 26 entrepreneurial centers including LEDAa¹, incubators and technology parks and of those 22 are joined into the Association of Croatian Entrepreneurial Support Institutions (UHiPP). Out of 21 Croatian Counties seven Counties still don't have any local business support institution.

Problems in development of SMEs in Croatia

a) *poor entrepreneurial and management skills combined with low quality of consulting services;*

- the problem with entrepreneurial skills is related to loan application problems because of the majority of business plans and other loan application support documentation get turned down due to their low quality and non-professionalism
- insufficient knowledge and skills of entrepreneurs to manage their businesses properly, as a result of which a significant number of small entrepreneurs do not make a profit in the first years of their businesses and are forced to close them down
- lack of managerial skills, especially relating to drawing up realistic plans, making decisions and undertaking the responsibility for their implementation and, a lack of advisory institutions relating to these areas

b) *lack of information;* general business information, information on market demand, including export opportunities (lack of market research data as well as lack of marketing ideas and concrete projects for the penetration in foreign markets) and finally lack of information on loan and credit possibilities and procedures

c) *financial problems;* loan application procedures are complicated and time consuming. Credits to SMEs are viewed by commercial banks as too risky and administratively costly (information asymmetry - deficiency of information on SMEs makes accurate risk assessment difficult)

2. CURRENT STATUS OF THE SME FINANCING IN CROATIA

SMEs in Croatia are depending upon three sources of funding:

- a) loans (distributed by the commercial banking system)
- b) microcredits (provided mostly by NGOs)
- c) Equity Funds

2.1. LOANS

Loans that SMEs can apply for are based on commercial banks own funds, on soft loans from International Financial Institutions or donors and on central, regional and local government funding.

With the time many commercial banks started to use their own funds for SME credit but these funds are rather scarce and limited in volume, since most of them are reluctant to lend to the SME sector because of high risks and overhead costs. Lending to small businesses is very risky because of the high degree of uncertainties faced by them (high failure rate, market changes, economic fluctuation and lack of collateral). Commercial and credit banks have no experience of dealing with SMEs. The administrative costs of lending to SMEs are very high and the size of loans is too small to cover these costs because of the:

- a) lack of transparency in evaluating loans and lack of skills of financial institutions in dealing with SMEs
- b) the banking sector in Croatia is inadequate with outdated national clearing systems
- c) the majority of transactions are made in cash because of uncertain and delayed electronic money transfer systems
- d) SMEs are unable to provide the collateral and/or security demanded by lending institutions
- e) lack of reliable market information and credit histories

This is especially evident in segment of lending for SME Start-ups. In the same time several of these banks act as handling banks for "on lending SME funds from International Financial Institutions, either directly (EBRD, IFC) or via Croatian Bank for Reconstruction and Development. These banks get soft loans at preferential rates, take an agreed spread and on-lend these funds (at market rates mostly) to SMEs in specified sectors (for example; tourism, agriculture) in accordance with the International Financial Institutions specifications for use of these funds. Central and Local Governments also use Commercial Banks for SME Credits, for their own targeted SME promotion programs. The problems connected with those credits arise bad co-ordination between them and general lack of information on them. The banks, which are in charge of disbursement of these credits

are not so effective as meant by owners of these funds and applicants.

The result was availability of much funds for SME lending, but not with the expected results due to insufficient co-ordination, information and lack of transparency of the various systems, weak legal and economic environment for the SME sector, stringent collateral conditions and slow banking/ guarantee procedures and finally a lack of good SME project proposals/ loan requests.

Central Government SME Finance support schemes

Several Ministries have become involved in providing incentives and direct support for SME financing, via arrangements with selected commercial banks.

Programs were:

- universal program for both existing SME and start-ups,
- program for "Territories with special government interests",
- program for "Development of existing SMEs" program START for Start-ups,
- program "Success" for bigger enterprises.

One of the main incentives for the banks for all these programs is the coverage of up to 80% of the risk by the Croatian Guarantee Agency (HGA).

The existing instruments for SME finance support provided by central government are:

1) Import-export crediting program (in co-operation with Zagrebacka banka)

Aims	increasing export by the SME sector
Users	crafts, SMEs, co-operatives
Purpose of credit	financing export preparation, export financing
Credit conditions	8 % annual interest (not fixed) quarterly repayment Ministry of Crafts and SMEs subsidies 2 % of the interest, thus entrepreneurs pay 6 % interest repayment period 24 months minimum amount 10 000 DM maximum amount; not fixed
Insurance instruments	assurance of the Croatian Guarantee Agency real estate assurance hard currency deposits personal guarantee
Application procedure	public tender, decisions are made within 15 days
Criteria	legal conditions project quality export orientation creation of new jobs

Source: Croatian Ministry for Crafts and SME, 2000.

2) "FENIKS - Program of crediting reconstruction and advancement of management (in co-operation with Raiffeisenbank Austria)

Aims	reconstruction and development of SMEs
Users	SME employing less than 250 employees with high quality reconstructing program credit capability and liquidity
Purpose of credit	long term investment in infrastructure, reconstruction, construction, etc. purchase of individual equipment
Credit conditions	7,5 % annual interest repayment period up to 7 years grace period 2 years repayment monthly or quarterly
Insurance instruments	mortgage insurance contract with commercial bank equities, shares, etc.
Application procedure	public tender, application to the Ministry of Crafts and SMEs loan applications are approved by the bank
Criteria	production expansion job creation new product development/penetration of new markets decreasing production costs and utilization of new technologies

Source: Croatian Ministry for Crafts and SME, 2000.

3) "Commercialization of innovations " Programme of crediting and support to innovators and entrepreneurs (In co-operation with Zagrebacka banka)

Aims	start- up of SME projects based on innovations
Users	crafts, SMEs independent entrepreneurs starting business based on innovations
Purpose of credit	basic infrastructure and operating costs working capital
Credit conditions	8% annual interest rate, quarterly repayment 2 % of interests subsidized by the Ministry of Crafts and SMEs repayment period 5-10 years minimum amount 10 000 DM
Insurance instruments	guarantee from the Croatian Guarantee Agency
Application procedure	public tender, applications submitted to the Ministry of Crafts and SMEs loan application approved by the bank
Criteria	innovative character of the project commercial feasibility

Source: Croatian Ministry for Crafts and SME, 2000.

4) "Snow ball" - Programme for development of SME through credits to entrepreneurs (in co-operation with Counties and commercial banks)

Aims	facilitating SME access to finance
Users	crafts, SMEs co-operatives individuals
Purpose of credit	purchase of land construction , equipment purchase, expansion of business facilities purchase of transport vehicles
Credit conditions	up to 8 % annual interest rate (variable) repayment period up to 7 years grace period up to 24 months minimum amount 10 000 DM
Insurance instruments	real estate mortgage
Application procedure	public tender decisions are made within 15 days
Criteria	feasibility of business plan

Source: Croatian Ministry for Crafts and SME, 2000.

Local government SME finance support schemes

In addition to Central Government initiatives, a number of County governments have taken other initiatives based on their own regional budget funding. They invite selected commercial banks to sign with them special agreements for enhancing SME lending in the respective region on the basis of special incentives for the bank. The county governments make deposits in the bank as a kind of guarantee. The bank in turn agrees to provide five times the amount of the deposit from its own banking funds for lending to SMEs in the region. SME lending programs vary from county to county but conditions are similar. Interests rate is around 8% with maturity of maximum 9 years, with 2 years grace period. Programs are intended for both existing firms and start-ups. Commercial banks, on the basis of their contacts with the local authorities, committed credit lines out of their own funds amounting to HRK 18,6 million in 1997, HRK 215,7 million in 1998 and HRK 194,1 million in 1999 (the total was about HRK 428,3 million). Therefore, in the three years of that program, the total funding potential amounted to about HRK 750 million. To this further HRK 210 million for the other programs should be added: HRK 40 million for the commercialization of innovation, HRK 120 million for export support for SMEs, and HRK 50 million for restructuring existing SMEs with at least 25% state holdings.

Efficacy of credits

After the application process organized by local authorities, the program resulted in over ten thousand applications for the three-year period (1668 in 1997, 4804 in 1998 and 4119 in 1999). Altogether, 2413 loans with total value of HRK 384,9 million were approved. But there are rather dramatic differences in approval rates between counties. They can be explained by the very different capacities and commitments of local administrations, bureaucratic inertia and bottlenecks and excessive paperwork. The structure

of activity points to priorities: 314 loans were in agriculture and food production, 631 in manufacturing and 259 in business services.

Programs work better for the existing SMEs. There is much interest from start-ups too, but few are getting loans for lack of proper documentation or collateral. If all loans are repaid at the end of the period, then local government gets back its initial provision. One large bank has agreements in 12 counties, another large one - in 10. Smaller banks have fewer agreements usually. Both banking sector and SME associations have been rather critical to all these efforts. Several banks do participate, but not always in the same way for all initiatives. They view some of them as too risky or not well conceived maybe. Banks and SME associations often state that procedures are too slow and cumbersome for all parties involved.

5) Realization of SME loans program for the year 2000 of the Ministry of the Crafts and SMEs

PROGRAMME	No. OF APPLICATIONS	SUBMITTED		No. OF APPLICATIONS	APPROVED
	<i>Total submitted to Ministry</i>	<i>Forwarded to banks</i>	<i>Amount transferred to banks (in Croatian Kunas)</i>	Approved by banks	Total amount approved (in Croatian Kunas)
"Counties and towns"	2480	1031	454.783.517	107	53.181.757
"Commercialization of innovations"	76	35	30.341.000	1	
"Export"	81	42	59.397.000	17	

Source: Croatian Ministry for Crafts and SME, 2000.

Commercial banks SME-lending programs

Commercial banks take active part in the provision of loans for SMEs financed by various national and international organizations /agencies. The banks are offering to the enterprises commercial short-term loans (maximum 1 year repayment period), medium-term loans (2-3 years repayment period) and long-term loans (over 3 years). Loans are not so attractive to SMEs. Average interest rate is 8-9 % (annually) and repayment period hardly ever exceeds 3 years (only exceptionally 5 years). Mortgage on assets, amounting 100 to 200 % of the loan value is requested as a guarantee. Basically, the banks are not particularly interested in production oriented SMEs. Banks are facing risky decisions when giving loans to SMEs. The level of insolvency in Croatia is quite high and that means that SME loans applications need very good evaluation of the projects and for that banks mostly don't have the adequate resources, staff etc.

The Croatian Guarantee Agency (HGA) is a special financial institution established by the Republic of Croatia. The HGA's mission is to provide support in establishment and development of entrepreneurial activities in Croatia. Activities include: issuing guarantees for loans approved by banks,

saving institutions and other legal persons and provision of financial support for decreasing loans-related costs. Up to now 2300 loan guarantees for a total of DM 120 million have been issued, as well as 2400 loan-related-cost supports to entrepreneurs for a total of DM 3,5 million. HGA in addition to banks analyses loan requests, documentation, such as business plans, collaterals etc. Banks have stated that its procedure is cumbersome and long. SME representatives have stated that its capital is too limited. The added that HGA activities are too much tuned to larger enterprise units and that family businesses and small enterprises have no place there.

Croatian Bank for Reconstruction and Development (HBOR)

HBOR is fully state owned public institution with broad objective to stimulate economic development in the country on the behalf of the government. HBOR provides SME loans via commercial banks but only recently has started with direct lending.

HBOR credit lines to commercial banks for on-lending to SMEs:

- Loans to returnees: 159 loans for total DM 33,9 million
 - loans for domestic entrepreneurship development: 101 loans total DM 52 million
 - loans for existing SMEs: 571 loans for total DM 30 million
 - loans for start-ups and firms relocation to former war zones: 5815 loans for total dm 195,7 million
 - loans for start-ups in islands: 15 loans for total DM 1,9 million
 - loans to farmers in East Slavonia: 258 loans for total DM 7,4 million
 - loans to family businesses in tourism sector; 47 loans for total DM 1,68 million
- HBOR has provided loans to Joint- ventures for a total of DM 50 million.

HBOR efficacy

HBOR faces a serious problem regarding its high volume of under used funds with an estimated total of around DM 50 million - funds intended for SME on-lending but which have not been fully used for that purpose. The reason for that is that the commercial banks who a few years ago were short of equity and glad to use HBOR funds for on-lending to SME, now claim they have enough own funds for that purpose and that the spread of 2 % they get from HBOR is to low if they have to bear all the risk. Besides, many of them use these facilities to provide "cheap money" to some of their best and well-known SME clients estimated as low risk clients.

International on-lending providers

- European Bank for Reconstruction and Development (EBRD)
 - EBRD has been active in SME credit matters via commercial banks on lending. EBRD credit lines to commercial banks for on-lending to SME is estimated to total EURO 100 million. In the same time EBRD provides SME support via its participation in the "Business Advisory Services " (BAS) program in Croatia

- The World Bank Group (WB)

The World Bank has no specific SME related financial funds. On the other hand, IFC (International Finance Corporation) has been operating three SME credit lines via local commercial banks amounted in total to US\$ 23 million. Altogether IFC has approved eight projects for a total of US\$ 69,940 million.

- Norwegian Government - NORAD

Norway has allocated DM 25 million for Croatia. NORAD program finances long-term development co-operation and administers long-term government-to-government co-operation and co-ordinates co-operation with partners in civil society and local business and industry. For the purpose of upgrading Croatian SME financing system these resources can be used for providing support in the form of grants and loans for the establishment of enterprises and production units as well as for reforms in the public sector that will make it easier to attract private capital within the framework of national interests and international obligations

- UNDP and UNOPS started a 4-year program for “Local Economic Development Agencies” (LEDAs). In the first phase of LEDA activities have been concentrated on giving small credits (maximum US\$ 7000) via local banks to families. The loans were guaranteed for 50 % by UNDP.

Under phase 2 small credits will be provided to SMEs, with an initial ceiling of EURO 25000, to be increased to EURO 50 000 later on probably.

The UNDP-EU collaboration program is seen as very effective basically because it responds to urgent identified needs in special problem areas with high poverty.

Funds for technical assistance

- United States Government - USAID

USAID activities in financial sector are addressing mainly the banking reconstruction and supervision, thus the focus is on the micro-level. Regarding the SME supporting programs one can emphasize FLAG (Firm Level Assistance Group), ADF (America’s Development Foundation), NOA and SEAF (Small enterprise Fund).

- German Government - GTZ

The aim of the project between Croatian Ministry of Crafts and SME and the Deutsche Gesellschaft fur Technische Zusammenarbeit (GTZ) is efficiency improvement in the Ministry and the county offices for entrepreneurship promotion.

- Dutch Government

The Dutch Government has initiated a program of support to the Croatian Government on transfer of know-how and experiences in development of the SME sector.

MICROCREDITS

SMEs are recognized as an engine of economic growth and a source of sustainable development. Within this sector micro and small-enterprises are of special importance because they are considered as the cradle of entrepreneurship, particularly in environment facing high unemployment and poverty. SMEs could play a significant role in these underdeveloped regions because they produce and distribute local products and provide services and in doing this they could generate full and part-time jobs and create income for the population. Due to the collapse of the former centrally planned economies, increasing inflation and economic uncertainty personal savings have been eroded and people lack the financial reserves to start a business. However, in underdeveloped regions rural and industrial districts facing structural adjustment needs, micro-enterprises might provide the way out of stagnation. There is a dramatic need for micro and small enterprise finance institutions in Croatia. The financial sector in Croatia, as in most countries, focuses on lending to larger companies and on consumer credits, rather than lending to micro- and small enterprises. In rural areas, outside of wage earners, people have very limited contacts with and knowledge of banks. NGOs activities and funding have primarily focused on humanitarian assistance. This source of funds is currently drying up. There will be a lot of competition for the limited funds available for sustainable economic development. This will result in a large number of NGOs both local and international closing down operations in Croatia. Donors have focused primarily on humanitarian assistance. As UNHCR and other humanitarian organizations phase out operations there is a lack of new organizations providing funding for long-term economic development. Bilateral aid from donors such as USAID has focused on humanitarian aid. Due to its GDP Croatia is not normally entitled to receive development assistance from these organizations. The two most active NGOs are CARITAS/CRS with national coverage and the NOA/Opportunity INTL, operating in Osijek.

EBRD

The EBRD provides funds to ten programs for SMEs in agriculture, crafts, and industry. Loan amounts vary from \$ 250,000 to \$3.5 Million. These programs are generally done through the HBOR/Croatian Bank for Reconstruction and Development. Commercial banks are paid a 1 percent intermediation fee.

UNHCR

UNHCR is the premiere international organization involved in humanitarian aid in the war torn areas of Croatia. The organization prefers to work through NGOs, local organizations and municipal governments and avoid direct implementation. UNHCR main focus is on rural areas. Although UNHCR is interested in durable solutions, its time frame limits the impact that it can have on sustainable institutional and economic development. UNHCR is using Quick Impact Program methodology, which focuses on giving beneficiaries basic inputs such as an agricultural tool kit (ex. tools, seeds and a dozen chickens), which will allow them to be immediately functional. UNHCR has funded training of women's groups, basic book keeping, and small loan programs in which participants are provided with inputs or loans averaging about US \$ 1,000. Since there are also humanitarian concerns including reconciliation, UNHCR credit programs rarely require 100%

repayment or interest.

USAID

USAID'S assistance is focused primarily on humanitarian assistance in war torn areas. USAID has provided US \$ three million to Opportunity International to develop a credit union and micro/small enterprise lending program in Osijek, in Eastern Slavonia. As the war torn areas return to normal, USAID does not plan to fund economic development programs because Croatia's GDP is higher than their traditional cut off level for USAID assistance. Staff involved in the credit/economic development sector felt that US \$ 1,000 - US \$ 3,000 was an appropriate range for micro-finance loans in the Croatian context.

World Bank

Croatia joined the Bank and the International Development Agency (IDA) in February 1993. The World Bank program in Croatia focuses on three major themes in the government's reform program: 1). Reforming public finance, 2). Encouraging private sector growth and 3). Rebuilding and upgrading infrastructure. To date, the Bank has committed US\$279.5 million to Croatia for six operations. In March of 1996 the Bank approved a US\$17 million loan to finance the development of support services for individual farmers. At the present time, the Bank does not have any projects in the area of micro-finance although it is financing a micro-finance project in Bosnia.

NGOs In Micro & SME Finance

There are very few NGOs operating in the field of micro-finance. NGO activities tend to focus on the area of Eastern Slavonia and on humanitarian aid. This is understandable since this is also donor's main area of interest. The two key players in Micro/SME finance are CARITAS and NOA/ OPPORTUNITIES INTL. CARITAS provides credit throughout the country (Zagreb, Zadar, Šibenik, Split, Rijeka and Pakovo) and NOA, a local credit union, is operating in the area of Osijek. Both organizations apply commercial interest rates. In the case of NOA/Opportunities Intl., the objective is to create a financially sustainable credit union.

NOA & Opportunities International

NOA is a local credit union, which was founded in October 1996 in Osijek. Its registration, which was done under the 1989 Law on Savings and Loan Institutions, took five months and was done at the commercial court in Osijek. Informational discussions were also held with the Ministry of Finance and the National Bank. As a credit union it follows rules similar to those of a limited liability company and is subject to taxes. Opportunities Intl. is funded by a \$3 M grant from USAID/Croatia. Opportunities INTL. provides on-site technical assistance in the area of management and credit analysis/procedures. Opportunities INTL. also has a regional office in Vienna which provides technical backstopping to the project. Maximum credits are \$20,000 and there is no minimum. NOA provides assistance to clients in developing a cash flow for their business. NOA's board includes several professors and financial experts who provide assistance in this area. They find the cash flow exercise to be a very useful tool in getting clients to be realistic about their cash needs.

CARE Intl.

CARE Intl. has a regional office in Zagreb, which covers Croatia, Bosnia & Herzegovina. They have currently submitted a funding request to the World Bank in Sarajevo for funding of a micro-finance institution, which will be based upon the Grameen Bank model. This would provide loans from \$ 300 to \$ 3,000 to members of solidarity groups. CARE INTL. hopes that the World Bank will fund a similar micro- finance project in Croatia.

Caritas/Catholic Relief Services

CARITAS has created a loan guaranty fund operating through the Zagrebacka Banka. Funding for this program has been provided by CARITAS Germany. CARITAS/CRS has negotiated a multiplier of four times the amount of their guaranty. This translates into an amount of US \$ 2.059 million, by 1997 figures, available for loans. Till 1997, they have extended 201 loans, nationally. Under the program loans can be up to US \$ 11,765. Overall loans vary in size from US \$ 2,940 - US \$ 4,700. In their agreement with the bank, CARITAS is responsible for field visits (assessment of business activity/client character and loan follow-up). The bank is responsible for undertaking a credit check and signing the loan contract with the client. In each of the areas covered by the program, activities are coordinated and handled by a region credit manager, an employee of CARITAS .

2.2. SME- EQUITY PARTICIPATION SYSTEMS

There are two equity funds in Croatia - Adriatic Ltd and SEAF (Small Enterprise Assistance Fund). As the name indicates the latter is specialized for SME development. SEAF- Croatia is private, non-for-profit company, founded in Croatia. Its activities are supported by the USAID, which allocated a grant of US\$ 5 millions. Besides, SEAF is looking for the additional funding from international organizations such as IFC, EBRD as well as from local organizations and private companies. SEAF provides direct financing to privately owned SMEs, primarily in agribusiness, light industry and business services. SEAF pledges all of its profits to remain in the countries for further investment. It provides not only capital, but also financial support such as business planning assistance, technical consulting in the area of marketing, production, accounting and assistance in finding additional financial means. Terms for the equity participation by SEAF are:

a) enterprises that are important in the sense of creating opportunities to increase employment and economic development in the country and the region concerned;

b) SMEs with growth potential and good management.

Up to now 15 investments have been made. Average investment is US\$ 143 000. Main investing sectors are:

a) high tech (software mainly) 1/3;

b) agriculture (for example pig breeding) 1/3;

c) other sectors (such as food processing, business services - accounting firms) 1/3.

Their share taking is mostly between 25-49 % but the system is flexible.

2.3. LEASING IN CROATIA

Modern financial leasing is relatively new to Croatia. It was introduced in the early 1990's. Due to the non-existence of a leasing association there are no statistics with regard to the exact number of leasing companies and items such as annual volume or penetration. The industry comprises of many Austrian entities, one German/French joint venture, and a handful of domestic Croatian entities. The Austrian entities have approximately 80-90% of the market share. This is due to lack of adequate funding avenues for the domestic entities. Vehicles constitute approximately 70-80% of total annual volume.

Just as in other emerging lease economies, the typical Croatian lease is a finance lease; yet, based on a VAT nuance that discriminates against a finance lease, many lessors choose to do business under the label of operating leases. VAT aspects are substantially embellished in the appropriate section in this report.

Though the leasing industry in Croatia is not at their full potential one should take into account the fact that leasing has played an important role in increased investment and capital formation in other emerging economies

PROBLEMS:

1) There are various SME credit lines and guarantee systems, but entrepreneurs and support institutions find that present SME credit system is not very appropriate for the real needs of the whole SME sector.

1a) Entrepreneurs and support institutions claim that the banks are very reluctant for SME lending - especially for long-term investment credit and for start-ups.

1b) Banks state that lending to SMEs is connected with great risks and high overhead costs. Banks experience shows many examples of entrepreneurs submitting poor project proposals, insufficient documentation and weak business plans. As one of the major problems they emphasize weak Courts system and poor property registers concerning collateral.

3. RECOMMENDED FINANCIAL INSTRUMENTS FOR THE DEVELOPMENT OF SME SECTOR IN CROATIA AND THEIR FEASIBILITY

Legal Framework

The Ministry for Crafts and SMEs has made a draft proposal of a Law on stimulating small and medium entrepreneurship. The Law is expected to create legal grounds for proposing and undertaking economic policy measures aimed toward dynamic development of SMEs. The proposed draft is comparable with appropriate laws in EU countries. The Law would allow and enable regional reallocation and activation of local resources. The news is the proposed Law places special emphases on the SME Agency as an organizational headquarters for co-ordinated actions between government and entrepreneurs in the SME sector. Among other tasks the Agency would be in charge of providing loan guarantees for SMEs, co-financing of banking loan interests, monitoring of loan restrictions and implementation and monitoring, analysis and reporting on effects of the stimulating measures.

Change in Policy of Financial Institutions

1) *Croatian Bank for Reconstruction and Development is launching a program of direct lending,*

Due to mentioned problems with commercial banks and their disinterest in on-lending to SMEs HBOR is entering into direct lending activities to SME end users.

2) *HBOR should broaden the co-operation with IFIs*

HBOR should also consider broadening their co-operation with new institutions willing to provide funds for on lending to SMEs such as IFC.

In general, there is evident need for better co-ordination among SME funds providers, developing systems of targeted support to potential clients, simpler procedures and overall transparency.

3.1. POSSIBLE STEPS FOR IMPLEMENTING A MORE ADEQUATE SMES LENDING SYSTEM IN CROATIA

- Improving the legal framework and supporting institutions

Poorly formulated laws, inadequate or non-existent legal registries, and other impediments block the usage of movable goods as collateral to secure loans. These problems can also affect the use of real property as collateral (mortgage loans) and are likely to affect small-scale firms more than micro-enterprises since micro-enterprise loans are based more on character or group guarantees. Small firms may have collateral, but given the large fixed costs of registering that collateral (repeated trips to and

long waits at the registry office) and of executing it in case of problems (two years spent at court instead of a quick administrative hearing and repossession), they are not such appetizing clients for the banks. Reducing these fixed costs promotes efficiency and lending in general and may particularly benefit small firms, where these costs are especially large compared to the total size of the loan. Another institution with potential for improving the target group's access to credit is credit bureaus. These can facilitate the gathering of credit histories on individual borrowers. This information function has an obvious justification and should lower the transaction costs and uncertainty surrounding repeated lending. Since high costs and risks are two of the key impediments for lending to the target group, this public service may be of great benefit to them, at least if it tracks small enough loan sizes.

- Improving: SME related business-information-dissemination, business plan preparation and evaluation

Banks state that lending to SMEs is connected with great risks because of the general lack of information about entrepreneurs as well about the feasibility of their projects. Lacking business related information could be broadly divided into administrative information and market information. Entrepreneurs with a business idea wishing to start or to expand a business but the staff evaluating those ideas need to know as precisely as possible details on this type of production as well as about the market of these products or services. Availability of such information is proportional to minimizing the risks associated with lending transaction. Keeping track on credit applicants also minimizes risks. And finally, establishment of a unified register of information on SMEs containing credit register, a market information register etc. improves the business environment as a whole.

Upgrading of risk assessment policy is connected with upgrading market and production/technology research activities in SME support institution or making availability (extraction of them by specialists) of this information more effective.

Due to previously explained problems with the loans approvals, there is a strong need for standardization and unification of methodology in preparation and evaluation of business plans and investment feasibility studies for SMEs. For that purpose SME support institutions should use the existing support programs such as "Business Advisory Services" funded by EBRD, which are programmatically directed to improving success of SME loan requests, quality business plans and financial statements.

- Improving the loan approvals techniques - downscaling

Why don't banks of their own volition offer credit to the target group? This question is particularly vexing in countries that have eliminated interest rate ceilings so that lenders can charge a profit-making interest rate on their small loans. And it is even more vexing since the Grameen Bank, Indonesia's BRI, Accion International's more successful Latin American affiliates such as Banco Sol, IPC projects such as Banco de los Andes, and others have demonstrated that repayment rates can be

kept high and administrative loan costs can be kept within manageable bounds by using new group and individual lending technologies. These new technologies include frequent repayment intervals, loans that increase progressively in size and duration, rigorous repayment monitoring using sophisticated PC software with rapid follow-up of emerging problems, performance-based pay, and other important design elements. Certainly, it would seem, some bankers would be willing to overcome cultural barriers and offer financial services to the target group using these technologies if there were a good profit to be made from this activity.

Downscaling, or the deliberate attempt by donors and governments to get commercial banks to serve the target group, is aimed at speeding up this diffusion process. It does this by reducing the initial investment cost and effort for the bank to put an appropriate credit technology in place, providing software and training of loan officers and other bank personnel involved. Note that unlike continued government involvement in public guarantee schemes, the involvement here is one-shot.

- Upgrading instruments for SME finance

This has much the same rationale as downscaling, only in reverse. Here, we try to take very successful financial NGOs that are already lending to the target group and give them the banking skills and technology needed to compete as regulated financial institutions capable of taking deposits as well as making loans.

- Improving the banking regulations

Regulations were generally conceived with traditional large commercial bank loans in mind. Such a system can impose large fixed costs on small-size loans, reducing the demand and supply of these loans. Some countries have followed more enlightened practices. Banks in Uruguay are making small loans (under approximately US\$15,000) with a certain small share of their assets without much of the regulatory paperwork needed to establish loan quality. Rather, the currentness of the loan is used to rate each individual operation. This system reduces the costs of serving the target group, but does not expose the banks to really substantial risks.

- Introducing small cap banks

For those who are discouraged with how slow commercial banks are to pick up on available innovations and to serve the target group, and for those who are equally discouraged about how difficult it is to make socially oriented NGOs into hard-boiled financial institutions, small cap banks may be a good response to regulatory irrationality. For example, the idea is that in the countryside, local entrepreneurs know agriculture, many of the potential borrowers, and the local culture very well. Some of these entrepreneurs would make excellent bankers, but many don't have access to the several million dollars of capital normally required to start a bank. Rather than make excessively risky loans and be tempted by the lure of fraudulent schemes and loan kickbacks, etc., the owner will be motivated to pursue legitimate banking, not gambling and fraud. If several million dollars is the right amount in the relatively wealthy and high-cost urban

areas, a much lower amount will often be appropriate in the rural areas, where people frequently have much less wealth and where the costs of launching a simple bank to make small loans is far less. In closing, there are many ways beside credit guarantees for getting financial services to the target group. What I am suggesting here is that we should first try to figure out what's wrong or missing in the private market system.

- Crafting a new improved loan guarantee agency

Croatian authorities are willing to build a comprehensive loan support scheme including a variety of appropriate financial instruments aimed at loan and guarantee mechanisms. They are interested in the establishment of a new Loan guarantee fund system, not necessarily centralized as the existing one.

Guarantee organization has to be adequately staffed to process claims quickly— without repeating what the bank has already processed— and to handle claims without delay or dispute. An adequate guarantee fund should be a fund reaching a “leverage level of between 5 and 10 (i.e., guarantee volume of 5 to 10 times the fund amount) within 5 years of operation. A lower level would raise questions as to the anticipated default rate, would tend to enhance “moral hazard” dangers, and would undermine justification for the existence of the scheme. This guarantee scheme should obtain from borrowers whatever collateral they can offer, despite its inadequacy. Loan recovery should be pursued vigorously even after the guarantee is paid out, as in the East Asian schemes. The lender should assume some of the risk. The risk sharing proportion will depend on the track record of the financial institution's SME loan portfolio, the adequacy of the guarantee fund, and the general culture of debt repayments in Croatia. It is advisable that lenders should assume at least 30–40 percent of the risk and never less than 20 percent. Risk sharing at 50 percent may significantly decrease the banks' interest in participating in the scheme and may reduce the additionality² generated. This guarantee scheme should be regularly monitored and there should be immediate action in revising the scheme when problems begin to develop. There is possibility to include commercial banks, or banks guarantee requirements in these institutions design. That means that in order to be effective it had to respond to the needs of banking sector regarding SME loan security.

3.2. LAUNCHING ADDITIONAL MICRO-LENDING PROGRAMMES

Microcredit programs should serve as a policy alternative to unemployment benefits and job training programs, because they contribute to self-employment and economic self-reliance of poor and low-income families. These new unemployed or underemployed have become a new class of poor and economically marginalized people without previous experience or even knowledge of how to enter the market economy. Many unemployed individuals are forced to turn to self-employment as a means to create income for themselves and their families. However, there are difficulties and risks in entering the business world in a weak and hostile environment characterized

by economic instability, high and growing inflation, transition bureaucracy, lack of information and credit facilities, and the presence of the grey economy and Mafia. To facilitate the transition to a market economy in Croatia and help victims of the economic transformation process overcome poverty and start life afresh, there is a need to launch micro-credit programs.

UNDP intends to withdraw from this program by the end of 2002. The existing LEDAs should then become fully autonomous bodies and manage credit lines on their own. Other Micro finance pilot projects in Croatia should use their experience in projecting their own activities.

In order to launch new micro-lending programs one should start from the weaknesses of existing financial facilities: the volume of financial resources is very modest and limited, eligibility criteria for access to credit are not always clearly spelled out and rules and methods for accepting requests are not transparent, local program managers often have little control over centrally planned eligibility criteria and services especially if they are designed by foreign consultants, there are problems in transferring the experiences of OECD countries to Croatia, there appears to be little sharing of information among financial intermediaries/banks/institutions or between the transition economies in the region and finally micro-crediting in broad macroeconomic terms is not considered as an anti-poverty strategy in Croatia. It is surprising that the EBRD, whose primary aim consists of providing financial means to Croatia, operates basically with medium enterprises and has no program for small firms.

In order to develop micro-credit organizations in Croatia, one needs a combination of capacity-building, funding, policy development and performance-based objectives to develop into professionally managed, permanent and self-sustainable institutions. While establishing long-term capacity-building programs, experimentation should be encouraged to develop national models, taking into account thorough strategic and business programming. The amount of aid for foreign counseling and advice should be decreased and financial funds should be provided for credit guarantee schemes for start-up entrepreneurs.

While the Micro-credit Summit has stated that approximately USD 21.6 Bn will be required to reach 100 million of the poorest families in the world by the year 2005, Economic Commission for Europe estimates that at least 3 million households have to be reached in transition countries, a part of it being in Croatia.

Micro-credit schemes should provide loans for micro- entrepreneurs to become self-employed in the order of magnitude of between USD 1,500 and 2,500, which should consist of a real financial allocation plus a soft component oriented to training and counseling. More comprehensive micro-credit loan systems based on credit guarantee intermediaries, either LGS³ or MGS⁴, should make available loans of between USD 5,000 and USD 10,000. These loans should be primarily oriented towards the manufacturing and service sectors, creating higher employment and manufacturing value added.

3 LGS – Loan Guarantee System
4 MGS – Mutual Guarantee System

3.3. EXPANDING FINANCING THROUGH EQUITY FUNDS IN CROATIA

Venture backed companies stimulate economy in the following manner: they are fast growing (meaning that, as EU experience suggests⁵, sales revenues rise twice as fast as the top European companies); they create more jobs than average; they invest heavily spending above average on research and development activities. In majority of cases venture backed company benefits from more than one investment, especially in the start up and early stages of development. In general, venture capital investors provide more than just finance. The package of other contributions consists of: financial advises to SME venture capital backed, help in crafting and implementing a corporate strategy, producing additional ideas for entrepreneurs, serving as channels of contacts and market information. And finally, after couple of years being 100 % privately owned, they can turn to specialized stock markets. In future, parallel with the process of European integration those companies can choose to be listed in one of the European markets designed for young and growing SMEs: Nouveau March in France, The Alternative Investment Market in United Kingdom, European EASDAQ.

For that purpose potential entrepreneurs should have information about European Seed Capital Scheme. In 1989 the Commission launched this pilot scheme to “stimulate the creation of start-up capital funds” and it has subsequently supported the establishment of 23 Seed Capital Funds. The objective is to make capital available to new businesses, which would normally have extreme difficulty in raising funds from the market and to improve the quality of seed stage projects. Typical projects eligible for support might be those with a relatively long development phase, often involving new technology. The Funds would allow management and financial support to be obtained prior to embarking on the development and innovation phases. In addition to seed capital, the Funds should also be able to provide support services such as financial planning, advice on further sources of finance, market analysis and business strategy development. As of 1/2/96, the 23 Funds have raised EURO 52 million in capital, of which EURO 35.4 million has been invested in 285 new enterprises, generating 2,876 direct jobs. The criteria investments must meet are:

- the company’s total permitted external seed capital requirement must not exceed EURO 350,000;
- companies, which are already trading, must also meet the following criteria:
 - their existing risk capital investment must not exceed Euro 50,000;
 - their annual sales must not exceed Euro 100,000;
 - they must have fewer than 10 employees;
 - the total value of their share capital at the seed funding share price must not exceed Euro 1.5 million.

There is a need to better use already existing infrastructure and networking of existing equity participation funds as SEAF at the regional level. These funds can very effectively handle information on potential co-operation in different countries in the region. But there are also know how funds on

equity participation SME authorities could learn about SME equity participation from and collaborate with them in order to attract other venture funds, especially for financing high tech, innovative goods, SME start-ups.

3.4. EXPANDING THE ROLE OF LEASING IN SME FINANCING IN CROATIA

Leasing

Leasing can be a great way to get around the fact that target group borrowers don't have much collateral or that it may be difficult and costly to seize and sell any collateral that they do have. Leased equipment provides much or all of its own collateral and (depending on the country's legal system) can be easily repossessed since the lessee does not become the owner; the leasing company retains ownership. Financial leasing has been tremendously successful throughout the world since its introduction some 40-50 years ago because it meets a demand not met by traditional bank lending. There are a number of reasons businesses lease:

1. It allows for better cash management of working capital
2. It provides a hedge against technological obsolescence.
3. It can provide 100% financing, i.e., no down payment is required. It also requires payment for only the value of the property's use when the value of ownership is not needed.
4. It provides a fixed payment.
5. It is a flexible form of financing.
6. It provides a hedge against inflation.
7. It allows better utilization of tax benefits by both lessor and lessee.
8. It conserves credit lines.
9. It expands credit sources.
10. It diversifies credit sources.
11. It may provide off-balance sheet financing.
12. The lessor may provide non-financial services not readily available from other credit sources, such as equipment service and maintenance.
13. The lessee may be able to take advantage of the economies of scale of the lessor's purchasing power.

It may better accommodate capital budgets than alternative financing.

It has fewer restrictive covenants than traditional financing.

End of term options can be varied to suit lessee needs.

Leasing requests generally have a faster response time than bank loan requests.

It can be particularly attractive to small and medium-sized enterprises ("SMEs"), which may not otherwise be able to obtain financing—and SMEs

are usually the major engine of growth for an emerging market economy.

In an emerging market, banks are often the first to commence leasing activity in a country, usually through a leasing company wholly owned by the bank and licensed as a “non-bank financial institution,” because of the way the banking laws and regulations are written. In this situation, if the commercial banking sector is not particularly well developed or innovative, it may not be motivated, interested or capable of introducing leasing. Leasing in a developing economy is rarely initiated by the manufacturing sector or existing equipment dealers and almost never by traditional rental companies. If the structure of the banking regulations allow, leasing may be established as a separate stand-alone company not legally a part of a commercial bank or regulated non-bank financial institution, but the investors behind the leasing company will almost certainly come from the financial community.

Leasing can also be initiated by international financial institutions, such as those ones established by IFC. The IFC has been particularly active in promoting leasing in emerging markets, having invested in leasing companies in over 36 emerging markets and completed over 50 leasing-related technical assistance projects to governments.

Leasing Can Contribute to Economic Development in the Financial Sector and the General Economy in many ways.

Leasing provides a number of significant contributions to a country's economic development.

Allows more businesses, particularly SMEs access to financing. Lessors are often willing to do a lease transaction with parties who may not be able to qualify for traditional bank loans. In doing so, lessors are not necessarily taking greater risks than banks are. In fact, in many countries, defaults on lease contracts are often lower than those on loans. This may be due in part to the additional enforcement clout that a lessor has -it may be able to repossess the equipment more easily than a bank can foreclose on collateral. The quick and immediate loss of the equipment may be a strong incentive to make the lease payments in a timely manner. This higher level of security against credit risk, along with the more entrepreneurial focus of lease companies, tends to make them more aggressive than the traditional banking community. The result can be more businesses, expanded employment, more tax revenue and increased overall economic growth.

Increases the domestic capital base. As a financial product, leasing needs its own funding, which tends to further mobilize domestic capital. A significant portion of this funding comes from the lease companies' own bank lines. The increased borrowing requirements by their lease company customers necessitate an increase in the banks own borrowings, with the consequential increase in the domestic capital base.

Provides competition to traditional banks. Depending upon the language of a country's banking laws, leasing may first be introduced by a bank acting through a subsidiary established for the purpose, or, if regulations permit, by an independent lease company. Regardless, financial leasing ultimately provides an additional source of financing in the marketplace and a product in competition to traditional bank products. Such competition generally compels banks to become more efficient in their lending practices.

Encourages financial product innovation. Because leasing companies are very capital consumptive in their expanding purchases of more and more equipment for lease to their lessees, leasing companies also tend to be at forefront of new capital market financial product development to meet such capital needs. For example, leasing companies in addition to promoting issuance of commercial paper, bonds, stock offerings and similar capital product, can encourage the introduction of non-recourse lending, securitization, and other more sophisticated investment vehicles—all of which can help the country attract not only domestic capital but foreign capital as well.

Helps to develop secondary markets. Although the initial lease products offered in a country are almost always “full-payout” and the equipment is transferred to the lessee at the end of the lease term for a nominal or token amount, lessors will ultimately begin to take a true residual value position that will force them to dispose of the asset at a price near its fair market value. In a number of emerging economies, there are severely limited organized markets for used equipment. Leasing, because it generates a steady supply of used equipment, can help develop an organized secondary market for a variety of goods. Vehicles and other transportation equipment, because of its high residual values and ready saleability, is typically the type of asset that leads the way.

Recommendation for the leasing industry in Croatia

- a) The finance lease/operating lease distinction for VAT purposes should be abandoned and VAT on any transfer at the end of the lease would be upon the actual transfer price.
- b) The following measure would be abandonment the Finance/Operating Lease Determination by Customs Officials (that would mean abandoning the practice of analyzing lease transactions for determining their status as finance leases or operating leases).
- c) Monetary authorities should form a financial leasing study group for the purpose of familiarizing itself with the business of financial leasing for the purpose of creating an informed awareness of an important financial market product.
- d) Croatia should adopt the dual party vehicle registration system, with a recorded distinction between “legal owner” and “registered owner.” The registered owner should not be allowed to dispose of the vehicle without the consent of the legal owner, and the legal owner should not be responsible for traffic fines, accidents or other matters arising from the use of the vehicle.
- e) Banks should be required to engage in financial leasing activity only through a subsidiary and not directly as part of the bank’s other financial services. For reasons stated in the general section on licensing, banks engaging in leasing directly have an unfair and undesirable advantage over independent lease companies. The better approach is to require banks to engage in leasing through a subsidiary. Banking prudential norms currently established would remain applicable at the bank level but separate prudential norms for the subsidiary would be unnecessary and should not be established.

f) A registry of interests in collateral can be invaluable in providing creditors and potential creditors of a party applying for financial advance information about what assets of the applicant are currently unencumbered and remain available as security for the pending application. This is true whether the credit application be for a loan or a lease. A computerized, central registry, indexed off the name of the debtor, can quickly and efficiently provide this information. It can also help reduce fraudulent practices by lessees, such as obtaining multiple financing of the same item of equipment or transferring or selling the leased equipment.

OVERVIEW OF THE SME FINANCE ENVIRONMENT AND PRACTICES IN THE REPUBLIC OF MACEDONIA

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1. GENERAL OVERVIEW OF THE MACEDONIAN SME SECTOR

1.1. COUNTRY AND SECTOR BACKGROUND

Overall Environment for SME Development

Since its independence in 1991, parallel to the introduction of structural reforms and privatization, the Macedonian economy experienced a number of major external shocks resulting from the turbulent political developments in the Balkan Region: disintegration of the FRY; UN sanctions against FRY, blocking Macedonia's major access to Europe; an embargo imposed by the southern neighbor, Greece, the impact from the Kosovo Refugee Crisis (1999) and finally the Albanian insurgency from Kosovo at the outset of 2001.

As a consequence, traditional markets within the former division of labor in former Yugoslavia and with other countries in Central, East and Southeast Europe broke away. Conventional transport routes were disrupted. Orders of Western Europe and the USA for products and services were suspended. Hence, the combined effects of these developments severely affected the country's economy, hampered reforms and stalled the entire process of transition to market economy. It has been widely assumed however that the Macedonian economy will gain momentum as political tensions in the region subside.

Institutional framework for SME Development

When the present Macedonian Government (GoM) came to power at the end of 1998, it inherited a reform agenda formulated by the previous administration and supported by the IMF. The agenda involved some difficult structural reform measures, including the closure and liquidation of forty (of which twelve are leading industrial companies) loss making large socially owned enterprises. The Government consented to go ahead with the reform agenda as advised and is pressing on with structural reforms in the enterprise, banking and social sectors. In the context, GoM has already taken far-reaching measures to reform trade and agricultural pricing policies and extend privatization to previously socially owned enterprises in agriculture.

Despite the fact that the overall business environment in the country is not as yet favorable to private sector development, there is a growing concern and better understanding, on the part of the Macedonian administration

and the political establishment in general, for the need of a continuous improvement of the existing institutional infrastructure. Consequently, SME sector development support has been on the increase since 1998. Meanwhile, an array of foreign donor entities committed some DEM 200 million, over the past two years only, for SME development and promotion (first ever foreign financial support for the sector): from soft loans to various forms of technical assistance (TA).

Still, a number of limiting factors to SME development persist and will have to be addressed accordingly. The lack of *an efficient and durable network of information collection and distribution, relevant to SME sector*, is cited as one of the leading constraints to private entrepreneurship and SME development in general (see Annex I - Most Important constraints to SME Development).

National Policy

- 1) The overall legal, monetary, fiscal and administrative environment is not fully adjusted to the growing needs conducive to private sector development and particularly not with regard to enhanced SME promotion.
- 2) There are no decisive policies for SME promotion; consequently there are no incentives, exemptions, etc.
- 3) The only existing definition or classification of enterprises in the Republic of Macedonia is based on Article 4 of the Accounting Law. This classification refers to the number of employees, annual income and average value of assets. Handicraft activities are per definition specific trades and can have up to 10 employees, including family members. In addition there exists the status of self-employment.
- 4) The mandate and role of different government bodies (ministries, branch offices, agencies and municipalities) at various levels - national, regional, municipal - are not clear.
- 5) Procedures for registering an enterprise are still rather cumbersome and there is no bankruptcy and foreclosure legislation. The Government of Macedonia (GoM) is currently planning to introduce a one-stop-shop where all necessary documents can be obtained in order to facilitate registration.
- 6) Regulations concerning taxation and accounting are complicated and apply to all companies regardless of their size and/or turnover. However, the fiscal system reform drive is gaining momentum: (i) corporate income tax is introduced (ii) personal income tax has been reduced to 18% and 15% respectively and (iii) the retail sales tax was replaced by a uniform 19% VAT (effective April 1, 2000).
- 7) Basically, the same laws apply to both foreign investors and domestic enterprises.
- 8) The legislation concerning real estate (land property law) is still incomplete. A land reform and establishment of codification scheme are envisaged in addition to the Denationalization Act (already past in Parliament)
- 9) Inflation is low and the Macedonian *denar* (a local currency unit, pegged to the German mark) is rather stable as result of stringent monetary policy mechanisms.

10) Organizations of civil society are scarce and not sufficiently developed. As a result, there is very little entrepreneurial participation in policy dialogue or decision-making.

Financial Services

1) Lack of access to credits, banking and financial services are considered one of the major constraints of the SME and handicraft sectors. The existing banking and financial system does not really cater adequately (yet) for the needs of the SMEs. Therefore a profound reform of the banking and financial sector is strongly required.

2) Despite the existence of private banks, the banking sector is still state-governed. All local inter-bank payments, including payments within the National Bank, and all commercial financial transactions are settled through the Central Payments Operation Service.

3) Banks offer limited range of services, have rarely regional branches and do not offer specialized services to small enterprises.

4) There is an increase in foreign funding for SME development, but access to information is still difficult and procedures for obtaining credits are not always transparent.

The Institutional Setting for SME Development

1) The general institutional infrastructure for SME promotion is in its early stage of development. There are but a few independent organizations for business promotion such as economic chambers, industry associations and business clubs. An additional constraint is the lack of tradition in policy dialogue among major stakeholders.

2) The Macedonian Chamber of Economy is a reminiscence of the past era. It seems to represent the interest of the large companies only, although membership is compulsory for all registered companies.

3) With the exception of the City of Skopje Regional Chamber, the rest of the (most exist on paper only) regional chambers in the country are hardly operational.

4) The few existing Associations of Handicrafts are organized at either national or regional levels, but in practice have limited impact on promoting policy dialogue

5) The collapse of the former system and the restructuring or liquidation of the leading domestic international trading companies resulted in disruption of the traditional distribution channels. Hence, the performance of most import and export oriented SMEs was severely affected.

6) The system of vocational education and training is still inadequate. In addition to the lack of training in diverse technical skills, there is a growing demand for specialized training in marketing, management, IT, accounting and finance.

1.2. MACEDONIAN SMALL BUSINESS ENVIRONMENT HIGHLIGHTS

Political Environment	The current political environment in the region, despite the satisfactory political climate in Macedonia, is still a limiting factor to increased (direct) foreign participation in SME development.
Financial Services	Financial services are still undeveloped, while domestic banks fail to adequately respond to the increasing needs for financial assistance and advice of private entrepreneurs and the SME sector in general.
Credit Policy	There is little transparency and limited access yet to both domestic and foreign funding intended for SME development.
General Institutional Support	<p>Despite the establishment of a network of SME assistance facilities, a long-term strategy with a comprehensive and decisive support is needed to fostering the Sector's development.</p> <p>Access to business related information (particularly with regard to financial issues) is still limited while the existing legislature pertaining to SME sector will have to be upgraded.</p>
Special Institutions for the Promotion of SMEs	A number of specialized institutions for the promotion of SMEs have been established since 1998 with the assistance of foreign donors or are in the making. The ultimate objective is the setting up of a network of Regional Enterprise Support Centers (RESC), which will be placed under the auspices of the PHARE funded National Enterprise Promotion Agency (NEPA), perceived as the umbrella organization for SME Development Promotion.
Communication Instruments	Despite a universe of available printed and electronic media, the dissemination of SME related information is still very limited. The preferred communication of most SME promotion and development institutions and assistance facilities is by mail rather than by open communication. Printed or electronic media are used, to a certain extent, for communication with the general public. In contrast, contact with target audiences is predominantly maintained by mail, fax or phone. Although Macedonia has at least three major INTERNET providers, this communication instrument is still not in wide use by both SME assistance facilities and private entrepreneurs alike.
SMEs Forums	There is practically no tradition in private – public dialogue, networking or regular exchange of information among groups or individuals working within the SME sector. However, several informal groups of senior independent business consultants specializing in SME sector development meet on a regular basis and currently act as an interface between the client base and the relevant institutions involved in SME promotion, assistance and development.

2. CURRENT STATUS OF SME FINANCE

2.1. MACEDONIAN FINANCIAL SECTOR OVERVIEW

The country has a two-tier banking system with the National Bank of Macedonia (NBM) responsible for the design and implementation of monetary policy and supervising banks and savings houses. Monetary policy is determined jointly by the NBM and the Government. The Securities Commission monitors the stock exchange while the Ministry of Finance oversees the insurance sector. Parliament appoints the members of the NBM's Board. The President of the Republic of Macedonia proposes a candidate for governor of the NBM, but the Parliament issues the actual appointment. The governor of the NBM examines the suitability of the Chief Executive Officers of the commercial banks.

The Macedonian Currency is the *denar* (MKD). Monetary independence was proclaimed in April 1992 with the establishment of the national currency. Monetary reforms were oriented towards further growth of the monetary independence of the National Bank, as well as reform of the instruments for monetary regulation.

The foreign debt of Macedonia was inherited from the former Republic of Yugoslavia. The repayment follows a pattern of slowly decreasing the amount of debt. The amount of debt has been steadily reduced in the last decade. The principal as of December 1998 was USD 1.398 billion.

The hard currency reserves of the National Bank have reached around 700 million USD (by 2000), a substantial increase compared to the symbolic USD 20 million inherited at independence.

Taxation, Accounting and Audit

Taxation

With the move to a market-based economy well under way, the process of developing a tax system in Macedonia, which is compatible with an open economy, has increased in importance. The process of tax reform is still underway.

The current taxation regime in Macedonia is based mainly on the laws enacted in 1993 for profit tax, sales tax, property tax, personal income tax and excise tax.

The establishment of companies by foreign investors is regulated under the Law on Trade Companies. The Law on Trade Companies allows foreign companies or persons to establish a new company or to purchase shares in a domestic company. A company established by foreign investors has the same tax status as a domestic company. The Law's provisions are the same for domestic and foreign investors and the company with foreign investment enjoys the same rights and obligations as a domestic company.

At present, all enterprises are subject to payment of the following taxes: profit tax, property tax, excise tax, personal income tax, sales tax, social benefits, state and local fees, custom duties and certain less significant

taxes.

An important step toward rationalizing the tax system is the replacement of the sales taxes with VAT (Value Added Tax). The Law on VAT was enacted in 1999 and became effective on April 1, 2000.

Profit Tax Allowances for Foreign Investments

For joint ventures, the Profit Tax Law provides for a tax reduction at the proportionate level of profits, which belong to a foreign person for the first three years of operation. In order to receive this tax advantage, the foreign ownership in the company must be at least 20%. The law also provides for tax reductions for foreign persons performing registered activities that are non-residents of the Republic of Macedonia for the first three years of operation. Total tax reduction for the three years must not exceed the initially invested amount and the investor must continue to operate at least three additional years, otherwise, the investor is obligated to pay the tax liability.

Custom Duties

Custom rates are addressed in the Law on Custom Tariffs and have been in force since August 1996. Custom duties are levied on imported goods. The rates vary from 0 to 35% for a majority of goods and up to 60% for some agricultural goods. Imports of crude oil and essential items are subject to rates of less than 5%, around 5% on raw materials and equipment, 10% on oil derivatives and about 12% to 15% on other products. Rates on luxury goods are higher. The simple average tariff rate declined from 28% to 15.04% in 1997. The detailed schedule of custom rates can be found in the *Tariff Book*. Under certain conditions, the import of raw materials, reproduction materials, fuel and other auxiliary materials for production of goods for export is treated as a temporary import and are not subject to custom duties.

The temporary import and export of goods is a separate segment of the foreign trade operations and is regulated by the Law for Foreign Trade and Law on Custom Duties.

Accounting

All enterprises in Macedonia must keep financial records in accordance with the Accountancy Law and Financial Operations Law. Furthermore, the internal accounting standards of the company must also be included. Not all of these internal standards comply with international standards for accounting and auditing. International Accounting Standards (IAS) have been officially accepted in Macedonia since 1997, but the implementation is going very slowly. Most enterprises in Macedonia are making an effort to keep their books according to generally accepted accounting principles and procedures. Consequently, care should be taken in reviewing and comparing financial statements.

Auditing

The Audit Law was passed in December 1997. An audit may be performed by a domestic or foreign legal entity registered to provide such services in the Republic of Macedonia in accordance with the Audit Law and Law for

Trading Companies.

At the present time there are 11 registered auditing companies. Five large worldwide accounting companies have branch offices in Macedonia: Price Waterhouse-Coopers, Deloitte and Touche, Arthur Andersen, KPMG and Ernst & Young.

Joint stock companies, holding companies, stock market quoted companies, as well as, the limited liability companies (that are meeting the criteria) are required to audit their accounts.

Banking Sector

The entire financial sector has undergone considerable change since the country issued the first independent currency in April 1992. Incorporation into the Federal Republic of Yugoslavia left Macedonia with a highly unbalanced banking sector. One bank had a market share of almost 65 percent of bank assets and a disproportionate share of bank branches and key business.

The Banks and Savings Houses Act of May 1993 established new rules for establishing banks including base capital requirements of USD 1.5 million for setting up a domestic bank and USD 4.5 million for setting up a bank authorized for external transactions. These amounts were increased with the April 1996 amendment to the Act to USD 3.5 million and USD 11 million respectively. The amendment is to be implemented by the end of 2001.

In 1996, the Deposit Insurance Fund was established and all banks and savings houses were required to be shareholders.

Currently there are 22 commercial banks, suggesting the country has a surplus of banks. Some consolidation has already begun, with Kreditna Banka-Bitola merging with Export-Import Banka. A Greek Credit Bank has purchased Kreditna Banka. However, these five banks: Komercijalna Banka-Skopje, Stopanska Banka-Skopje, Makedonska Banka-Skopje, Stopanska Banka-Bitola, Tutunska Banka, and Stopanska Banka in particular, continue to dominate the sector.

The largest commercial bank, with about 30 percent of total business and 38 percent of total assets is Stopanska Banka. Komercijalna Banka, Makedonska Banka (formerly Ljubljanska Banka), Stopanska Banka-Bitola and Tutunska Banka are the other four large banks. All have branches in some of the regional cities and towns. Komercijalna Banka was a part of Stopanska Banka until 1990, when it was privatized.

Following years of restructuring, the government recently privatized the remaining shares in Stopanska Banka (some 85%). The Hellenic Bank from Greece purchased 65%, 10% was purchased by EBRD and 10% by IFC for a total of 87 million USD. The National Bank expects the deal to bring new stability to the banking system, as well as Western expertise and business practices. A money market began operations in November 1997 and trades primarily in treasury bills.

**Non-bank
Financial
Institutions**

The Macedonian Stock Exchange (MSE) was founded in late 1995 as the first organized bourse in the history of the Republic, which trades stocks and bonds. The trade volume continues to be low, but several large transactions such as the acquisition of Balkan Steel for 20 million USD, were made on the Stock Exchange. The MSE has 17 members, of which 13 are banks, two are savings houses and two are insurance companies.

There are three markets on the MSE: the first lists blue-chip companies with a market capitalization of at least USD 8 million, the second lists companies that have at least a USD 550,000 market capitalization, while the third operates, in effect, as an OTC (over-the-counter) market.

There are five insurance companies with total assets, which amount up to 3 percent of GDP. The largest of the lot holds 80% of the total assets of the insurance sector.

Multilateral and Other Sources of Financing

Macedonia has received multilateral funding from several sources, most notably the International Monetary Fund (IMF), the World Bank and the European Bank for Reconstruction and Development (EBRD). The financial arrangements with these institutions are designed for stabilization of the economy and building the basis for attracting foreign direct investments. The first equity investment fund has begun to operate in Macedonia.

International Monetary Fund (IMF)

The country has enjoyed excellent relations with the IMF since paying its arrears with the IMF in 1994. Early in 2000, the Government opted for an Enhanced Financial Facility (EEF) Loan for 80 million USD to support the economic program from 2000-2002. This is a continuation of the previously implemented Enhanced Adjustment Facility (ESAF).

With IMF support, the Government is planning to introduce a private pension system and to eventually increase the retirement age.

The World Bank

The country joined the World Bank and the International Development Association (IDA) in February 1993. The World Bank has been working with the Macedonian Government to assist the production sector development, support stabilization and structural reform with analytical input and adjustment lending with the aim to strengthen the social safety net through investment lending and technical assistance.

Since Macedonia joined the World Bank and IDA, commitments total approximately USD 500 million for 17 projects.

The International Finance Corporation (IFC), a member of the World Bank Group, has been very supportive in the transitional process of the economy in Macedonia and in building a quality business climate for foreign investments. The IFC launched an extensive program (IFC's Reach) to foster private investments and promote private sector development in a total of 16 countries. In early 2001 IFC established a regional SME promotion program (SEED) worth ca. USD 32 million of which Macedonia is one of the beneficiary states.

European Union - PHARE

In March 1996, the country became a full member of the PHARE program. The Cooperation Agreement with the EU was signed in July 1997, while implementation started in January 1998. Funds are allocated to support the enterprise and financial sectors, public investment and infrastructure, agriculture and natural resources, social sectors and human resources, and reform sustainability.

European Bank for Reconstruction and Development - EBRD

As of November 1999, the European Bank for Reconstruction and Development has approved 11 projects totaling 200 million USD. Of these, six are in the public sector and five are in the private sector. Among the private sector projects, a total of 65 million USD has been loaned to the private banking sector.

The EBRD strategy focuses on new projects, which will have a high impact on private sector development. The Bank is also making loans and direct investments in private projects in the industrial and agribusiness sectors and will actively support foreign direct investments.

The EBRD is proceeding with specific infrastructure projects, mostly those that have a direct impact on the facilitation of private sector development and on the regional integration of the country.

Investment Funds

Financial intermediaries like investment funds and private pension funds previously did not exist in the country. There was a state pension fund and several insurance companies.

An investment fund called Small Enterprise Assistance Fund (SEAF) has begun to operate and already 5 equity investments have been concluded. SEAF provides financial support using equity funding from the United States Agency for International Development (USAID), European Bank for Reconstruction and Development (EBRD), IFC and the German Investment Fund (DEG).

Bilateral Funding

There is a large network of countries assisting Macedonia in attracting foreign investments. A program of loans, equity investments and direct financial aid is in place. Among the most active supporters are the USA, the Netherlands, Canada, Denmark, Italy, Japan, Norway, Germany, United Kingdom, Austria and Switzerland. Several of these countries, most notably the USA, have provided technical support for the transformation of the enterprises in order to achieve economic restructuring and sustainable growth.

2.2. INVESTMENT CLIMATE AND OPPORTUNITIES

The Macedonian economy has begun a long awaited recovery. The short-term outlook is cautiously positive, with estimated real growth rates rising on a sustainable basis, from approximately 1% per annum in 1996-97 to

approximately 3.5% in 1998 and to approximately 4.5% to 5% projected for 2001/2002. This growth will depend upon continued strong growth in agriculture and trade, coupled with accelerated growth in the industrial, mining and service sectors. Exports are expected to continue with an average growth rate of 5-6% per annum (projection for 2000-2002). This growth is expected to come from agriculture, agro-processing, labor-intensive light industry and metalworking. Exports will be promoted through the maintenance of competitive exchange rates, structural reforms, which facilitate resource relocation, and promotion of private sector development and strengthening of corporate governance.

Most of the larger industries in Macedonia have the capacity to satisfy the former Yugoslavian market, for example, the tobacco, chemical, food processing and pharmaceutical industries. Therefore, the trading relations between the former republics of Yugoslavia could still be very strong, especially in agricultural products, processed food, wine, tobacco, and the chemical industry. These capacities should lead to further regional trade and investment cooperation with not only Greece and the former Yugoslav Republics, but also, Albania, Bulgaria, Romania, Turkey, the Czech Republic, Hungary and Poland.

According to a study commissioned by EU - PHARE Program on the Improvement of Export Capabilities, a number of sub-sectors were identified as having particular export potential:

- Processed foodstuffs and wines
- Fruits and vegetables
- Furniture
- Construction
- Automotive accessories
- Tobacco and cigarettes
- Metal fabrication and steel pipe
- Lamb meat
- Electric motors
- Software development
- Packaging
- Telecommunication equipment
- Shoes
- Electronic equipment
- Finished textile goods
- Vehicle and bus assembly
- Finished leather goods

Foreign Direct Investment (FDI)

With an estimated USD 160 million invested by October 1999 (exclusive of the proceeds from the sale of the Macedonian Telecommunications in 2000 amounting to DEM 700 million) was a strong year for foreign investment in Macedonia as compared to a mere USD 30 million invested in 1997 and USD 12 million in 1996 respectively. Greece is so far the largest (single) foreign investor in the country, with a total investment in excess of USD 300 million, the better part being invested in small businesses and retail outlets.

Investment Opportunities

The Government has outlined a number of sectors with strong investment potential including textiles, finished leather goods, telecommunication equipment, wine, furniture and food processing.

It has also indicated its intention to accelerate the privatization process. The latest government information shows that privatization has not been completed in 10% of the companies in Macedonia. This should open opportunities for Western companies, especially, those active in telecommunications, light industry and banking and finance.

Investment Incentives

Since attracting foreign investment is a priority, the Government seeks ways to make the investment environment more attractive. As of early 1999, incentives available to foreign investors included tax breaks and non-payment of customs tariffs for inputs to be used in production. If the foreign company's participation is greater than 20% of the total equity then it is entitled to a credit on profit tax for the first three years commencing from the date of investment. The tax payable is reduced in proportion to the percentage of the foreign equity. The Profit Tax Law also provides for tax exemption on reinvested assets.

2.3. EXISTING FINANCIAL INSTRUMENTS

Micro Credit Lines for M/SME Development

A series of micro credit lines (MCL) are currently at disposal for the financing of micro to small and medium-sized enterprises (M/SMEs). Resulting from a detailed survey of the Macedonian financial system, these financial instruments are specifically designed to meet the current needs of Macedonian small business. They were also aimed at assisting Macedonia to set up its first and only National Enterprise Promotion Agency (NEPA), as well as help establish one (i) Micro Credit Fund (MCF) in addition to a (ii) Micro Credit Line (MCL) for SME support and development.

The latter two institutions (MCF and MCL) were assigned to the following tasks:

- 1) Promote and develop new small businesses in order to increase employment.
- 2) Provide easier access of SMEs to financial funds in order to foster SMEs development.
- 3) Support export activities of SMEs.

MCF (Micro Credit Fund) has adopted the following credit policy:

- MCF represents a *revolving fund*, which is jointly financed by: EU-PHARE, Government of Macedonia and the commercial banks operating in the territory. The revolving principle means that funds transferred to the banks for SME funding through loans/credits, are deposited with each one of the authorized commercial banks. The banks are appointed as fund managers and can re-use the funds at will for the same purposes.
- MCF works through the Commercial Banks (they contribute with 1/3 of each credit/ loan).
- All granted credits/loans are expressed in Macedonian *denars* (MKD) and the repayment- servicing of the debt is also in local currency. The banks charge a customary (local) interest rate, which is still rather high (18% on the average).
- A split-off of the risk principle. The guarantee scheme (security) provides for the sharing of risk between NEPA and the bank-creditor in a 47% to 53% ratio on the borrowed amount.

Other Micro-lending Institutions

- Opportunity International - A non-governmental and non-profit organization, registered according the Law for Association of Citizens. Infact, it is a project funded by USAID and Opportunity International from Chicago. The source of capital is raised through private donations managed by USAID. The target groups are individuals like: sole proprietors, entrepreneurs, start-up SMEs, individual farmers, retailers, groups of citizens. Total funds amount to ca. USD 10 million. 1810 applicants have been granted approval by the year of 2000, with an average loan of USD 3000 and an interest rate ranging from 16-22%.
- MEDF (Macedonian Enterprise Development Foundation) – Another non-governmental, non-profit organization, established by the Government of Netherlands with the objective to: stimulate self-employment, development of SMEs, support of farmers, poverty reduction, investment in equipment, for fixed assets or working capital in SMEs. Total funds are USD 4 million, averaging to USD 10.000 per beneficiary and an interest rate as low as 7 to 12% per year.
- CRS (Catholic Relief Services) - Non-governmental humanitarian organization that grants small loans (from USD 3000 to 5000 on the average) for disabled persons, female entrepreneurs, minorities groups and alike.

Banking Sector (also see Appendix 1)

- Balkanska Banka Skopje - Short-term loans with collateral such as bill of exchange and personal checks of the borrower.
- Export-Import Banka - NEPA / PHARE - Credits for SMEs with business plan and collateral.
- Investbanka Skopje - Credits for agribusiness in rural areas. Collateral in transferable assets.

- Komercijalna Banka - Start-up credits only with mortgage on real estate.
- Macedonian Bank for Development Promotion - SMEs long-term loans with mortgage as collateral.
- Makedonska Banka - Long-term credits from WB with 2:1 ratio of collateral.
- Ohridska Banka - IBRD, PHARE/NEPA, and ICDF-Taiwan credit lines.
- Radobank - PHARE/NEPA credits for SMEs as above.
- Stopanska Banka - ICDF credits for SMEs.
- Tutunska Banka - SMEs credit lines from the Netherlands, Taiwan and PHARE/ NEPA.

Small Savings & Loan Institutions

There are several domestic Small Savings and Loan Institutions operating in the territory, of which most significant are: Diduko, Feršped, Inter - Falko, Mladinec and Poshtenska providing short-term loans to individual entrepreneurs and /or SMEs by means of mandatory collaterals.

Multilateral Institutions

- DEG: Start-up support for SMEs with collateral.
- EBRD: Long-term loan for private sector development.
- WB: Private sector credit line.
- IFC-SEF: Small enterprise fund.

Investment Funds

The establishment of *venture capital investment funds* is another suitable means of SME finance.

The catch is that this instrument bridges the gap between the needs of the borrower for fresh capital on the one side and the factor of risk on the other (to which creditors, investors, suppliers and vendors alike are exposed).

The basic assessment criteria applied is the achieving of a high *internal rate of return* (IRR), as a basic decision-making parameter in the process of evaluation of a prospective investment.

The origins of venture capital are in the early 1950s when many rich, daring businesspersons initiated the establishment of investment funds to cover the risk in funding of small business operations.

Several *venture capital funds* currently operate in this country as well:

- SEAF (Small Enterprise Assistance Fund) provides venture capital to (emerging) SMEs.
- ICDF - Taiwanese investment fund for SME Development.

Guarantee Agencies

Two international *guarantee agencies* offer Political Risk Insurance:

1) MIGA (Multi-lateral Investment Guarantee Agency) a WB Group member organization. It focuses on *political risk insurance* with a portfolio covering several economic sectors: agribusiness, energy, construction, telecom, banking, services, etc.

2) OPIC (Overseas Private Investment Corporation), an independent US governmental agency that provides political risk insurance and loan insurance.

The above agencies do not cater for the SME sector and therefore they will not be addressed to in this elaboration.

Development Agencies & Technical Assistance Programs

Several leading development agencies and programs provide various forms of assistance to the Macedonian economy and society in general:

- USTDA (US Trade and Development Agency) - Technical assistance, studies, briefings for all sectors.
- ARD (Agency for Reconstruction & Development) – Loan managers of Taiwanese fund for SME sector development and support, also managers of a soft credit line from the Government of Netherlands (ICDF) for SME development promotion.
- Ecolinks (Eurasian Partnership for Environmentally Sustainable Economies) – An USAID grant aid program for solving environmental problems (global climatic changes, local environment, cleaner production, water quality management, etc.)
- Macedonian Privatization Agency (Labor Re-deployment Program) - Small business assistance, small business incubators, loan guarantee programs, also managing IDA-WB loans.
- OSI (Open Society Institute) - Agribusiness short-term and long-term loans.
- REC (Regional Environmental Center) for CEE - Technical assistance to NGOs working on environmental issues.
- WOCCU (World Council of Credit Unions)- It operates as a local (in rural areas) savings facility and provides credits to the local communities. Credit unions are facilities of self-finance by the local communities.
- PRISMA (Partners for Economic Development in the RM) – An USAID-supported program for job creation and economic development.

Business Advisory Services (BAS) in Support of SME Finance

The management consulting structure in the RM comprises of four categories of BAS services: (i) domestic consulting firms, (ii) sole practitioners, (iii) representative offices of the of the Big Five international consulting companies and (iv) academic and research institutions. They all cater to a mixed clientele of domestic and foreign companies, including a universe of multilateral organizations and institutions represented in the country, reputable international cooperation agencies and NGOs.

Key players in the domestic management consulting industry are as follows:

- Subsidiaries of the Big Five auditing and consulting firms: PWH-Coopers, Arthur Andersen, Ernst & Young, KPMG and Deloitte & Touche provide a wide range of BAS from auditing to management consulting.
- MCA-2000 (Management Consulting Association) – The first industry association in its respective field of activity pools a distinctive group of some 40-50 consulting firms (with several hundred specialists and staff), covering the following sectors: management consulting, IT, SME promotion and development, marketing, human resource management, technical consulting etc.
- Individual experts specializing in academic work and scientific research recruited from among leading academics with prestigious academic degrees and professional reputation.
- Macedonian Business Resource Center (MBRC). A business advisory entity established in 1995 by Crimson Capital Corp., as a provider of consulting services in CEE and sponsored by USAID.
- Other foreign advisory entities for SME development and promotion include:

(i) Southeast Europe Enterprise Development initiative (SEED), established by the WB Group; (ii) A network of business support centers (ESA) funded by the British Know-How Fund); as well as (iii) the country offices of several international cooperation agencies (USAID, GTZ, DEG, SDC.) representing major donor countries.

2.4. GENERAL ACCESS TO FINANCING

Micro-Lending Practices and Performance

NEPA - A typical access to sources of finance for an average M/SME sector beneficiary and private entrepreneur is evident from the following example. Typically, the Applicant approaches a credit institution either directly or, as of recently, a prevailing current practice, through an intermediary - the National Enterprise Promotion Agency (NEPA) network. Initial briefing and guidance are provided to the prospective client by NEPA's professional staff. The Applicant or would-be Client drafts a Business Plan (BP) with the assistance of NEPA experts or external advisors. Should NEPA positively assess the submitted BP, the Client will be recommended to the relevant commercial bank as a viable borrower. However, the final approval remains the bank's sole privilege. In theory, a good BP is a major (formal) prerequisite for a credit approval. In practice additional lobbying with *incentives* is not uncommon in securing the deal.

By end-2000, over 800 credit applications were filed to the commercial banks. Over a half of the applications (55%) were granted approval amounting to some USD 8 million, with an average of 18.000 per beneficiary.

The rejected applications however are subject to additional analysis and evaluation, while the applicants (private entrepreneurs) are offered additional training by NEPA. Currently a total of seven commercial banks are assigned to micro-lending operations (MCL).

Opportunity International – Originally a US-sponsored non-governmental and non-profit organization headquartered in Chicago, USA catering to a target group comprising: entrepreneurs, sole proprietors, start-up SMEs, individual farmers, shopkeepers, groups of citizens. This institution manages a fund of some USD 10 million and has a track record of 1810 applicants (data for 2000), with an average borrowing of USD 3000, at an interest rate ranging from 16-22% and a very high rate of return (exceeding 85%).

Macedonian Enterprise Development Foundation (MEDF) – Another non-governmental and non-profit organization, established by the Government of the Netherlands with the goals: promote self-employment, foster SME development and start-ups, provide support to farmers, engage in alleviation of poverty, as well as provide fixed assets or working capital for SMEs. The available capital is in excess of USD 4 million. The average loans amount to USD 10.000, while the interest rates range from 7 – 12% annually.

Catholic Relief Services (CRS) – Non-governmental, humanitarian organization grants small loans (averaging from USD 3000-5000) to handicapped /disabled persons, female entrepreneurs, minority groups...

The Effectiveness of the Existing Financial Instruments is in a strong correlation with the common business practices and the overall SME Enabling Environment.

2.5. EFFECTIVENESS OF THE EXISTING FINANCIAL INSTRUMENTS

In practice, the majority of financial institutions in the country (especially the banking sector) are still reluctant to disclose information and data with regard to their credit portfolios and performance. This is partly arising from the lack of obligation for a public disclosure of ill performance and in particular for the management of delinquent loans.

As presented above, the most efficient instruments of SME finance in Macedonia are by no means the existing micro-landing schemes and funds, which compared to the other financial services, are quite popular, achieving rather high rates of return in comparison to the performance (sale) of standard banking products.

The ongoing reform of the banking sector, endorsed and supported by the IMF and the World Bank, is expected to yield results in due course, thus adding momentum to an already commenced process of SME promotion and development.

2.6. ENABLING ENVIRONMENT FOR SME FINANCE

The Macedonian SME Enabling Environment is still in the making. Institutional support for the sector in general marks a considerable improvements over the last few years compared to the preceding period and prospects will be improving as the economy picks –up, following the numerous upheavals experienced over the ten years of independence. However, the lack of national strategy for sector promotion and development is envisaged as

one of the major constraints, in addition to the still weak financial industry and lack of transparency in SME funding. In principle, the ideal Environment should be simple, supportive, predictable and above all transparent.

2.7. CONSTRAINTS (CURRENT) IN SME FINANCE (SEE APPENDIX III)

Some of the major Constraints to SME Finance will probably lag for sometime for a number of both subjective, as well as objective reasons. Constraints which need to be addressed promptly may be listed in the following order:

- Pending legislative and tax reforms include upgrading of property rights, registration, collateral and mortgages, business law and labor law.
- State bureaucracy and local self-government are still inefficient and burdened with complex regulations and procedures.
- Lack of relevant business information and practical instruments for dissemination of business related information and data.
- Lack of private-public dialogue, industry associations and advocates of SME Development and Promotion.
- Lack of opportunities for business promotion (participation in trade fairs, analysis of sector performance, economic and marketing research, regular monitoring of offer and demand).
- Corrupt business practices.
- Economic growth is hampered by a volatile political environment (in the region).
- Poor regulations for public procurement persist.
- Business opportunities are limited due to poor tradition in clustering and outsourcing, in addition to the customary impartiality and strong influence of the political parties and senior government officials in economic life.
- Some state monopolies remain untouched.

3. RECOMMENDED FINANCIAL INSTRUMENTS FOR THE SME SECTOR DEVELOPMENT

3.1. TYPES OF FINANCIAL INSTRUMENTS

Venture Capital (Local & International)

Venture capital is in principle directed towards projects (clients), which have been assessed to having the capacity of achieving fast growth, high profit and a rather high IRR (Internal Rate of Return). The investment strategy, though flexible, depends on a number of criteria such as: type of industry, age of the company, size of the loan, geographic region...

An access to *venture capital* is usually achieved in the following ways:

1. By recommendation (from a portfolio company).
2. By direct access or via.
3. By public presentation.

The process of project and/or applicant/client evaluation consists of:

1. Initial screening of applicant;
2. Due diligence: interviews, consulting analysis, recommendations, references;
3. Evaluation of applicant: IRR, age, financial history, liquidity, future development, perspectives;
4. Establishment of a frame work/structure for the deal, defining exit strategy, signing Conditional Term Sheet;
5. Signing of a JV (Joint Venture) contract and Contract of Mutual Agreement.

The brief presentation of venture capital managers currently operating in the territory is as follows:

IFC- SEF (International Finance Corporation - Small Enterprise Fund)

Type of investment: Debt (long-term or medium term), Equity and Quasi-equity.

With reference to the track record projects financed up-to-date, the activity of IFC - SEF has obviously been aimed at funding large companies. The average investment size is USD 2.5 million or a maximum 40% of the project cost. The repayment period is usually 5-8 years and depends on the Fund's exit strategy (buy back, public offering or third-party sale).

SEAF-Macedonia

SEAF-Macedonia is a venture capital fund promoting SME development in RM.

Basically, it is a commercial company affiliated with SEAF Washington D.C. in addition to other contributing entities: USAID, EBRD, IFC and DEG (German Investment Fund). The Fund is an investing rather than lending institution. It acts as an active partner during the (agreed) period of ownership although it holds minority shares (25 - 49%). After 3 - 7 years SEAF seeks opportunities to sell its shares back to the partner or (with the partners consent) to a third party. SEAF Macedonia has been, so far, targeting medium sized companies,

with average investment ranging from USD 200.000 to 800.000. In some cases (not a practice though), SEAF invests in start-up companies as well. However, such clients are selected from among reputable entrepreneurs, with good financial status and business performance in addition to their commitment to a venture.

Therefore, in practice, it is quite unlikely that micro and small firms would be given access to venture capital funds.

East European Food Fund (Jupiter Asset Management Ltd.)

The source of capital is EBRD and UK institutions. The type of investment is equity, with a variable period of return. The Fund invests in large food and beverages sector operations with investment size ranging from USD 2-7 million.

An average client from the SME sector will not be obviously in the target group of Jupiter Asset Management Ltd.

Micro-financing / Micro-lending (Micro - loan Programs)

Micro-lending schemes are usually managed through financial mediators who then offer loans to individual farmers, micro or small to medium-sized enterprises. These are aimed, in principle, for creation of new jobs. The terms and conditions for a credit approval are relative to the 4C criteria (Capital, Character, Capacity and Collateral).

In the case of Macedonia such schemes could be very useful in tourism sector as this industry is labor intensive and has rather ample opportunities for development (family businesses in particular), as well as for the employment of young professionals and women entrepreneurs.

Other (Prospective) Assistance Mechanisms to SME Development

- Leasing (Lease - A legal contract for occupancy or use of equipment, in return for money). Leasing is a common way to start and maintain a small business in a market economy, the key players are: lesser, lessee and the lending bank. Macedonia, due to lack of regulatory instruments and tradition, is still at the outset of this practice, but opportunities certainly lie ahead.
- Guarantees (The basic instrument that secures a creditors interest are: mortgages, pledges and other instruments imposed by the lending bank). Two investment guarantee agencies are currently operating in the RM: (i) MIGA, member of the WB Group - political risk insurance in all sectors and (ii). OPIC – dealing with political risk insurance, direct loans, loan guaranties and project finance.
- Investment Angels (An unconventional investment vehicle). In theory a potential investor may be approached in different ways: via the Internet, public announcements in media, courtesy of industry associations / chambers of commerce or via the so-called *Angel Networks* catering to specific industries. In real life “Angels” may just appear, but that is unlikely. In the USA, for example, specific industries or specific communities (like Silicon Valley) offer ACE Network (Angel Capital Electronic Network) sponsored by the Small Business Association (SBA). It helps both entrepreneurs and small investors to find each other, and eventually

discuss business. It is original, informal way how to promote ideas and present them to the public and potential investors (*angels*). The most interesting fields are: IT, electronics, entertainment, show business etc.

- Chamber of Commerce. A good way of participating in the business community. In RM, however, both the Republican Chamber of Economy and Regional Chamber of Commerce are still reminiscent of the old socialist era. Although membership is compulsory for all duly registered companies (enforced by law) the Republican Chamber serves, traditionally, only large-size companies and mostly the ones that are still partly or fully owned by the state.

Therefore there is a grave need for the establishment of industry associations and perhaps a Chamber of Commerce catering to the SME sector in particular in order to address at least but not as last the following issues: legal advice, mentor system for start-up entrepreneurs, alternative dispute-resolution, ethical behavior / good business practice, development of the angel-networks, small business information system etc. These activities should by all means be coordinated with the present mandate of the National Enterprise Promotion Agency, which is focused on assisting new entrepreneurs and start-up businesses.

SME Assistance Programs

A proposed inventory of other useful tools of SME finance promotion envisaged by the authors of this study is as follows:

- Training Programs.
- Regional SME Service Centers.
- Encouragement programs: national awards for successful SMEs, e.g. *Little Giant* award.
- Financial Programs for SMEs: development fund, credit guarantee fund, venture capital and mutual guarantee funds.
- SME Consulting Programs: voluntary consultants program, professional advisory group, one-stop shop (SME problem solving center), *task force* for SMEs.

Author's Remark:

It should be noted in the context that WB Group set up in March 2000 a global SME department with IFC, MIGA in cooperation with representatives of the small business communities worldwide, all in order to promote a comprehensive and more efficient SME support program. The Program was initiated by the drafting of *country maps*, identification of priority needs and analysis of key development factors and constraints.

3.2. FEASIBILITY OF IMPLEMENTING NEW FINANCIAL INSTRUMENTS

Bearing in mind the constantly improving enabling environment and the gradual picking-up of the Macedonian economy the feasibility of

implementing new financial instruments becomes even more realistic.

However, a more substantial (foreign) support to the Macedonian economy is very much conditioned on the improvement of the overall political climate in the region, which is still quite volatile. The recently triggered Albanian insurgency from Kosovo into Macedonia hampers efforts to an increased presence of foreign capital in the country thus decreasing possibilities for a more substantial SME support and finance.

The ongoing reform of the banking sector is expected to significantly improve the operating environment. This will particularly foster SME finance promotion.

However, the lack of tradition in the funding of small businesses will for some time remain one of the more the significant constraints to SME finance promotion in addition to the customary reluctance of banks to deal with "small" private players.

The growing presence of foreign donor entities is extremely helpful in boosting SME promotion and development. In the context, qualified business advisory services and finance counseling will be needed in order to bridge the increasing offer (of capital) and demand.

Although periodical surveys will have to be conducted in order to assessing the market, it is already obvious that the predominantly foreign capital inflows for SME finance can not meet the increasing requirements for fresh money by the growing SME sector which, realistically, already constitutes the backbone of the Macedonian economy. Therefore, a major shift in SME finance policy will be required in order to cope with present day challenges. This should include not just a clear vision and strategy for sector promotion and development, but also a feasible strategy with the setting-up of specific targets and time frames for the realization of objectives.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

4.1. PROPOSED CHANGES IN CURRENT POLICY, LEGISLATION AND PROCEDURES

The list of proposals for viable changes and/or up-grade of the current SME promotion policy, legislation and procedures is as follows.

The following financial instruments intended to foster SME development should strongly be taken into consideration:

1. Risk Capital Facilities.
2. Transitional Joint Ventures.
3. Guarantee Facility Development.

Establishment of Clearing Banks, members of the National Clearing House network. The major role of the latter being settlement of payments between commercial banks, thus assisting SMEs in facilitating financial transactions and offsetting overdue liabilities and claims.

4. Enterprise Board: The EU Committee of Regions has endorsed the establishment of *enterprise boards* assigned to act as clearing points between public funding agencies, banks and individual entrepreneurs. In addition, the *boards* will have the authority to grant or reject loan applications.

In addition, the door should remain open to implementing other successful instruments in worldwide practice in SME finance promotion.

Venture Capital Schemes

Possibilities should also be explored for the implementing of venture capital schemes as an additional tool (where applicable) for SME development. However, one should note that venture capital is seldom used for the financing of start-up firms (in the USA only 6% of the venture capital is invested in start-up companies).

Venture Capital Fund

Transforming pension, social security or health care funds into venture capital funds intended for investment is an option. However, the latter may be a risky enterprise unless the state provides a security in addition to a package of efficient legal instruments to protect the pledged investment.

Policy Measures

Policy measures should be addressed in particular to the following issues:

- Draft new legislation against corrupt business practices and promote good governance principles nation-wide.
- Up-grade existing legislature pertaining to public procurement and specifically with regard to spending for the health and defense sectors.
- Further promote reforms in the public administration. Also introduce meritocracy in recruitment for the public administration.

- Introduce anti-trust regulation based on modern business practice and promote free competition in order to counter oligarchy.
- Draft new regulation pertaining to the founding of independent industry associations and specifically re-draft the existing (obsolete) Law on the Chamber of Commerce of the Republic of Macedonia.

APPENDICES

APPENDIX I

BANKING SECTOR

MACEDONIAN BANKS

1. BALKANSKA BANKA A.D. SKOPJE

Types of Available Funds:

1. Short term loans.
2. Long-term consumers' credit.

2. EXPORT-IMPORT BANKA A.D.

Types of Available Funds:

1. Small and medium-sized companies - National Enterprise Promotion Agency (NEPA) credit line.
2. Small and medium-sized companies - Macedonian Bank for Development Promotion credit line.
3. Short term loan.

3. INVESTBANKA A.D. / Revolving Credit Fund

Types of Available Funds:

1. Agricultural producers in specified rural areas (International Fund for Agricultural Development).
2. Agricultural producers in specified rural areas.
3. Small and medium-sized enterprises.

4. IZVOZNO KREDITNA BANKA

Types of Available Funds:

1. Credit line of SOROS Economic Development Fund.
2. Small and medium-sized companies - Macedonian Bank for Development Promotion credit line.
3. Small and medium-sized enterprises: Commodity Aid Program from Republic of Italy - 24.6 billion liras - through Macedonian Bank for Development Promotion.
4. Small and medium-sized companies - NEPA credit lines.
5. Short term loans from Bank funds.

5. KOMERCIJALNA BANKA A.D.

Types of Available Funds:

1. Private Sector Development Project from International Bank for Reconstruction and Development, Washington, D.C.

2. AKA Ausufuhr Kreditgesellschaft MBH - Frankfurt credit line for the purchase of equipment and services from Germany.
3. Bayerische Vereinsbank AG (BV) credit line for the purchase of equipment and services from Germany.
4. Swiss Bank Corporation credit line for the purchase of equipment and services from Switzerland.
5. Zurircher Kantonalbank - Zurich credit line for the purchase of equipment.
6. Private Sector Development Project of International Cooperation and Development Fund of Republic of China.
7. Small and medium-sized companies - NEPA credit line.
8. Credit line for small and medium enterprises development / Financing export through Macedonian Bank for Development Promotion credit line.
9. Commodity Aid Program from Republic of Italy through MBDP.
10. Partial Financing of Individual Sub-projects in private sector to stimulate job creation.
11. Trade Finance Facility agreement with EBRD.
12. Trade Finance Guaranty Facility Agreement with Turk Eximbank.
13. Medium term Export Credit Insurance Facility Agreement between Komercijalna Banka A.D. and Exim Bank Turkey.

6. KOMERCIJALNO INVESTICIONA BANKA A.D. KUMANOVO

Types of Available Funds:

1. Micro credit line from PHARE via National Enterprise Promotion Agency (NEPA.)
2. Short-term loan.

7. KREDITNA BANKA BITOLA

Types of Available Funds:

1. Short term loans from Bank funds.

8. KREDITNA BANKA A.D. SKOPJE

Types of Available Funds:

1. Short term loans.

9. MACEDONIAN BANK FOR DEVELOPMENT PROMOTION

Types of Available Funds:

1. Financing of small and medium-sized enterprises - long term loans
2. Commodity Aid Program from Italy - 24.6 billion liras.

10. MAKEDONSKA BANKA A.D.

Types of Available Funds:

1. Long term credits from the World Bank.
2. Short term loans.

11. OHRIDSKA BANKA A.D. OHRID

Types of Available Funds:

1. Private Sector Development Project - International Bank for Reconstruction and Development (IBRD).
2. Credit Program from PHARE through NEPA.
3. Project for Private Sector Development - International Cooperation and Development Fund (ICDF) of Republic of China.
4. Credit line from foreign commercial banks.
5. Bank funds.

12. PELAGONISKA BANKA

Types of Available Funds:

1. Bank Funds.

13. RADOBANK

Types of Available Funds:

1. Small and medium-sized private companies and enterprises privatized more than 51% - NEPA - PHARE credit line.
2. Credit line for small and medium-sized enterprises from the International Cooperation Development Fund and from Republic of China (Taiwan).
3. Small and medium-sized companies - Macedonian Bank for Development Promotion.
4. Commodity Aid Program from Republic of Italy - through Macedonian Bank for Development Promotion.
5. SME's Credit Program financed by the Netherlands.
6. Procedures for allowing short term credits and guaranties.

14. SILEKS BANKA

Types of Available Funds:

1. Short term loans.

15. STOPANSKA BANKA A.D. BITOLA

Types of Available Funds:

1. World Bank Credit Line.
2. Credit line from the National Agency for Reconstruction and Development Commodity Aid Program from Italy worth LIT 24.6 billion through Macedonian Bank for Development Promotion.
3. Short term credits – Bank's own funds.

16. STOPANSKA BANKA A.D. - SKOPJE

Types of Available Funds:

1. Fortis Bank, Brussels - Belgian credit line for the purchase of equipment and services from Belgium.

2. Czech Export Bank, Prague - Czech credit line for the purchase of equipment and services from the Czech Republic.
3. Vseobecna Uverova Banka, Bratislava - Slovakian credit line for purchase of raw materials from Slovakia.
4. Banko Bilbao Viczcaya, Madrid - Spain for commercial and public sector development projects.
5. Banca Agricola Mantovana, Mantova - Italian credit line for purchase of equipment and capital goods from Italy.
6. Export Import Bank, Taipei - Taiwanese credit line for purchase of equipment from Taiwan.
7. Deutsche Genossenschaftsbank AG, F/M (DG Bank) - German credit line for the purchase of capital goods from the European Union.
8. Council of Europe Development Bank.
9. Commodity Aid Program - Italian Credit Line through Macedonian Bank for Development Promotion.
10. International Cooperation and Development Fund (ICDF) - from Republic of China.
11. Small and medium-sized companies - Macedonian Bank for Development Promotion credit line.
12. EBRD Trade Facilitation Program MME.

17. TETEKs BANKA

Types of Available Funds:

1. Short term loans.

18. TETOVSKA BANKA

Types of Available Funds:

1. Short term credits from bank funds.
2. Commodity Aid Program from Republic of Italy for small and medium-sized enterprises through Macedonian Bank for Development Promotion.

19. TUTUNSKA BANKA A.D. SKOPJE

Types of Available Funds:

1. Credit Line financed by the International Cooperation and Development Fund of the Republic of China – Taiwan.
2. SME's Credit Program Financed by the Netherlands.
3. Micro credit line of PHARE through NEPA.
4. Macedonian Bank for Development Promotion credit line.
5. Commodity Aid Program from Republic of Italy for small and medium-sized enterprises - Macedonian Bank for Development Promotion.
6. Short term loans - (Bank clients)

20. ZEMJODELSKA BANKA

Types of Available Funds:

1. Short term loans from own funds.

FOREIGN BANKS BRANCH OFFICES

1. T.C. ZIRAAT BANKASI

Types of Available Funds:

1. Short term loans from own funds and customer resources.

APPENDIX II

NON-BANKING FINANCIAL INSTITUTIONS AND SERVICES

SMALL SAVINGS AND LOAN INSTITUTIONS

1. BAVAG

Types of Loans:

- Short term.

2. DIKUKO

Types of Loans:

- Short term.

3. FERSPED

Types of Loans:

- Short term.

4. INKO

Types of Loans:

- Short term:

Up to 1 month (possible extension);

Up to 1 year (possible extension).

5. INTER FALCO

Types of Loans:

- Short term.

6. KIRO KUCUK

Types of Loans:

- Short term.

7. MAK BS

Types of Loans:

- Short term.

8. MALESHEVKA

Types of Loans:

- Short term.

9. MIT STEDILNICA

Types of Loans:

- Short term.

10. MLADINEC

Types of Loans:

- Short term.

11. PEON

Types of Loans:

- Short term.

12. POSTENSKA

Types of Loans:

- Short term.

13. FULM

Types of Loans:

- Short term.

MULTILATERAL INSTITUTIONS

1. DEUTSCHE INVESTITIONS UND ENTWICKLUNGS GESELLSCHAFT MBH (DEG)

Types of Available Funds:

- Start-up businesses for German returnees.
- Small and medium-sized businesses established no longer than 3 years - financed by the Macedonian source.

2. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

Types of Available Funds:

- Direct financing in public and private sector activities.
- Direct Investment Facility.

3. WORLD BANK - PRIVATE AND FINANCIAL SECTOR DEVELOPMENT PROJECT THROUGH NATIONAL BANK OF MACEDONIA

Types of Available Funds:

- Credit Loans.

4. THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)

Types of Available Funds:

- Currency Pool Loans.
- LIBOR-based Single Currency Loans.
- Fixed-rate Single Currency Loans.

5. INTERNATIONAL FINANCIAL CORPORATION (IFC) SMALL ENTERPRISE FUND (SEF)

Types of Available Funds:

- Debt (long or medium term), Equity, and Quasi-equity.

INVESTMENT FUNDS

1. SMALL ENTERPRISE ASSISTANCE FUNDS (SEAF) MACEDONIA

Types of Available Funds:

- Equity, Quasi-equity and Debt.

2. THE DANUBE FUND

Types of Available Funds:

- Equity or Quasi-equity.

3. EAST EUROPEAN FOOD FUND (JUPITER ASSET MANAGEMENT LIMITED)

Types of Available Funds:

- Equity.

4. EUROMERCHANT BALKAN FUND

Types of Available Funds:

- Equity.

5. ICDF EQUITY INVESTMENT FUND FOR SMALL AND MEDIUM-SIZED ENTERPRISES IN MACEDONIA

Types of Available Funds:

- Equity Investment Fund for Small and Medium Sized Enterprises in Macedonia.

GUARANTEE AGENCIES

1. MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)

Services Offered:

- Political Risk Insurance.

2. OVERSEAS PRIVATE INVESTMENT CORPORATION (OPIC)

Services Offered:

- Political Risk Insurance.
- Direct Loans.
- Loan Guarantees.
- OPIC Financed Investment Funds.

MICROLENDING INSTITUTIONS

1. MOZNOSTI (OPPORTUNITY INTERNATIONAL)

Types of Available Funds:

- Individual Loans (Purchase of equipment and working capital).
- Group Loans.
- Liquidity Loans.
- Start-up businesses and emerging businesses, agriculturists and livestock farmers.
- Trading firms with registered shops.
- Group of citizens (from 3 to 5) from the economically deprived part of the population, occupied in handcrafts, tailoring, hairdressing, retailing etc.
- Short term liquidity loans.

2. MACEDONIAN ENTERPRISE DEVELOPMENT FOUNDATION (MEDF)

Types of Available Funds:

- Loans to Financial Intermediaries intended for on-lending to Agricultural Intermediaries for on-lending to individual farmers.
- Loans to Financial Intermediaries intended for financing investment projects of individual small scale enterprises (SSE).
- Loans to micro-finance institutes for on-lending to micro enterprises.

3. NATIONAL ENTERPRISE PROMOTION AGENCY NEPA

Types of Available Funds:

- Micro Credit Line - Macedonian denar (MKD) loans for small companies, with fixed denar annuity.

4. CATHOLIC RELIEF SERVICES (CRS) HORIZONTI MICROFINANCE

Services Offered:

- Small loans to micro-entrepreneurs (female).

DEVELOPMENT AGENCIES AND PROGRAMS

1. UNITED STATES TRADE AND DEVELOPMENT AGENCY (USTDA)

Services Offered:

Grant funding for:

- Feasibility Studies;
- Definitional Missions;
- Desk Studies;
- Technical Symposia;
- Orientation Visits;
- Business Briefings;
- Trade-Related Training;
- Technical Assistance.

2. AGENCY FOR RECONSTRUCTION AND DEVELOPMENT

Types of Available Funds:

- Small and medium-sized companies and agriculture - International Corporate Development Fund (ICDF) - Loan for purchase of Taiwanese equipment.
- SCHAAP Credit line for procurement of cows from the Netherlands.
- Soft Loan - Taiwanese Fund valued of USD 20 million for fixed assets and working capital.

3. ECOLINKS (EURASIAN-AMERICAN PARTNERSHIP FOR ENVIRONMENTALLY SUSTAINABLE ECONOMICS)

Types of Available Funds:

Grants:

- Quick Response Awards.
- Challenge Grant Program.

4. LABOR RE-DEPLOYMENT PROGRAM SOCIAL SUPPORT PROJECT IDA-3268-MK

Services Offered:

- Development of an administrative framework to enable Privatization Agency (PA) to provide resources to Macedonian Socially Owned Enterprises (MSOE), or selected local organizations, so they can organize labor redeployment services for workers displaced by privatization;
- Provision of labor redeployment services to the workers displaced by bankruptcy / labor restructuring and the Kosovo conflict, by contracting with local services providers to deliver services:
 - Job Counseling;
 - Retraining;
 - Public Works;
 - Small Business Incubators;
 - Regional Development Planning;
- Loan Guarantee Program.

5. OPEN SOCIETY INSTITUTE – MACEDONIA (SOROS FUND)

Types of Available Funds:

- Long term Loans.
- Short term Loans.

6. REGIONAL ENVIRONMENTAL CENTER FOR CENTRAL AND EASTERN EUROPE

Types of Available Funds:

- Technical assistance/grants.
- Information Database.

7. AGENCY FOR ECONOMICALLY UNDEVELOPED AREAS

Types of Available Funds:

- Direct support through channeling of funds, investment projects support and indirect measures of economic policy.

8. WORLD COUNCIL OF CREDIT UNIONS (WOCCU)

Types of Available Funds:

- Rural Credit.

9. PRISMA PARTNERS FOR ECONOMIC DEVELOPMENT IN MACEDONIA

Objectives:

- Establish new ways of doing business by enabling local communities to create jobs and promote economic development;
- Promote expanded services to unemployed workers by creating Labor Model adjustment committees;
- Enhance enterprise competitiveness by promoting labor-management cooperation and improving training in order to get Macedonia back to work.

FOREIGN GOVERNMENTS CREDIT LINES

1. ITALIAN EMBASSY

Types of Available Funds:

- Loans.

2. TECHNICAL MISSION OF THE REPUBLIC OF CHINA (TAIWAN) IN THE REPUBLIC OF MACEDONIA

Types of Available Funds:

- Small and medium-sized enterprises credit line.
- Agricultural credit line.

TECHNICAL ASSISTANCE

1. ENVIRONMENTAL ACTION PROGRAM SUPPORT (EAPS)

Types of Available Funds:

- The EAPS Project itself does not finance investment projects but rather provides financial support for project preparation to access financing resources. It also provides specialized technical assistance for environmental investments.

2. KNOW-HOW FUND

Types of Available Funds:

- Technical assistance support available in the line with the Country Strategy Paper. Further information or copies of the Country Strategy Paper available upon request.

3. LAND O'LAKES INC.

Types of Available Funds:

- Only technical assistance given.

4. REGIONAL CHAMBER OF COMMERCE, SKOPJE

Types of Available Funds:

- There are no available resources at the moment, only technical assistance.

5. TURN AROUND MANAGEMENT PROGRAMME (TAM)

Types of Available Funds:

- Technical assistance only.

6. CROWN AGENTS

Services Offered:

- The company delivers specialist and multi-disciplinary services in international trade, procurement, finance and institutional development.

SME FINANCING IN MONTENEGRO

PETAR IVANOVIC, CEED, MONTENEGRO

1. BACKGROUND INFORMATION

Since 1989 Montenegro had negative economic growth or decrease in total income. In 1989 GDP in Montenegro was US\$ 1,407 million and in 2000 – US\$ 700 million (twice less than ten years ago). In 2000 a positive GDP growth was registered for the first time during the last decade. This trend was influenced by the brake-up of former Yugoslavia, the wars in: Slovenia, Croatia, Bosnia and Kosovo, the NATO bombing, the sanctions imposed by International community, political pressures and instabilities, hyperinflation, etc.

Two major, endogen causes of economic downturn in Montenegro are:

1. Political cause, or slower transition of political sphere in Montenegro, which caused domination of daily politics over the economy.
2. Economic system – slower abandoning the way of thinking based on past, according to which state is a major player in economy, industry is a basic sector in economy, financial system doesn't allocate savings and citizens expect from Government to solve all their problems.

Can trend of economic downturn be stopped in short term? By answering this question, we will point out the most important cause of transition in Montenegro: time!¹ Actually, Montenegro, and the whole Balkan region have started with delay in transition processes, opposite to other southeastern countries.² It is so called delayed transition.

Montenegro also survived three shocks:

1. "Recession shock" (decrease of GDP in 2000 - 50% of the 1989 GDP)
2. "Demographical shock" (increase of population of 13% during the last ten years, including refugees)
3. "Delayed transition shock" (at least 7 years of delayed transition compared with other Eastern European countries)

Preconditions for faster implementation of economic reform in Montenegro are already created and any further delay or waiting would be catastrophic for the economic and political stability of Montenegro and would delay the further development of transition process.

Macro economy of Montenegro can be described with three essential disequilibria:

1. External disequilibria, with three major components: (i) external debt of

1 Time is non-material cause in informatical economy.

2 This constitution is valid for almost all former Yugoslav states, despite the reform project of Ante Markovic from 1989. Which was the first such reform project in Eastern Europe!

Montenegro of US\$ 567 million (vs. US\$ 12,2 billion debt of FRY), (ii) negative trade balance in 2000 of US\$ 193 million or 26% of GDP³, and (iii) positive flow of citizens' transfers from abroad

2. Internal disequilibria, described with high unemployment rate. The number of employees in Montenegro is 142,000 out of which 54,000 (38%) work in non-productive part of the economy. There are some estimates that 15-20,000 employees work in the informal sector. The unemployment rate is 28%. This represents the major problem of the economy: how to create productive employment?

3. Budgetary disequilibria. The budget deficit in 2000 was DEM 156 million, or 12% of GDP.

Current economic activity, above all disequilibria, characterizes several positive trends. For example: industrial production growth of 3.7%; average wage increased by 21%; employment rate increased by 2.2 %; in December 2000 CPI was 2.5%, RPI – 1.1%; GDP growth rate in 2000 was 4.5%.

A business opportunity in Montenegro exists in the area of: (i) tourism⁴, (ii) services (especially those complementary with tourism) and (iii) agriculture. Also, Montenegrin coast is 293 km long and opportunities exist in further development of the Port of Bar and the infrastructure. At the moment capacities exist for production of 100,000 tons of aluminum, 400,000 tons of raw Ferro, 1,000,000 tons of bauxite, 75,000 tons of salt, 2,700,000 tons of coal.

3 This data should be analysed in the context of DEM introduction as a legal payment currency and freedom of individuals to use DEM according to their preferences and interest!

4 According to estimations of German firm – DEG – a financial company, which works on tourism strategy of Montenegro (and also has worked on a similar one for Turkey), Montenegro could make revenues of DEM 1,6 billions from tourism for fifteen years, without multiplication effects.

2. ECONOMIC REFORMS IN MONTENEGRO

Montenegro has more or less its own economic system. Reforms have started at a wide front of structural and macroeconomic changes, in order to introduce the capitalism in Montenegro.

Key axle of structural reforms is privatization. A generally accepted political attitude in Montenegro is that all state property may be privatized. Legal framework that enables conduction of transparent privatization has been prepared. 25% of the total capital has been privatized up to date. Privatization of 35-40% during this year is expected.

In monetary reform, the introduction of DEM, first as a parallel and then as the only mean of payment was among the most important reform decisions. By introducing the DEM, Montenegro has determined that it will not change its economy by printing money. The implementation of Central Bank Law is under procedure. A Banking Law has been adopted.

The Security Papers Law that regulates financial market and capital market has been adopted as well. Fiscal reform and introduction of VAT is going on. Accounting and statistical standards are introduced. Transparency and publicity of budget have been increased, since it is published monthly.

The total complex of foreign trade and customs is subject to reform. Custom duties have been decreased from average federal level of about 25% to 0-12%! Foreign Investments Law has been adopted. Foreigners have the same rights, obligations and procedures as citizens of Montenegro. For more than one year visas for Montenegro are abolished.

Montenegrin economic system longs for very liberal market economy. The concept of the microstate is a strategic vision before all. The concept of the microstate is a connection among the present situation, the economic reforms and the strategy for development of Montenegro. "Market is a mechanism that turns enemies into friends", as would Hayek said. That's why I consider free market as the only guarantee for peace and prosperity at this area.

3. SMEs IN MONTENEGRO

Entrepreneurs in Montenegro should be able to derive opportunities from the following advantages that can be enjoyed by the small and medium-sized businessmen: the entrepreneurial attitude of the people (especially the younger ones), the high skill base and low wage costs of labor, the inefficiency and low competitive standards of the majority of state-owned enterprises, the increasing expectations and desires of consumers for western-quality products and services and the opportunities available through the privatization program.

One can often hear complaints regarding the procedure of establishing an enterprise. The procedure of registration of enterprises in Montenegro is:

- Complicated, long and slow;
- Creates discretionary rights in Government administration;
- Involves a large number of institutions;
- Requires gathering voluminous documentation.

In 1990, approximately 2,000 new enterprises were established in Montenegro according to the rather liberal legal conditions then prevailing. According to the criteria of the special program of the Government of Montenegro from 1999, implemented through the Fund for Employment, the cost of creating 2,000 jobs amounted to about DEM 12,000,000. This amount would be an important capital fund for crediting small businesses, and creating multiple effects associated with its development.

Despite the fact that financial requirements are very high (as compared to the average wage), Montenegrin entrepreneurs rather register their business in one of the incorporated forms instead of "physical person".

In 2000, there were 15,227 business units registered in the Republic of Montenegro, out of which 6,550 submitted balance sheets and income statements at the end of the fiscal year. Of all these registered businesses, there were 97% small business units with up to 50 employees. Of all the registered businesses, 54% are located in the central part of the country, 26% - in the southern coastal part, and the rest - in the northern part.

Table 1 Registered Businesses by Geographical Position

Position	Number	Share %
Northern part of Montenegro	2, 982	19.6
Central part of Montenegro	8, 215	54.0
Southern part of Montenegro	4, 030	26.5
Total	15, 227	100.0

Source: CEED, *SME Statistics in Montenegro, June 2000*.

The business environment still discourages prosperity of private enterprise. Entrepreneurs are complaining about the attitude of officials, as well as the general public, toward private initiative and profit making. The general economic and political turbulent transition is an obstacle for the improvement of the business performance. However, entrepreneurs expect improvement in the general economic situation and in their own businesses.

Table 2 Registered Business Units by Legal Organizational Forms

Date	Private enterprises	State and public enterprises	Mixed	Total
01/01/1991	1, 567	388	24	1, 979
01/01/1992	3, 267	527	70	3, 864
01/01/1993	7, 141	686	228	8, 055
01/01/1994	11, 312	951	289	12, 552
01/01/1995	13, 398	1, 036	360	14, 794
01/01/1996	15, 476	1, 029	452	16, 957
01/01/1997	16, 477	1, 011	570	18, 058
01/01/1998	16, 166	978	580	17, 724
01/01/1999	14, 887	954	552	16, 393
01/01/2000	14, 089	638	500	15, 227

Source: CEED, *SME Statistics in Montenegro, June 2000*.

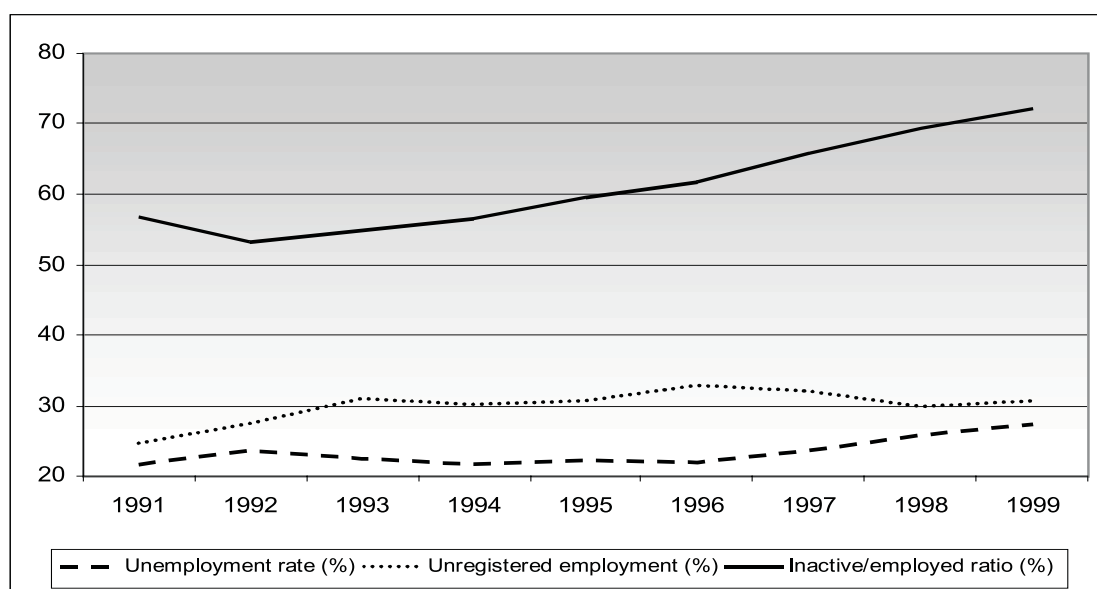
The unemployment rate in Montenegro is still high (28%). But, only through SME sector we can solve the problem with unemployment. In the last two years CEED from Podgorica and CIPE from Washington DC, among others, have been working together on helping entrepreneurs to start up their business and on providing basic consulting services to them on how to stay in the business.

Table 3 Registered Businesses by Number of Employees, April 2001.

Size	Number	Share %
Up to 50 employed	14, 760	96.9
50–250 employed	215	1.4
Above 250 employed	17	0.1
Unclassified	235	1.5
Total	15, 227	100.0

Source: CEED, *SME Statistics in Montenegro, June 2000*.

Figure 1 Unemployment Rate, Unregistered Employment as a Share of the Labor Force, and the Inactive/Employed Ratio



Source: ISSP, *Montenegro Economic Trends, May and June 2000*.

In the last nine years there have been unfavorable trends in the Montenegrin labor market: the unemployment rate and the share of unregistered labor force is increasing (see figure 1). At the same time the ratio of unemployed to employed is rapidly increasing. That ratio is now at 72%.

Recession, which was experienced in all Central and East European transition countries, is clearly evident. We know from experience, that this recession could be overcome by further exploitation of the existing capacity and of a favorable international environment. SME sector can become important interactive factor.

SME sector participates in GDP by 30% (according to the official sources) and by 49% by estimates based on the surveys conducted by CEED. SME sector in Montenegro is a very flexible one (adoptable to new markets,

frequent changes of the laws and regulations and sudden changes in the business and political environment). In the case of Montenegro it is more oriented to the market forces than large one - mostly government-owned firms.

At the beginning of the year a governmental Agency for SME development was established. A strategy for SME development is still missing in Montenegro.

4. SMEs FINANCING

At the moment in Montenegro the following sources of loans to SME financing exist: (i) governmental programs: Fund for Development and Bureau for Employment and (ii) donor programs: Opportunity International, World Vision and Land O'Lake. Donor programs deal with micro financing, while governmental programs include micro financing, as well as small-scale loans (usually up to DEM 50,000).

In addition to the existing loan programs, two banks recently started operations aimed to reach SME sector: (i) Euromarket bank (the first foreign bank in Montenegro) and (ii) Montenegro Commercial Bank (with the financial support from KfW).

Other banks are busy with their bad loans and do not want to lend money. A Guarantee Bank with the role to provide guarantees for loans extended to small businesses does not exist in Montenegro.

However, entrepreneurs are facing many obstacles. One of the most significant obstacles is the cost and lack of access to investment capital; interest rates on loans range from 15% to 36%; lack of financial discipline and the current banking system (which was designed to finance the needs of the large state-owned enterprises) is not able to meet the needs of small businesses. Another major obstacle is the lack of venture capital funds.

Still, the most commonly cited sources of capital at start-up are savings and loans from the family and friends. According to the CEED survey titled "Barriers for Doing Business in Montenegro" start-up bank loans were used by only 18% of the firms, while 55% relied on savings as their sole source of start-up capital and an additional 27% of the firms used a combination of savings and loans from the family or friends, or both.

Savings are a prominent source of start-up capital for firms in all sectors. Manufacturers and service-based firms are more likely to have obtained bank credit at start-up. Firms oriented to export are more likely to receive bank financing at start-up.

While enterprises still rely to a considerable extent on savings to finance their operations the role of savings since the start-up has declined. Of firms currently relying to some degree on savings, more than one third rely on savings as their sole current capital source.

The most common current source of capital is reinvested profits (cited by 62% of all firms involved in the mentioned survey). Of these firms, 57% rely on reinvested profits as their sole current financing source. Another 22% rely on reinvested profits combined with savings. Overall, less than 4% of the sample currently relies on a minimum of three sources of capital to support their operations.

Retail trade enterprises are somewhat more likely to rely on savings as a financing source, with manufacturers and wholesale traders are more likely

to rely on bank loans.

Evidence from around the world demonstrates that access to finance is a key problem that much of the private sector and in particular the smallest enterprises face in both developed and developing countries. CEED survey has addressed the issue of finance by focusing on two variables:

- The degree to which the business community utilizes the banking system as a source of finance, and
- The specific financial needs of enterprises both in amount and duration.

Bank Credit Utilization: Results show that 41% of the total sample has obtained a loan from a bank, while 59% has never received a loan. Also, fewer than 12% of firms that have never received a loan have applied for a loan. Combining these results, we see that nearly one-half of the sample has never applied for a bank loan.

There appears to be a direct correlation between current gross revenue level and success in borrowing from a bank. A total of 21% of firms with annual gross revenue lower than DEM 10,000 has received a bank loan. This success rate increases as we move to larger gross revenue levels: 56% of firms with more than DEM 100,000 in annual gross revenue have received a bank loan.

Table 4 Gross Revenue Level and Finance

Amount of a loan needed (in 000 DEM)	Annual gross revenue of the firm in 000 DEM					
	1-10	10-25	25-50	50-100	>100	
0	2.6%	4.5%	3.4%	1.9%	9.6%	22.0%
0-5	1.7%	0.6%	0.9%	0.0%	0.9%	4.1%
5-10	3.4%	2.8%	0.9%	0.9%	0.4%	8.3%
10-20	2.1%	2.8%	2.8%	2.3%	1.1%	11.1%
20-50	1.9%	3.2%	3.2%	3.4%	4.3%	16.0%
50-100	2.1%	1.5%	2.3%	4.5%	6.8%	17.3%
100-200	0.2%	0.2%	1.1%	1.7%	6.8%	10.0%
>200	2.1%	0.2%	0.2%	0.4%	8.3%	11.3%
Total:	16.2%	15.8%	14.7%	15.1%	38.2%	

Only within the manufacturing and wholesale trade sectors there is a majority of firms, which have obtained bank financing. A total of 46% of the firms engaged in exporting to some degree have received a bank loan. Nearly 80% of the firms, regardless of whether they have borrowed previously, have expressed a preference to bank financing. Firms that have already borrowed are more likely to prefer longer-term capital.

Demand for Credit: The entire sample indicates fairly significant medium term capital requirements. Over 50% of the firms have expressed the need for at least DEM 20,000 in credit; nearly one-third of the firms expressed the need for credit between DEM 20–100,000, and over 20% of the sample expressed the need for credit in excess of DEM 100,000. Firms with greater gross revenue tend to require greater amounts of bank financing. However, the smallest firms also have a substantial financing need, both in amount and in duration.

In terms of loan maturity, nearly 50% of the total sample prefers loan maturity of at least 12 months. Out of the total number of firms that have expressed a need for credit, 63% prefer a term of at least 12 months, 43% prefer a term of at least two years, 23% prefer a term of at least three years, and 18% prefer a term of at least four years.

Like in other countries in the region, entrepreneurs in Montenegro face *business liquidity problems*. This is a particularly strong problem in a system that still has a weak banking sector. The share of firms with liquidity problems in Montenegro is very high. For example, this share in Hungary is around 30%, out of which only 8 to 9% has frequent problems. Payment problems exist in both areas, particularly for receivables. Nearly two-thirds of the total sample report receivable problems. A total of 58% of firms report problems over the preceding six months in paying for goods and services.

Taxes are regarded by entrepreneurs as being too high, as well as being major cost factor for the entrepreneur. The complications of, and the frequent changes to, the system are such as to require even the smallest enterprise to devote a disproportionate amount of time to fulfilling all tax regulations. As a result, much economic activity is forced into the informal economy.

The improved access to external financing of SMEs in Montenegro is one of the major prerequisites for the further growth of the sector. The commercial banks at present implement a conservative policy in providing resources to the sector. Nevertheless, several problems between banks and SMEs applying for loans exist, such as: (i) the legal framework, (ii) the low level of managerial skills of the SMEs and (iii) the lack of appropriate information about the borrowers (this is linked with the efforts initiated in the moment and related to the introduction of the international accounting standards).

5. NO ACCESS TO OUTSIDE FINANCIAL SOURCES AS A BARRIER TO SME DEVELOPMENT

A large number of the firms in Montenegro consider limited finance sources to be a problem (according to the same survey results, more than 67% of the firms consider limited finance sources to be a problem, while more than 30% of the surveyed firms consider it to be a “very serious” problem). The greatest number of complaints regarding limited finance sources as a barrier comes from firms involved in tourism (more than 83%) and in construction activities (more than 78%).

Access to financial sources is a “very serious” problem for every third firm involved in the manufacturing, wholesale trade, agriculture, and service sectors.

Limited access to financial sources is a problem of equal importance to public firms and to nonprofit organizations as a major market and for firms that primarily work with private persons.

The access to financial sources is the greatest problem for entrepreneurs and owners of firms who are 25- to 30-years-old (83%) and 51- to 60-years-old (72%). Nevertheless, a fewer number of complaints regarding limited financial sources comes from 20- to 25-year-old owners (53%) and from those older than 60 (52%), and from two out of three owners or entrepreneurs who are 31- to 40-years-old and 41- to 50-years-old.

Access to outside financial sources is an equal problem both for women and men. The firm’s size does not have significant influence on access to outside financial sources. The problem is almost equal for all four firm categories.

Firms that need greater amounts of credits consider limited access to financial sources to be a bigger problem than those firms that have also asked for bank credits, but for lower amounts.

6. CONCLUSIONS

There are strong signs of a huge and unsatisfied demand for finance - especially medium, and long-term finance, among firms of all sizes, ages, and sectors. The banking system does not meet the needs of the SME sector. About 60% of the SME sector in Montenegro has never received a loan from a bank.

Savings and loans from the family and friends seem to be the most commonly cited sources of capital at the start-up stage .

There is evidence that the most common current sources of capital are: (i) reinvested profits and (ii) reinvested profits combined with savings.

There are no doubts that resolving one of the key problems - access to financing - would have impact on:

- The further development of SME sector in Montenegro;
- The stronger participation of SME sector in Montenegrin GDP;
- The creation of new jobs;
- The creation of new markets;
- The establishment of new ties within the region;
- The improvement of the business environment.

7. RECOMMENDED FINANCIAL INSTRUMENTS FOR THE DEVELOPMENT OF THE SME SECTOR

There is a strong need for support and assistance in various areas. There are many problems that can be solved internally in Montenegro (i.e. implementation of appropriate legal framework, better taxation laws, incentive schemes to young and growing companies, creating a positive climate for entrepreneurs, etc.).

We believe that one of the areas where assistance is needed is education of the entrepreneurs (especially in the area of strategic planning, foreign languages, marketing, business financing, etc.).

We recommend establishing a special nongovernmental fund to finance SMEs. At the same time, government-funded SME finance should focus on the financially underserved groups with a strategic goal of introducing them into the financial markets.

Although the recent experience is based on a small sample (smaller than one presented in this paper), the *joint venture* as a model of financing SME companies seems to be successful at this stage of transition of Montenegrin economy. The truth is that this form of financing is in the initial stage of development in Montenegro, but obviously it meets the business interests and the needs of some companies. Therefore, we recommend it as an instrument that is worth supporting.

Next area where immediate action would have a great impact on the future growth of private companies in Montenegro is related to the capital market. The one side of it is also related to training (simply because entrepreneurs must be taught how to approach and deal with banks, how to select optimal source of financing for their specific needs and how to approach to capital market). But the other side is related to providing long-term loans at low interest rates.

Within the framework of the SEE region, we believe that establishment of a unique data base about business ideas needed to be financed might be a first step to: (i) internalization of the local businesses and (ii) bringing together potential investors from and out of the region and the “owners” of the proposed business ideas. Such a database would be driven by the basic market rules: supply and demand.

At the end, we recommend stronger involvement of the business community in addressing issues that are relevant to business financing. It is very important to allow the business community to formulate, articulate, and lobby for the issues relevant to business development. Business environment in Montenegro might be significantly improved by creating a framework for public-private partnership.

ROMANIAN CASE STUDY

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1. A GENERAL OVERVIEW OF THE SME SECTOR

1.1. THE IMPORTANCE OF THE SME SECTOR FOR THE ECONOMY

The SME sector in Romania has been defined in line with EU legislation according to the Law no. 133/1999 regarding the stimulation of private entrepreneurs for the establishment and development of small and medium enterprises. The SMEs are defined by three criteria:

- number of employees (micro enterprises: up to 9 employees; small enterprises: 10 – 49 employees; medium enterprises: 50 – 249 enterprises);
- annual turnover (equivalent of max. EURO 8 million);
- independence relative to large companies (SMEs are those companies which do not have as shareholders or associates legal persons having more than 250 employees and holding more than 25% of the share capital).

Table 1 Share of the SME sector in Romania

Indicators	1997	1998	1999
Number of companies that reported balance sheet ¹	98.1 %	97.9 %	97.7 %
Number of employees	38.2 %	35.0 %	40.2 %
Total wage fund	27.7 %	27.7 %	27.1 %
Turnover	42.2 %	46.9 %	44.9 %
Gross profit	49.6 %	54.1 %	45.9 %
Gross losses	42.0 %	39.5 %	35.5 %
Net profit	53.2 %	56.2 %	47.0 %
Total assets	32.5 %	29.5 %	26.9 %
Own development fund	53.7 %	54.0 %	42.5 %
Loans	29.6 %	28.6 %	30.9 %
Export incomes	3.8 %	4.5 %	4.8 %
Gross value-added	35.6 %	33.4 %	30.4 %

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

1 The figure does not include self-employed people and family associations registered according to Decree-law no. 54/1990 (they do not have to lodge balance sheets).

The SME sector in Romania has steadily grown in importance during the transition years, reaching in 1999 a share of 45% in the turnover and of 40% in the total employment in companies that reported balance sheets, although they own only 27% of total assets. SMEs contribute also with about 70% to budget revenues.

As one can note from the table below, a high percentage of employment in trade, agriculture and tourism is within SMEs, the lowest shares being in transport (25.6%) and industry (26.2%). Although the share of the SME sector varied in the last three years for many of the above indicators, it grew constantly as regards number of employees and export incomes.

Table 2 Share of SME employment by industries

	1997	1998	1999
In total employment in commercial companies	38.2 %	35.0 %	40.2 %
Industry, out of which:	18.2 %	23.3 %	26.2 %
- textiles, leather and footwear	14.0 %	15.9 %	16.1 %
- food	36.3 %	47.4 %	53.9 %
- pulp and paper	46.4 %	57.6 %	60.7 %
- metal construction and products	22.4 %	25.7 %	31.9 %
- other industrial activities	10.6 %	13.1 %	15.7 %
Agriculture	48.9 %	56.8 %	63.1 %
Construction	41.9 %	27.6 %	51.4 %
Trade	85.1 %	70.0 %	73.5 %
Tourism	69.5 %	60.3 %	62.6 %
Transport	51.5 %	24.6 %	25.6 %
Services	57.9 %	41.3 %	49.6 %

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

As of June 30, 2000, there were over 379,000 small and medium sized enterprises, most of them in trade (63.6%). Nearly 91.7% of SMEs are micro-enterprises, followed by small enterprises with 6.6% and medium sized enterprises with 1.7%.

Most of SMEs are in trade. As regards manufacturing, most of the SMEs are in Wood processing (3.3%), Food and tobacco industry (2.7%) and in the Light industry (2.1%).

Table 3 Structure of active SMEs as of June 30, 2000

	TOTAL SMEs				By size categories			
			0-9		10-49		50-249	
	No.	%	No.	%	No.	%	No.	%
TOTAL of which:	379459	100.0	347768	91.7	25090	6.6	6601	1.7
Trade	241199	63.6	230125	95.4	9913	4.1	1161	0.5
Real estate, rentals and services rendered especially to firms	26111	6.9	24004	91.9	1630	6.2	477	1.8
Hotels and restaurants	15867	4.2	14517	91.5	1156	7.3	194	1.2
Wood processing	12422	3.3	9825	79.1	2005	16.1	592	4.8
Transport	12126	3.2	10884	89.8	879	7.2	363	3.0
Construction	10741	2.8	7647	71.2	2195	20.4	899	8.4
Food and tobacco	10117	2.7	7485	74.0	2080	20.6	552	5.5
Light industry	8119	2.1	5707	70.3	1414	17.4	998	12.3
Machinery and equipment	4072	1.1	2820	69.3	879	21.6	373	9.2
Chemical industry	3191	0.8	2550	79.9	496	15.5	145	4.5
Metallurgy	1949	0.5	1427	73.2	354	18.2	168	8.6
Financial, banking and insurance	1577	0.4	1383	87.7	180	11.4	14	0.9
Electrical and optical equipment	1414	0.4	1125	79.6	212	15.0	77	5.4
Post and telecommunications	717	0.2	563	78.5	111	15.5	43	6.0
Mining and quarrying	401	0.1	269	67.1	80	20.0	52	13.0
Power industry	284	0.1	93	32.7	69	24.3	122	43.0
Other branches	29152	7.7	27344	93.8	1437	4.9	371	1.3

Source: BCR – *Influenta modificarilor legislative intervenite in domeniul creditarii si al fiscalitatii in relatia banca-IMM, 2000*

SMEs account for over 30% of companies with export revenues, although for only 4.8% of total export revenues. However, the total number of exporting SMEs, as well as their share in total number of SMEs and their share in total export revenues, has been increasing, indicating an increased competitiveness and interest to foreign markets.

Table 4 Distribution of SMEs by industry and size categories

	1997			1998			1999			
	TOTAL	Out of which:		Out of which:		Out of which:				
	Micro	Small	Medium	Micro	Small	Medium	Micro	Small	Medium	
Industry	100.0	80.4	15.6	4.0	79.7	16.1	4.2	79.9	15.8	4.3
Agriculture	100.0	67.4	18.8	13.8	69.8	18.4	11.8	74.1	17.1	8.8
Construction	100.0	68.2	21.9	9.8	68.2	22.5	9.3	71.5	20.5	8.0
Trade	100.0	96.6	3.0	0.3	96.2	3.4	0.4	96.1	3.5	0.4
Tourism	100.0	79.9	15.5	4.6	81.0	12.3	6.7	81.5	12.1	5.4
Transport	100.0	91.8	4.4	3.8	91.9	4.6	3.5	91.9	5.0	3.0
Services	100.0	93.9	5.1	1.0	94.2	4.8	1.1	94.3	4.7	1.0
TOTAL	100.0	93.3	5.3	1.4	92.9	5.7	1.4	92.8	5.8	1.4

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

Table 5 Share of SMEs in total exports

	1997	1998	1999
Number of exporting SMEs	5750	6245	7041
Export revenues (USD mill.)	287.3	334.7	375.1
Share of exporting SMEs in total number of SMEs (%)	1.5	1.6	1.8
Share in total number of companies with export revenues (%)	34.9	33.2	32.1
Share in total export revenues	3.8	4.5	4.8

Source: ANDR, *Report 2000*

1.2. EXISTING GOVERNMENT POLICIES AND INSTITUTIONS SUPPORTING THE SECTOR

The need to encourage the private sector and within it small and medium-sized enterprises was at the core of many government policies during the last ten years.

The first policy approach to the SME sector development by the Romanian Government was recorded in 1991, when a strategy study was initiated with PHARE support. The technical assistance team delivered the study² in the first quarter of 1992 and it became the basis of the first strategy document issued by the government in August the same year, accompanied by a

three-year program. Until then, the most significant measures with a favourable impact on the SME sector were: the issuing in 1990 of a decree-law permitting the establishment of several kinds of private undertakings, the enacting in 1991 of the company law, the setting up of the grounds for privatisation by giving the status of commercial companies to the former state enterprises and enacting the privatisation law.

Yet, the strategy adopted in 1992 initiated a new approach, based on the awareness of policy makers and the public about the fact that SMEs are not equal to the private sector and committed the government to an active policy aimed at catalysing the development of a strong SME sector from scratch. The strategy was conceived as a very comprehensive one, listing a full set of policies and measures. They were mainly up-front measures preparing the grounds for a future SME sector, and therefore focussed on legal, institutional, educational and cultural matters. The strategy, however, was implemented only partially.

During 1993-1996, several policy papers emphasised the commitment of the government to support the development of the SME sector but few real measures were actually put into practice.

Out of them, the following are the more significant:

- enactment of the Government Ordinance 25/1993 regarding the development of SMEs,
- establishment of two credit lines with subsidised interest rates,
- setting-up of the Romanian Guarantee Fund for private investors; and
- implementation of several donor programs.

The policy documents issued by the government during that period emphasised the priority given to the building up of a countrywide network of SME advisory and development centres.

All these measures had a limited effect because of weaknesses in design and implementation. Thus, the GO 25/1993 has been criticised because of its wrong definition of SMEs and because its declarative character (the lack of any clear obligation of the government). The credit scheme financed from the unemployment fund³ was not correlated with the SME policy and was affected by the periodic selection of another implementing bank; it created dissatisfaction because of the reimbursement period considered to be too short, the too high percentage of the investor's own contribution, and the time consuming bureaucratic procedures. The low amount allocated for the second credit scheme with subsidised interest⁴ allowed very few entrepreneurs to take advantage of it. Further, the upper limit of the loan decreased very much in real terms because of the failure to upgrade it in nominal terms, despite the high inflation recorded several years.

The Romanian Guarantee Fund and the SME advisory and development centres were designed based upon the assumption that they would become immediately self-sustainable. As a consequence these centres were obliged to abandon their initial goal in favour of more lucrative activities, or to limit the access to their services to only a few entrepreneurs willing to pay high fees. Because of such inconsistencies of the adopted solutions, the

3 Instituted through an amendment brought in 1994 to Law no. 1/1991

4 Instituted through Government Decision no. 805/1995

effectiveness of the initial investment is now questionable.

During the same period, the profit tax exemption of new enterprises has been removed (1994) and the privatisation of small business units (asset privatisation) has been stopped. In such a way, two main incentives for enterprise creation were removed.

Since 1997, the necessity of a more substantial support for the development of the SME sector was strongly promoted by the representatives of the entrepreneurs and widely recognised by political groups. This resulted in the initiation of two new SME programs⁵. However, despite the fact that the programs approved in 1998 were well received by entrepreneurs, they had a modest impact because of their inconsistency and the small number of entrepreneurs who had the opportunity to access them. In 1999 a new SME Law was adopted: *Law 133/July 1999 concerning the stimulation and development of SMEs*, completed subsequently by the *Methodological norms regarding the modalities for financing programs and incentives for the set-up and development of SMEs* (through GD 797/September 1999).

The law offers private SMEs certain economic, financial and tax facilities, like:

- exemption from payment of custom duties on industrial machinery and equipment, as well as on imports of raw materials;
- tax exemption for the share of the reinvested gross profit;
- reduction with 20% of the profit tax in the case that the company increases by at least 10% its number of employees,
- reduction with 75% of tax on profits obtained from exported output;
- Guaranteeing credits through the set up of the National Credit Guarantee Fond for SMEs, with offices in each county;
- Simplification of the system for taxing incomes of natural persons, family associations and SMEs.

Law 133/1999 was very generous in providing facilities for SMEs, but unfortunately the facilities were not in line with the capacity of the public budget to finance them. As a result, the facilities were suspended immediately after the enactment of the law, and during the following period many of the provisions of the Law were explicitly repealed through other laws. Thus, Emergency Ordinance 215/December 1999 has repealed the stipulations offering facilities to SMEs for custom duties on equipment imports, and EO 217/December 1999 repealed the articles of the law concerning tax facilities. In March 2001, EO 297/2000 regarding the stimulation of private entrepreneurs and the setting-up and development of SMEs came to complete Law 133/1999. The ordinance offers various facilities, like tax exemption for reinvested gross profits, however under the condition of being approved by the public finance departments at county level. The methodological norms for applying Law 133 were approved only in March 2001 through GD 224/2001. The law needs to be republished, due to the many ordinances that affected it. However, it seems that the good intentions that have led to granting certain facilities to SMEs do not have a counterpart in financial resources of the state budget.

One important cause of the lack of continuity and coherency of SME policy was the frequent change of the institutional responsibility. Over a period of 10 years, the responsibility for SME policy has been successively entrusted to the National Agency for Privatisation, the Romanian Development Agency, once again to the National Agency for Privatisation, then to the Council for Reform. The National Agency for Small and Medium Enterprises was created by Government Decision no. 975/December 1998. Law 133/1999 provided for the creation of the National Agency for Small and Medium-Sized Enterprises (NASME). In May 2000, through EO 48/2000, NASME was merged with the National Agency for Regional Development, which became the governmental body in charge with policy making in the SME sector. In 2001, the newly elected government set up the *Ministry for Small and Medium-Sized Enterprises and Cooperatives*. There is also a *National Council of Small and Medium-sized Enterprises from Romania*.

Another institution of importance to SMEs is the recently created (GD 16/Jan. 2001) *Ministry of Development and Forecasting*, with attributions in regional development, attracting FDI and European integration. This institution will propose to the National Council for Regional Development the financing of regional development programs and projects, and will also establish the criteria, the priorities and the procedures for financing such programs and projects.

The governmental policy as regards SMEs is to improve the business and investment environment in Romania, to complete and simplify legislation, to restructure the tax system, as well as to support the private SME sector through various facilities and institutions. The Medium Term Economic Strategy document adopted in March 2000 after wide consultation with SME associations, political parties and a broad variety of civil society organisations and submitted to the European Commission included among the fundamental options of Romania for the medium term the following:

“The creation of an enabling business environment, based on a coherent and stable legal framework that ensures the development of the market competition, the reduction of transaction costs and the diminishing of the tax burden; the promotion of specific measures to stimulate small and medium-sized enterprises; a clear definition of the property rights; the ensuring of adequate administrative and judicial structures, capable to enforce the law and to ensure the respect of the contractual liabilities.”

Studies regarding the business environment have shown that the current legal and administrative settings are not favourable for the development of a sound SME sector in Romania. The same conclusion is confirmed by the statistics regarding the development of the SME sector in Romania, the screening of the main issues affecting the prospects for development of the sector - presented above - as well as by considering - in the following section - the obstacles faced by enterprises individually. This situation is partly due to the low performance of the Romanian economy, affected by the delay of structural adjustment, but the fundamental cause of this state

of affairs seems to lie more with weaknesses in policy making and implementation.

It is time to recognise that overall government policy, including the SME policy, “has been characterised by insufficient coherence, credibility and transparency”⁶. It has been difficult to feel confident in the coherence and completeness of national SME policy.

The OECD country survey of 1998, includes the following statement: “Because most of the restructuring problems are related to the existing large industrial companies, the governmental policy has, so far, concentrated on them. Some of the government’s efforts should be devoted from now on to the promotion of entrepreneurship and development of a new private sector”⁷.

From the point of view of the legal background, the points of concern are:

- lack of stable & coherent legal framework,
- need to improve enforcement of laws relating to SMEs,
- the level of bureaucracy and administrative burden/constraints,
- need for a standing monitoring & review mechanism on legal matters, and
- a need for a consultation and ‘advocacy’ function or mechanism.

1.3. EXISTING LEGAL FRAMEWORK FOR THE FINANCIAL MARKET

As regards the legal framework regulating the financial market with direct impact on SME financing, this has been approached through major laws, intended to enlarge and diversify the range of financial services on offer. Besides banking legislation, leasing and risk capital companies, guarantee funds and mortgage financing was also regulated.

Leasing companies were regulated through Law 90/1998 to enact GO 51/1997 on leasing operations and leasing companies and Title II of Law 99/1999. The law also regulates advertising for leasing operations of movables and real estate (for the first, in the Electronic Archive of movable liens, and for the latter in the Land Register).

Risk capital funds are defined in GO 20/1998 as investment companies, set up as closed investment funds, which raise financial resources from private Romanian or foreign individuals or companies.

Law 190/1999 regards mortgage credit for real estate investments, defined as credit given by authorised financial institutions to finance construction, buying, consolidation etc. of buildings for industrial, commercial or residential use. The minimum duration is of 5 years for legal persons and 10 years for natural persons. The collateral is in the form of a mortgage on the respective land or building. Institutions that may undertake mortgage credit are banks, the National Housing Agency, the Savings Bank and certain other financial institutions.

The legal base for guarantee funds is established by GO 23/1999 on the incorporation of guarantee funds. Thus, in order to support small and medium-sized enterprises, guarantee funds may be set up with the exclusive aim of guaranteeing part of the credits or other financing instruments that may be obtained from commercial banks or other sources. The law provides the possibility of setting up mutual credit guarantee consortia as associations without legal personality, through a private company contract among more parties.

The main business of co-guarantee funds is granting guarantees, in full or partly, for the operations of a guarantee fund. They are organised as joint-stock companies, by associations of traders, natural or legal persons, aiming at reducing financial risks or lessening the damages, which could arise from guarantee funds operations.

The Ministry for SMEs is currently working on a draft law for establishing the *National Fund for Guaranteeing Credits for SMEs*, for which the state budget has already earmarked ROL 50 billion and which will facilitate access to bank credits for SMEs. At present, the value of credit collaterals varies from 130 to 175% of the value of the credit. The Fund will guarantee up to 75% of the credit value.

Banks wishing to operate guarantee funds in favour of SMEs benefit from Art. 89 of the Bank Law.

Regulations on the securities market have been issued by the National Commission on Securities and have covered: authorisation and security intermediation (Order 3/1998), computerised transmission of documents (Order 5/1998), supervisory reports on the capital markets (Order 17/1998), creation and organisation of capital market for non-listed securities (Decision 540/1999, Order 4/1999), procedural regulations of the Arbitration Chamber of the Stock Exchange and RASDAQ.

Overall, Romanian legislation covers the requirements, but has been highly unstable, complicated and sometimes some legal regulations contradicting other ones. There is a need now for simplification and elimination of inconsistencies, as well as of further harmonization with European legislation.

2. CURRENT STATUS OF SME FINANCING

One of the most important problems, that SMEs in the Romanian economy face, is access to financing, a problem, closely linked to their other problems like obsolete equipment, high taxes (including wage taxes) and the legal requirement for paying VAT at the moment of invoicing. Romanian companies are frustrated by the awareness that their products are not internationally competitive. They believe this to be caused by lack of modern equipment and reduced access to technology. This, in turn, is in part due to difficult access to investment finance. The cost of finance in Romania is prohibitive, with a considerable impact on the profit and loss account and thence the balance sheets. Projects would need to show a very high rate of return in order to cover an interest rate on loan that is, at present, around 15% annually on hard currency loans and 65% - on local currency loans.

An important part of exports are carried out in the OPT system due among others to lack of financing required for producing for export.

Inter-enterprise arrears are still a disease of the Romanian economy and have reached in 1999 ROL 226,145 billion, or 43.3% of GDP, on the increase from the 36.1% of GDP in 1998. Due to unsold production, high inflation and high interest rates, economic operators resorted to arrears in payment to suppliers or/and public budgets to cover 71% of attracted financial resources.

In a study carried out by the Romanian Center for SMEs regarding their financial requirements, their main sources of finance are their own capital, supplier credits and bank credits. Besides those there are also credits from international programs, grants from international programs, leasing, subsidies, factoring.

2.1. EXISTING FINANCIAL INSTRUMENTS

Bank credit

There are several financial instruments already in use in Romania. The most widespread is bank credits, but in recent years other instruments started to be used, like leasing, factoring and others.

In a recent survey⁸, at the question regarding the top five difficulties encountered by SMEs, difficult access to credit held fifth place (other were high wage taxes, number and level of taxes, high profit taxes, payment of VAT at the issue of the invoice).

One can note that while the SME sector held in 1999 a share of 44.9% in total turnover and of 40.2% in total number of employees, its share in total loans to commercial companies was of only 30.9%. This may be linked to the lack of acceptable collateral, as well as to reticence in entering into debt, as interest rates were not only high, but also extremely volatile in the high-inflationary environment that characterised Romania during the transition years.

Table 6 Share of the SME sector in total loans to commercial companies with reported balance sheet

	1997	1998	1999
Industry, out of which:	17.9 %	17.5 %	20.7 %
- textiles, leather and footwear	10.2 %	12.7 %	20.8 %
- food	40.0 %	40.2 %	36.9 %
- pulp and paper	43.0 %	63.2 %	69.1 %
- metal construction and products	21.8 %	32.1 %	39.0 %
- other industrial activities	10.1 %	9.5 %	13.4 %
Agriculture	40.8 %	41.7 %	63.6 %
Construction	61.6 %	45.5 %	62.2 %
Trade	51.9 %	66.0 %	69.9 %
Tourism	56.6 %	46.2 %	15.3 %
Transport	12.7 %	10.6 %	9.3 %
Services	16.8 %	28.2 %	33.3 %
SME sector	29.6 %	28.6 %	30.9 %

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

Table 7 Distribution of total loans to the SME sector by size categories

	Private			State-owned			Mixed		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Micro	32.0%	38.5%	34.4%	7.7%	5.9%	4.4%	2.8%	3.4%	4.2%
Small	35.0%	31.8%	32.1%	18.0%	31.7%	31.6%	13.1%	15.8%	24.8%
Medium	33.0%	29.7%	33.5%	74.3%	62.4%	64.0%	84.1%	80.8%	71.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

While bank credits are a widely used financing instrument, high and unpredictable inflation and high collateral requirements limit their use.

Special Loan Programmes

- a) Foreign financing lines carried out through Romanian banks;
- b) Financing programs from own funds of Romanian banks;
- c) Other programs.

a) Foreign financing lines carried out through Romanian banks

There are several foreign financing lines carried out in Romania through various Romanian banks.

PHARE scheme

Since June 1999, three Romanian banks (CEC, Banca Romaneasca, Banca Comerciala Ion Tiriac) opened credit lines exclusively dedicated to SMEs with the support of the European Union that allocated to this sector the amount of EURO 5.75 million. PHARE credits for SMEs are granted over a period of 1 to 6 years and cover a maximum of 85% of the investment, the rest to be covered by the firm. Payment is done in quarterly instalments, after a grace period (3, 6, 12 months). Interest is set according to market rates and to the stipulations of the loan agreement. The credits are for tangible investments required for the modernization and development of existing manufacturing companies or for the establishing of new companies.

EBRD credits

EBRD signed in December 1999 an agreement with Banca Transilvania for the granting of short and medium-term credits to SMEs. Credit beneficiaries are to be Romanian private companies with up to 100 employees. Credit destination: investment projects, working capital, trade financing.

KfW financing line

Kreditanstalt fur Wiederaufbau (KfW), Germany has concluded loan agreement both with CEC, as well as with Eximbank. The first is for firms with up to 50 employees and has an upper limit of DM 100,000 for a period up to 2 years and an interest rate of 12-16% for credits in DM. The latter is for private companies with up to 250 employees. The credit upper limit is of DM 1 million over a period of 3 years.

RAEF small and medium-size loans

The Program for small and medium-size loans of the Romanian American Enterprise Fund is unfolded through Banca Romaneasca. The credit range is of USD 20,000-150,000, over a period of maximum 3 years and an annual interest rate of 15% payable in monthly instalments. Eligible are SMEs with less than 200 employees.

The private sector complains that the interest rates on credits remain very high; especially as for foreign credit lines there are many Romanian intermediaries (banks) that add their own margins and increase the cost of loans.

b) Financing programs from own funds of Romanian banks

CEC (former Savings Bank) offers short-, medium- and long-term credits to SMEs for credit lines, financing of stocks, operating capital and for equipment

(up to 85% of the investment value). CEC has participated in the tender organised by the Ministry of Labour and Social Protection regarding the unfolding of the SME financing line. It has also taken steps towards obtaining PHARE funds for operating and financial credits.

c) Other programs

- *Industrial Restructuring and Professional Redeployment Program* (RICOP), launched by the European Commission with the desire to help solve unemployment-linked problems. Within its five main components, RICOP has a SME financing component, which will be targeted towards job creation in 17 counties most affected by economic reform and involves a total financing of EURO 48 million.
- *Mining Affected Regions Restructuring Fund Program* (MARR) is a program financed by the PHARE program and is aimed at SMEs from the counties of Gorj and Hunedoara, affected by the mining restructuring program. The loans are for up to EURO 300,000. Eligible costs are mainly for tangible investments for the development and modernisation of existing or new enterprises.
- *Cooperative Housing Foundation micro-credit program*. This program targets for the moment the counties of Timis, Caras-Severin and Mehedinti and is financed by USAID. The loans granted are up to USD 20,000 with a repayment period of maximum 24 months. The specificity of this program is given by the fact that the amounts are given through associations to their members, on a revolving-type base. The program has been a success.
- *Program of the National Agency for SMEs* to support SMES in their marketing and exports.
- *Women Into the New Network for Entrepreneurial Reinforcement* project (WINNER), launched by DEVNET TIPS (international network for the promotion of business opportunities) and UNITEM (the UN Development Fund for Women). The program is designed as a pilot program for the support of women entrepreneurs and women managers from SMEs, support for their participation to new information and communication technologies (ICT) and e-trade;
- *ECOLINKS and CEEBIC programs* were initiated by the US Embassy in Bucharest and are financed by USAID. ECOLINKS offers to SMEs loans for financing feasibility studies and pilot-projects in the environmental field, while the CEEBIC program aims to supports trade links between SMEs from CEECs and those from the United States.

Venture Capital

Venture capital is regulated by Government Ordinance of January 30, 1998. Here are a number of venture capital funds operating in Romania, the most important being the *Romanian-American Enterprise Fund*. The RAEF was established in 1994 by the US Congress and was capitalised by a \$56 million grant from the United States Agency for International Development. RAEF is a private US corporation whose mission is to promote free enterprise and entrepreneurship in Romania through investments in and loans to small

and medium-sized enterprises. At present, the Fund has a Small Business Investment Fund, a Small and Medium Loan Program and a Micro Loan Program, besides the Major Transaction Program (which is aimed more towards bigger companies). RAEF has also transferred some of its know-how to the Romanian banks it works with in its loan programs.

The *Direct Investment Facility Program* was launched by EBRD as is addressed to SMEs from Romania, the Balkans and the Black Sea area. A consortium of firms lead by Euroconsultants of Greece administers the program. The investments can vary between USD 500,000 to USD 2.5 million over a period ranging from 3 to 5 years. EBRD participates directly in the social capital of the investing company.

Despite that a law on venture capital exists for some years now, no Romanian venture capital fund was set up, the existing ones being all foreign and set up with governmental or international institutions' support. Some of the reasons are not so much lack of funds, as lack of expertise and managerial skills in setting up and running such a fund. The state should encourage the setting up of such funds, through seed money and management skills.

Leasing

This is a financing modality through which the owner of an asset (lessor) grants another party (lessee) the exclusive right of use on that asset, usually over a determined period of time, in exchange for the payment of a fee. Leasing can be either *functional leasing* or *financial leasing*. Leasing companies were regulated through Law 90/1998 to enact GO 51/1997 on leasing operations and leasing companies and Title II of Law 99/1999.

There are already several leasing companies in Romania, the most important assets being leased being cars, computers, industrial equipment, buildings etc. This instrument should be strengthened, as it is a very good answer to the shortage of collaterals and the need of financing of SMEs.

Factoring

There are four banks in Romania that carry out factoring activities: Banca Comerciala Romana (BCR), Demirbank, Banca Romana de Dezvoltare – Groupe Societe Generale and Volksbank. While BCR and Demirbank carry out factoring both for exports and the domestic transactions, BRD carries out factoring only for exports, while Volksbank - only for the domestic market.

For example, BCR aims its factoring activity at SMEs. Activity started in 1998 and doubled, even tripled each year, with most of their clients being SMEs. Factoring is also a protection method that offers certainty of receiving payment as liabilities are sold to the bank.

Romanian legislation is nearly inexistent in this field, with problems appearing at repatriation of hard currencies that remain in the task of the economic operators although they are no longer responsible with this.

For a better use of this financial instrument we propose that it should be better publicised, increasing the awareness of SMEs as to its usefulness. Also there should be an improved collaboration with partner countries, with their adhesion to international factoring organisations like *Factors Chain International* in order for the banks to carry out the transactions in a regulated framework. For example, the BCR's factoring director complained that in

Bulgaria they had no correspondent, which impedes their activity in that relation.

Stock exchange The Bucharest Stock Exchange (BVB) could be an important financing source for medium-sized firms that are ready to go public. However, it is undercapitalised and with a very low activity. The local culture is also such that it is not seen as a viable instrument for attracting funds.

Grants There are also some grant schemes, of which we can mention the *Economic and Social Cohesion - PHARE 2000 Program* that is a joint EU-Romania program with a total budget of EURO 113 million, of which EU grants EURO 88 million. The program will be carried out through the Ministry of Development and Forecasting and the 8 Regional Development Agencies and will be aimed at supporting SME investments for the introduction of modern technologies, support for start-ups and SME development, and supporting SME access to unused assets resulted from the restructuring of state-owned enterprises. The financing per project will be between EURO 10,000 to 50,000 for a maximum of 18 months. The grant cannot exceed 60% of the project's total cost.

The *PHARE 2001 Program* is still being designed and will probably offer grants for start-ups and for SME cooperation projects, in total amount of EURO 132 million.

2.2. GENERAL ACCESS TO FINANCING

Small and medium-sized enterprises operate in a highly deteriorated environment in which barriers to their establishment and growth are very evident. Economic indicators show a macroeconomic environment characterised by continuous inflation, constant devaluation of the local currency against hard currency, reduced public and private investment, and decline in the GDP with an associated fall in the internal demand.

State monopolies and/or state dominance in many industrial sectors, mostly loss-making, prevents co-operation between small enterprises and large ones. A common feature is that large enterprises, particularly those in state ownership, tend not to respect their payment obligations and to pay slowly and late.

As a consequence of the eroded credibility, which makes it difficult for the country to borrow from the international financial market, the state is increasingly forced to borrow in the domestic market, with a crowding-out effect on the banking sector. This in turn has an impact on the amount of credit available for enterprise investment.

In the recent past, several surveys have investigated the difficulties that SMEs face in Romania.

Access to market

After the collapse of the previous internal market of the command economies, Romania has been forced to look for new markets. Currently, most import

and export is with EU member states. Access to both the domestic and the foreign markets, however, remains limited for a number of reasons: low quality of production, high cost and consequently non-competitive price, poor marketing including unattractive packaging, poor technical assistance etc.

In particular, however, Romanian companies are frustrated by the awareness that their products are not internationally competitive. They believe this to be caused by lack of modern equipment and reduced access to technology. This, in turn, is in part due to difficult access to investment finance.

Access to finance

Very often it is affirmed that access to finance is more important than the cost of that finance. Romanian companies do not seem to share this statement, as the cost of finance in Romania is prohibitive, with a considerable impact on the profit and loss account and thence the balance sheets. Projects would need to show a very high rate of return in order to cover an interest rate on loan that is, at present, around 15% annually on hard currency loans and 65% on local currency loans.

Leasing is not a widespread practice to access equipment, as it is in Western countries. Venture capital is a very selective finance instrument, which could not eventually have a massive impact on the SME sector. The available instruments, therefore, such as suppliers' credit, bank loans and enterprise trade credit, still represents the bulk of SME finance. Romania is still a case of a 'cash economy'. Most payments are on sight due to lack of trust and the material inability of suppliers to finance their clients. Bank loans are difficult to access in the first instance because of their high cost. Secondly, the specific situation of the banking system, which until the recent past had exceptionally high rates of default, imposes a tight financial prudence. The National Bank of Romania requires banks to cover loans with adequate collateral amounting up to the loan amount plus the amount of the first year interest rates, for example for a loan of ROL 100 the value of collateral should be at least ROL 160.

Given the long procedures for registering collateral, problems associated with collateralisation add to the cost issue.

Access to modern technology and quality supplies

Romanian enterprises have sufficient information on modern technology in the respective sector of activity. What is still underestimated is perhaps the importance of the know-how associated with each technology, e.g. the optimal layout of the working place where the machine is to be located, the maintenance schedule and practice of the purchased equipment, the quality of raw materials to use with a certain technology and how to do things right at the first attempt. Organisational issues in production and services are not dealt with effectively. A very low proportion of industrial assets are insured. Quality is still a critical issue both in services and manufacturing.

Access to public procurement

SMEs are under-represented as contractors in public procurement works and services, with the exception of the construction service. In other sectors, large state-owned enterprises or foreign enterprises have better chances

especially as they have the financial strength necessary to serve the public administration which, e.g., pays invoices off after a number of months.

Relationship with banks

SMEs claim that on the one hand Romanian banks lack professionalism and provoke them to waste a considerable amount of time. On the other hand foreign banks established in Romania are not interested to serve the SME sector. Costs of banking transactions are very high, for example as far as it relates to transactions in foreign exchange. The problem of the requirement for very high levels of collateral for bank borrowing is seen as a major issue that demands the attention of Government.

SMEs have a restricted access to financing, due to barriers like:

- Lack of technical skills required for drawing up a viable business plan;
- Lack of information regarding alternative sources of finance;
- Low possibilities in offering credit collaterals;
- Banks and venture capital funds prefer financing big firms, due to transaction costs;
- Interest rates are high (small businesses, high risks);
- Big companies have also access to other financing sources, while small firms do not.

Table 8 Financial ratios⁹ in the SME sector by type of ownership

<i>Type of ownership</i>	<i>Liquidity ratios</i>		<i>Solvability ratios</i>			<i>Profitability ratios</i>		
	<i>Current ratio</i>	<i>Quick ratio</i>	<i>Debt ratio</i>	<i>Cost of credit</i>	<i>Debt to equity</i>	<i>Net profit ratio</i>	<i>Return on assets</i>	<i>Return on equity</i>
1997								
Private	1.3	0.9	3.1	0.05	0.6	0.06	0.06	0.66
State-owned	1.3	1.1	1.2	0.03	0.1	0.02	0.04	0.05
Mixed	1.3	0.9	1.9	0.05	0.3	0.06	0.12	0.29
1998								
Private	1.2	0.8	2.9	0.03	0.7	0.04	0.10	0.39
State-owned	1.3	0.9	1.0	0.07	0.4	0.03	0.02	0.03
Mixed	1.2	0.9	2.3	0.04	0.6	0.04	0.09	0.27
1999								
Private	1.2	0.8	3.5	0.04	0.9	0.04	0.08	0.38
State-owned	1.0	0.8	1.7	0.05	0.8	0.03	0.02	0.05
Mixed	1.2	0.8	3.1	0.04	0.9	0.04	0.07	0.30

Source: ANDR – *The private sector of small and medium-sized enterprises in Romania, Report, Nov. 2000*

The financial ratios in the SME sector show that:

- Liquidity ratios are quite the same both in private as in state-owned or mixed firms. As an exception, a higher quick ratio (1.1) in the state-owned sector was gained in 1997, that fell to 0.8 by 1999;
- Private SMEs registered higher debt ratios, while state-owned ones had the lowest debt ratios;
- Debt to equity ratios increased constantly during the three analysed years;
- Net profit ratio was higher in private and mixed firms;
- Return on assets was also higher in private SMEs.

3. RECOMMENDED FINANCIAL INSTRUMENTS FOR THE DEVELOPMENT OF THE SME SECTOR

3.1. TYPES OF INSTRUMENTS

There are several financial instruments that could prove valuable in SME financing.

Mutual Funds

Mutual funds function based on collective and joint responsibility of the member companies. Each member participates with a certain amount to the fund's capital. From ICES discussions with representatives of business associations, the latter seemed extremely interested in such type of financing. ICES has also supported together with the Corporation for Enterprise Development of a study tour in the USA of a group of Romanian consultants on the topic of rural mutual credits. A law on rural credit is in Parliament at this moment, even though it was initiated in 1996.

Here, an alarm signal should be the negative experience with the credit cooperatives that changed themselves into popular banks and used non-prudential banking procedures, being on the verge of collapse when the National Bank obliged them to enter under its supervision. Romania has been hit by a series of scandals regarding both banks, as well as other financial institutions, and these scandals had a negative impact on the financial market. Thus, supervision of mutual funds should be strict and clear procedures should be set from the beginning, including the obligation of re-insurance.

Credit Guarantee Funds

Such schemes should be expanded. A success story is the existing *Rural Credit Guarantee Fund*.

Microcredits

Micro-credit programs can have a great impact on the welfare of a society as they address the poorest, which are helped to set up a small business. In Romania, such programs would be beneficial in areas most affected by poverty and unemployment, like rural areas, small mono-industrial towns, regions most affected by economic restructuring. They can be addressed to the unemployed, to young people in search of a job, to women or to older people that cannot any longer adapt easily to the job market, but who wish to set up a small venture.

The problems confronting micro-crediting schemes in Romania are¹⁰:

- Absence of legislation in the field and of Central Bank norms accepting the unfolding of such schemes through non-financial institutions (NGOs, cooperatives, community organisations etc.).
- Lack of interest from banks in working with small clients due to high

transaction costs.

- Lack of banking infrastructure in rural areas and small towns.
- Lack of adequate financial knowledge on the part of possible micro-credit users that further limits their access to credits.
- Inflationary environment that erodes the revolving funds involved in micro-credit schemes.
- Reduced community activity, passive and fatalist attitude towards poverty.

In order to deal with such issues, support should be given not only towards provision of funds for micro-credit schemes throughout the country, but also for technical assistance to increase financial and business skills in potential borrowers, to implicate the local community more actively and to increase the capacity of existing NGOs or associations to carry out such type of financing schemes. Micro-crediting carried out through local business associations could be developed, although the National Bank of Romania does not consider such associations mature enough. However, some pilot micro-crediting schemes have been set up and have proven to be a success.

Regional and Local Venture capital funds

A regional venture capital fund could attract donor funds and could also increase links among the countries in the region, while local venture funds, set up at the level of regions within the country, could benefit from better knowledge of local conditions. Such local funds could be started with seed money and would also attract funds from local small investors by going public on the stock exchange.

Angel Capital Networks

In addition to friends, family relatives, and business associates, angel networks can provide SMEs with access to prospective investors who are likely to become involved in private financings (i.e., supplying capital for start-ups, expansions or transfers of business ownership).

Angel networks are a loosely-defined array of organizations that facilitate initial contacts between entrepreneurs and investors. Generally, they are non-profit ones. Angel networks do not act as brokers or investment advisors and they do not become involved in completing or structuring transactions. After introducing entrepreneurs and potential investors, angel networks leave all further interactions to the parties involved.

It is hard to delineate angel networks precisely. They tend to vary in size, composition and orientation. Entities that become involved in angel networks include businesses, academic institutions, government agencies, economic development authorities, and profit making entities.

Angel networks do facilitate the provision of significant amounts of capital to fund start-ups and expansions. Typical angel investments range from \$10,000 to \$500,000 and sometimes approach \$1 million. Every year in the U.S., approximately 250,000 angels bankroll 20,000 companies. Throughout the years, angels invested at least \$10 billion.

Although there is no central tracking of angel networks or their participants, there are certain characteristics that can help determine the probability of a network's success. The most effective angel networks tend to be older with established credibility. There is, of course, a correlation between the number of people involved in a network and its success. Successful networks employ experienced staff and have sufficient funds to engage in aggressive marketing activities.

With respect to the angels themselves, research indicates that most are self-made, high net worth individuals who have built up their own successful businesses and are interested in putting their expertise and money into other entrepreneurial ventures.

The legal issues involved in soliciting capital through angel networks are generally the same as those involved in dealing with investors.

Angel capital networks can be set up through existing associations, like employers' associations, SME consulting centers, producers' associations etc.

4. CONCLUSIONS AND POLICY RECOMMENDATIONS

In a situation of scarce resources, support actions will need to be prioritised with clear selectivity criteria and the procedures for implementing and administrating support measures will need to be transparent and with full accountability. The actions should be addressed towards:

1. Developing specific proposals and actions to enhance access to finance;
2. Creating initiatives to enhance access to technology and information and to encourage innovation;
3. Provide support to promote exports and to improve SME skills to operate on the international market;
4. Concentrating grant funding on specific areas such as quality improvement, technology or productivity improvement, environmental control, export marketing, management training etc;
5. Improving the regulation of non-bank funding sources.

There is a stringent need to find ways of improving access to finance and particularly to address the problem of collateral for loans, improving access to the capital markets, leasing etc. There is also need to support start-ups and infant micro-enterprises, technology and innovation transfer/dissemination projects, quality improvement and quality insurance systems development, marketing activities, environmental control, energy saving and cooperation among enterprises projects through micro grant schemes.

There should be a focus on the following financial instruments:

- Guarantee funds;
- Mutual credit funds;
- Venture capital funds for SMEs;
- Angel capital networks;
- Micro-credit schemes.

Improving SMEs' access to financing depends both on general and specific measures. General measures imply stability in implementation of policies; simple, consistent and stable legislation; low inflation; modernisation of the payment systems in the banking sector; stricter enforcement of contracts and decrease in inter-enterprise arrears. Specific measures could comprise¹¹:

- Support start-ups and infant micro-enterprises, technology and innovation transfer/dissemination projects, quality improvement and quality insurance systems development, marketing activities, environmental

control, energy saving and cooperation among enterprises projects through micro grant schemes;

- Establish micro-credit schemes for SMEs;
- Establish low interest medium and long term credit schemes for SMEs;
- Promote the use of bills of exchange and promissory notes;
- Address in a comprehensive and coherent way the loan collateralisation issue;
- Support the establishment and operation of regional guaranty funds for SMEs and set up a re-guarantee mechanism;
- Create a banking system friendly to SMEs;
- Improve financing-related skills in the SME sector.

Supervision institutions should also be strengthened and clear procedures should be legislated. Attention should be given to a wide dissemination of know-how and expertise both of the financing institutions and of the SMEs themselves.

PRACTICE AND PROSPECTS OF SME FINANCING IN SERBIA

Zvonko Brnjas, Ph. D., European Movement in Serbia

INTRODUCTION

The SMEs in Serbia in their current operation nowadays still face quite a variety of financial, legal and other related problems and obstacles. Those difficulties are mostly not, so to say, SME-specific, but rather appear to be shared by most other sectors and functional segments within the national economy. Perhaps the most evidently acute one has been an overall shortage of financial resources even for maintaining the recurrent business operation, nothing to say of developmental undertakings. This is why at the very beginning of this paper we must stress that any researcher faced with the expectation to do his best in presenting the SME financial and operational practices based on recent Serbian experiences, could not avoid a feeling of being rather handicapped as compared to those responsible for presenting cases of most of other countries (even of most among those classified still to be in transitional phase) – if for no other reason, then because of the very much distorted overall economic situation, as well as due to the related shortage of many relevant data concerning the SME business operation and development.

The case of Serbia could, unfortunately, serve more as an example and experience out of which the lessons could be taught on how to avoid (or in some more fortunate cases) to overcome problems and difficulties. On the other hand, the overall results of this Conference, as well as the herein presented experiences of other countries in transition that have already gained some experiences in developing systems of SMEs financing, could be greatly helpful for the expected reforms in Serbia and in Yugoslavia as a whole.

1. AN OVERVIEW OF THE SME SECTOR IN SERBIAN ECONOMY

It is well known that Yugoslav ideology of socialism and corresponding economic philosophy were for the most part after the World War II fairly specific and rather different in comparison with other socialistic countries. The Yugoslav socialism in the most part of this period was structured in the form of so called self-management system. That system had had its own specific features, including among the others developing of a specific form of market economy that was rather open in terms of mobility of goods, capital and labour between enterprises and other economic entities, but hardly within them. However, in respect to the herein topically relevant subject matter: the small business entities (SMEs) - that system anyway remained almost equally unfavorable in Yugoslav economy as it was in the other types of socialist economies - primarily in the sense of their marginalization.

The self-management system had been gradually developed throughout the period since early fifties until the late eighties of 20th Century. In spite of the official Yugoslav "power to the workers" philosophy of economic development, yet the respective economic policies had been mostly concerned with the well-being of the so called "development priorities": mostly large, "socially owned" enterprises, and hence, heavily supported by the state, too. Some of them appeared to be fairly successful, but by and large, most of them eventually turned to be the so called "white elephants", since draining scarce capital resources for the sake of achieving eventually fairly poor effects.

On the other hand, the SME in Yugoslavia increasingly appeared in practice to represent the private sector "residual" within the manufacturing and servicing sectors of national economy. So, throughout that period the SMEs in Yugoslavia were mostly confined to the private sector¹, and to some extent to the cooperative sector, too.

Occasionally, the SME firms were also (at least rhetorically) praised for providing at low costs the new employment and incomes, but in reality, for most part, that sector of economy was left "on its own", i.e. hardly without any effective support by either the government policy measures or by the banking system financial support.

1.1. THE DEFINITION AND TYPOLOGY OF THE SME SEGMENT OF SERBIAN (YUGOSLAV) ECONOMY

The small and medium-sized enterprises in Yugoslavia have been defined by the Act on Accounting. There have been established the following three criteria for classification: (a) Number of employees: less than 50 employees

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One should keep in mind that this protracted negligence of the SMEs and private sector as a whole were not incidental. Namely, that was an effective methods for ensuring an absolute predominance within the national economy of the so called "socialist sector" - since it was ideologically considered to be by far more socially just and economically advantageous form of organizing economy, than meddling with the petty and "outside the system" private sector.

- are to be considered as small firms; from 50 to 250 - as medium-sized firms; over 250 employees - as large firms; (b) Total annual revenues: enterprises with total revenues equivalent up to 8 thousand average monthly gross salaries in Yugoslavia are to be considered as small firms; between 8 to 40 thousand - medium-sized firms; more than 40 thousand - large firms; (c) Average value of disposable assets: enterprises with assets equivalent to less than 6 thousand average monthly gross salaries in Yugoslavia, are to be considered small firms; between 6 and 30 thousand - medium-sized firms; and with more than 30 thousand - large firms.

The afore described "Cinderella" position of SMEs and of the private sector entrepreneurship, started being gradually abandoned after the introduction of the Federal Act on Enterprises for the entire former SFRY at the end of year 1988. That Act helped that differing approaches to the issues related to SME and the private sector operation in all republics of former Yugoslavia could start getting mutually adjusted. That fact (notwithstanding the dissolution of the Federation that took place a few years later) - at least initially contributed that processes of founding and further developing of large numbers of new privately owned SMEs within the economies of all new states that emerged henceforth.

In Serbia those processes, in spite of the very much unfavorable political and macroeconomic environment throughout the nineties', resulted in very wide coverage of a variety of private firms types that nowadays constitute by and large the most viable segment of the contemporary business scene in Serbia. Among them, the most typical are the following: (a) Traditional private firms that either survived the entire period of socialist economy or were formed during that period. The most among these have been micro-firms in terms of size, and practically without employees - except for the owner himself and mostly one or two assistants - usually the family members. Sectors of their operation have been related usually to traditional handicrafts, household supplies and services, personal services (barbershops, tailors, etc); (b) New private firms, formed on the ruins of larger so called "socially owned" firms, that failed in surviving turbulent times - including some ex-large corporations with monopolistic position in their particular field of foreign trade; (c) Private firms established for speculative purposes, i.e. the firms of such a character are those established by individuals who at the same time were employed in some large (still active) "socially owned" firm, and having a position sufficiently influential to ensure for their private firms certain exclusive (monopolistic) contracts or just to facilitate some corruptive activities; (d) The phantoms firms, created by people who were planning to do some business, but never started. There are tens of thousands of firms that are registered but inactive. It is interesting that because of the high costs and somewhat complicated procedures for establishing new units, the registered firms themselves have become the subjects of trading; (e) Successful private firms, i.e. the ones that are making sizable or even large profits for their owners.

Generally, this group of firms could be divided into two subgroups: the subgroup of those (i) firms originating from powerful oligarchic groups, close to the top of regime's pyramid (or from the regime itself). Some of those firms have actually by far overgrown the SME size, already becoming major

conglomerates or at least companies in some strategic field (cellular telephone networks, trading some strategic minerals and other raw materials and alike). The other subgroup of these successful firms could be considered to be (ii) authentic privately owned entrepreneurially oriented firms, i.e. being developed by authentic entrepreneurs. Currently, most of those firms are in terms of size represented by medium-sized enterprises.

When speaking of creating a supportive system for SME development, one should have in mind this kind of situation in Serbia. If we want to have really effective system of support, and to get optimal effects from the SME development, the subgroup of SMEs that we had defined as a group of authentically privately owned entrepreneurially oriented firms should be specified as a specially relevant target group for these measures.

1.2. THE ROLE AND IMPORTANCE OF THE SME SEGMENT OF SERBIAN ECONOMY – FACTS AND FIGURES

Although there is a variety of information sources on SMEs (like: Republic Statistical Offices; the chambers of commerce and business associations of private firms and entrepreneurs at various levels: republic, regions within Serbia, the City of Belgrade, etc.; the National Bank's Office for Payment Accounting, etc.) – yet, there are lots of problems in collecting authentic and coherent data. Each one of these institutions adjusts data collecting according to the specific requirements and criteria. The result is a relative plentitude of data, but mostly of relatively limited analytical quality.

Yet, those limitations are not of such a nature that they could make any analysis based upon available or estimated data concerning those units of tiny business impossible. We could assume with a fair confidence that it is analytically acceptable to draw at least some “grosso-modo” conclusions based upon the analysis substituting the required (and unavailable) data on SMEs in Serbia.

Table 1. contains data on the number of SMEs in Serbia, including data on micro-firms (so called Individual shops). Their share is dominant: those units account for over 70% of total number of firms; small and medium-sized firms account for around one quarter of the total, and large - less than a half of the total number of firms.

TABLE 1. TOTAL NUMBER OF SMEs AND DISTRIBUTION BY SIZE

Types of Firms Years	Micro	Small	Medium-sized	Large	Total
NUMBER OF FIRMS					
1994	187.544	62,377	3,049	1,297	254.267
1995	183.087	66,419	2,694	1,093	253.293
1996	183.870	69,187	2,532	995	256.584
1997	184.649	68,061	2,402	917	256.029
1998	185.542	68,454	2,429	896	257.321
1999	186.731	62,333	2,411	920	252.395
PERCENTAGE					
1994	73.7%	24.5%	1.2%	0.5%	100.0%
1995	72.3%	26.2%	1.1%	0.4%	100.0%
1996	71.7%	27.0%	1.0%	0.4%	100.0%
1997	72.1%	26.6%	1.0%	0.4%	100.0%
1998	72.1%	26.6%	1.0%	0.3%	100.0%
1999	74.0%	24.7%	1.0%	0.4%	100.0%

1.3. SMES CONTRIBUTION TO EMPLOYMENT IN SERBIA

According to the official data, large firms are still major employment generators: still accounting for more than 50% of total employment. The small firms account for 22.3% and the medium-sized ones - for 22,1% (Table 2).

TABLE 2. Contributions of the SMEs to total employment

Types of Firms	Number of Employees 000 of employees	%	Number of Employees 000 of employees	%
Micro firms	-	-	373.4	21.2%
Small firms	306.4	22.3%	306.4	17.5%
Medium-sized firms	305.3	22.1%	305.3	17.4%
Large firms	768.1	55.6%	768.1	43.8%
TOTAL	1,379.8	100.0%	1,753.2	100.0%

According to these data, the role of the large firms in the national economy is considerable. However, these data could be questioned from several aspects, i.e. some facts indicate a gross-overestimate of the large firms' role: (a) the first one refers to overestimate of the number of employees actually employed in large firms. Quite a number of them are still officially considered to be employed but they have either no real work to perform, or had been sent to the so called "compulsory holidays" (paid symbolically or unpaid); (b) the second refers to underestimate of the number of employees in SMEs. Because of the very high costs of employment (the taxes and

contributions calculated over the net-salaries are reaching over 100% above the basis) lots of SME employees are not registered at all, i.e. work illegally. This kind of employment is mostly characteristic for the so called "Individual Shops", with quite a common practice to hire workers in this way. (c) Finally, as a consequence of all that, lots of people are working in "black" or "gray" zone, i.e. are making for their living in informal sector.

There are estimations that, when taking into account all these considerations, more than 75% of employed people are working in SMEs (including the micro firms).

1.4. THE MAJOR PROBLEMS AND LIMITATIONS FOR DEVELOPMENT OF YUGOSLAV SMES

The Privatization Process

Although Serbia (Yugoslavia) had started the process of privatization at the end of 80-ies, due to the unfortunate sequence of events, it was stopped and even reverted, so at this moment the whole process is almost at the beginning. In December 2000, out of 7.5 thousand companies that should be privatized (around 4,000 socially owned firms, 3,000 firms in a status of mixed ownership, and 500 public companies) - only 5% entered that process.

The main features of the privatization process in FRY are the following: (a) due to the strong influence of external uneconomic factors, up to now, the privatization has taken the form of internal distribution of shares - the so called: "workers' shareholdings" i.e. without participation of foreign subjects, and consequently without injections of new "fresh" capital; (b) the process has got to some extant features of "muddling through"- the most striking example was revalorization that took place in 1994, in which capital, privatized up to that time, was actually reverted to socially owned; (c) finally, there is no clearly expressed interest for accelerating that process: from the side of workers, because it is not realistic to expect any capital gains as well as dividends from shares; from the side of the banks, because they do not know what to do with the companies; from the side of Government, because it could eventually face social problems that could be expected after acceleration of the process.

This kind of consideration is reflected also in the Government newest Law on Privatization Proposal that is already prepared and is supposed to be passed through Parliament procedure in the coming months. The proposal is based on concept of "strategic partner", i.e. the focus is on finding the partners for the firms that should be privatized. The idea is to give the advantage to the partners in privatization process in exchange for providing socially acceptable programs that would include preserving the work positions, new investments in firms, and alike. The deadline for finishing the whole should be 4 years.

The Fiscal System and Policies

From the point of view of SME development interests in FRY, generally speaking, the current effective fiscal system and accompanying policy measures are relatively unfavorable. The system is rather complicated, nontransparent, and without any specific element stimulating for SMEs.

However, according to the opinions of most of entrepreneurs, the tax system is of considerable importance for doing business in FRY, but it is certainly not the critical one. Namely, this factor is not the one upon which the ultimate or vital decisions depend, like those concerning starting or quitting business, expanding and employing new people, etc. In other words, the other issues appear to be of much greater importance, especially those concerning overall conditions and possibilities for financing business operations.

For the SMEs, as for all the other enterprises, taxes and excises on traded goods, as well as taxes on personal incomes of the citizens are the most important. The Act on Taxes upon the Value Added (as a fiscal instrument commonly applied in market economies) was introduced in Serbia, too, but its implementation has already been several postponed times. According to the officially declared fiscal policy intentions of the new Government of Serbia, that Act is to be introduced by the beginning of the year 2002. Another group of charges creating a considerable burden to enterprises are the taxes and contributions for pensions and health insurance that are connected to personal incomes of employees. Aggregate amounts of these charges are even somewhat exceeding the aggregate amounts of wages and salaries, i.e. the index of those charges slightly exceeds 100% of its basis.

The Underdeveloped Institutional Infrastructure Supporting the SMEs

Capital market. The capital market has already been institutionalized in former Yugoslavia, and at the end of 80-ies the turnover of the securities (mostly National Bank' securities) at the Belgrade's Stock Exchange reached considerable amounts. The capital market in contemporary FRY is legally based upon the Act on Securities from 1994. At the moment in FRY (Serbia), the Belgrade's Stock Exchange, as well as The Money Exchange Market are active. The activity of the first is focused on trading the variety of long-term bonds, and of the second one - upon trading short-term securities.

The most salient feature concerning functioning of these institutions in Serbia during the last decade was the absence of real securities for trading. The transactions have been restricted only to: (a) ad hoc operations with certain National Bank securities (mostly the short-term bonds and alike); (b) from time to time with short-term securities issued by some commercial banks; and quite rarely: (c) very small quantities of bonds and shares issued by some companies. However, the only operation that has been performed continuously all the time, was short-term lending cash money at enormously high interests rates.

The shares were not traded because: first, the number of firms that were privatized and consequently the amount of shares was symbolic; and second, the established legal regulations banned trading the issued shares before expiring a specific time-period. Hence, it could be concluded that capital market has been functioning in the "gray" or even in the "black" zone, circumventing banks and other regular channels of financial flows.

Labor market- Generally, the labor market in Serbia has functioned under heavy influence of very restrictive factors such as (a) heavy unemployment (the official figure of unemployment is 30%, while there are estimates that there are additional 20% of hidden unemployment); (b) underutilization of

the industrial capacities (in some cases, it has been reaching not more than 10%-15%); (c) delaying the privatization process which made possible strong political and psychological impacts of former socio-economic system of self-management, as well as the correspondingly old management structures to be preserved.

Heavy imbalances between the demand and supply of labor has caused the development of enormously large shares of "gray" and "black" economy, at which most people, the unemployed ones, as well as many among the officially employed, are actually making the bulk of earnings for their living.

The process of "brain-drain", i.e. the outflow of many young, and as a rule: mostly people, who are educated, talented, and with strongest entrepreneurial spirit and skills - could be considered also as a part and consequence of dramatic hardships (that have been reflected in irregularities of the Labor market) that FR Yugoslavia has experienced during the last decade of the 20th Century. There are reliable estimates that over 400 thousand young people have left FRY during 90-ies.

The SME consultancy support. The network of institutions that are supposed to deliver activities supportive to the SME development is rather weak, fragmented and generally poor (in quantity and quality) in its offer of the corresponding services.

The institutions that have been traditionally involved in different activities aimed towards SME and private firms are the Chambers of Commerce (at the levels of Federation, the two Republics and for the regions within Serbia), i.e. some "specialized" departments within them. They are usually called "Department for Small Business and Entrepreneurship". Unfortunately, up to now they did not have real credibility among authentic entrepreneurs and SMEs. Therefore, those institutional arrangements have been usually considered as a sort of additional burden (the Chambers are being financed through obligatory contributions of the members that are being paid out of gross salaries of the employees). On the other hand, those departments have not been properly equipped in terms of people and resources, and their activities have been mainly limited to preparing informative materials of general nature, e.g. on changes in legal environment, economic trends, etc.

2. THE CURRENT STATUS OF SME FINANCING

One of the major reasons why it appears to be difficult to discuss this component of SMEs economic environment in Serbia, is that throughout the prevalent part of the last decade, any kind of financial support to SME had been almost absent. Hence, the situation with the SME financing in Serbia within that period could be summarized in the following way:

- The most striking feature of situation with SME financing in Serbia until quite recently had been certainly a severe shortage (or, more precisely, an almost complete absence) of disposable financial resources within the banking system for any sort of effective SME developments. The most convincing indication of such a situation has been (i.e. presently still effective) the extremely high interest rates for borrowing money (calculated at the monthly basis, those rates have been fluctuating from 5% to even more than 10%). This could be partly explained by an overall insecurity, and hence by high risks for lending money for private investments in Serbia. Another, until quite recently effective factor, had been the high inflation, as well as non-transparency of most financial transactions. Yet, ultimately, the most influencing factor has been the overall shortage of free financial resources.
- Exclusion of the banking system from SME financing. The banking system has been chronically kept in a very difficult position, and its promised restructuring (implying first of all the proclaimed ownership transformation and accompanying financial recovery of banks) has never been seriously attempted. Hence, in spite of good intentions and the SME-favorable policies, a number of times proclaimed since the beginning of 90ies, the banking system by and large has remained excluded from the SME financing.
- The Non-transparency of Financial Flows. On the other hand, in spite of official data, indicating a total absence of financial funds for SME operations, some respectable business operations implying engagement of considerable financial resources have been certainly taking place within the economy, including some privileged parts of the private sector and SMEs. The main feature of those activities has been by all means the fact that the funds for that sort of financing are completely nontransparent, and one could only guess that those funds have been distributed mostly according to the non-market criteria (to political allies, friends, relatives, etc.) - meaning also: under a strong impact of corruption.
- Growing impact of informal or anonymous sources of financing ("gray" and "black" market). During the 90'-ies, a large part of Serbian economy, due to the circumstances outside its control, had slipped into the "gray" and/or "black" zones of operation; hence, this being applicable to the SME financing activities also. Namely, the extremely high unemployment rates have forced many people to seek ensuring their subsistence through self-employment. Of course, they were forced to tackle that problem

through private borrowing, first from relatives and friends living abroad, and then from some domestic usurers (mostly illegal, or semi-legal) that have been charging extremely high interest rates and by ensuring their loans with much larger real estate mortgages - including rather specific punitive methods of effecting the overdue repayment charges). Since there are not available official and transparent data on this form of financing, it is difficult to make any reliable guess of the aggregate amounts involved, but the presence of this form of SME financing is quite evident and quantitatively certainly rather significant.

The described features of the financial resource (capital) market for SMEs in Serbia had become evident to the point of making a major impact upon Serbian economic scene during the last decade (most of the 90-ies) and, of course, they are to some extent still present. However, nowadays in Serbia, as a result of political changes taking place since October 2000, the strong conviction prevails that this kind of situations, representing the parts and parcels of history's misfortunes - are being gradually but definitely left behind. Therefore, instead of elaborating further upon those unfortunate experiences, we would rather turn forward to the newly adopted or incoming policies and corresponding practices. Of course, by and large those practices have not yet become developed and effective to the point of allowing us to talk about a completely new situation, but at least we could talk about "the early signals" of those new practices.

The "earliest" among those signals seems to be the practice of micro crediting, that has been introduced in Serbia even before last October. The first micro-credits were released in Serbia a few years ago within UNHCR programs for refugees' aid. Micro Financing Bank was the first foreign bank to start its operation in Serbia last month. . The only domestic source for SMEs financing during the 90-ies was The Republic's Labour Market Support Office. The Republic's Agency for SME developments has also been established recently. One of the first initiatives to be launched (together with institutional support and some personal involvement of the authorized Serbian Government ministers and other officials) was to capacitate the Agency to establish and put into operation The Fund for Financing SME Developments. The activities of the Fund, are initially (for political reasons and due to scarcity of resources) limited to the, until quite recently, troubled region of southern Serbia. A month ago the establishment of The Fund for Exports Promotion was also initiated, which was also mostly the result of "positive pressures" exerted by the Government of Serbia. Finally, some of the well standing commercial banks are becoming also increasingly active in working with SMEs (though still within the rather limited and restrictive frameworks) at the capital market scene.

2.1. MICROFINANCING

Microfinancing, as well known, has already become quite a widespread form of SMEs financing throughout the world: from underdeveloped countries, to the most developed ones. There is already very good experience in ex-socialist countries, even in Montenegro, still the second member of Yugoslav Federation. Yet, the practice of microcrediting (or

microfinancing) still represents in Serbia a relatively unknown form of SME financing.

UNHCR microcredits

Actually, the UNHCR has already been releasing micro credits in Serbia to the refugees through mediation of altogether 6 agencies for quite some time. Strictly speaking, those activities do not belong to the category of microcrediting in the sense microcredits usually do have. Namely, since only the registered refugees are eligible for utilizing those microcredits, it is obvious that here the banking and humanitarian principles are being mixed. That is probably the main reason why those credits in Serbia are not so efficient in terms of the main banking criterion (the repayment rate), as those credits usually are (on the other hand there is an example of Montenegro, where the rate of unpaid microcredits is just about 1%).

Conditions

The credit is aimed to individuals who have the status of refugees. They are expected to submit to the UNHCR the standardized Application Form to the MicroFinS (the NGO that services the credit line). This form contains information that should be considered as a simplified Business Plan.

The amounts of credits to be lended start from 2,000 DEM for the first year of crediting. If the debtor timely repays that credit, he becomes eligible for applying for another credit, now of 3,000 DEM. After repaying this credit, too, the beneficiary could finally apply for amount of 4,500 DEM.

It is allowed for two persons from one family to apply for credits but they should apply for separate programs. It is not possible to apply as a group for one program in order to multiply the amounts of credits drawn.

The collateral security is a mortgage, but also the bill of exchange. There is no interest on this credit to be paid – the only cost is 1.5% that is supposed to be paid as a service charge to the Agency.

Generally the UNHCR credits are considered as very soft, and the rate of credits that are paid back is not high.

In the year 2000, the total amount of credits approved and drawn was cca USA \$ 2 million.

Yet, this experience in Serbia, even in terms of numbers and amounts of released credits, appears to be fairly important and valuable: first, for the sake of refugees and the benefits they have been drawing out of this; and second, because this practice helps training and introducing of loan officers, specialized for microcredits. These people are by all means, with short additional training, soon gradually to become capable of performing professional assignments concerning much larger and more complex microcredit programs in Serbia.

Micro Finance Bank

Micro Finance Bank started working in Serbia a few months ago. The Bank has been founded by several international financial institutions and banks:

- The European Bank for Reconstruction and Development (EBRD) which is the larger shareholder with 33.3%,

- Creditanstalt für Wiederaufbau (KfW) (16.7%), i.e. The Credit Bank for Reconstruction from Frankfurt;
- Commerzbank AG (16.7%), one of the leading European banks;
- Nederlandse Financieringsmaatschappij voor Ontwikkelinglanden (FMO) (16.7%), i.e., Dutch Organization for Development Aid to Foreign Countries;
- International Micro Investition AG (IMI) (16.7%) i.e. The International Organization for Microinvestments.

The total initial value of the project is supposed to be around US\$ 21.5 million and the contribution of the EBRD is supposed to be US\$ 7.0 million. At this moment, the paid share capital amounts up to US\$ 6.0 million. The bank is being run (in terms of operative management) by the group of managers of the German consulting company International Projekt Consult (IPC) and of Commerzbank AG. The Bank has its staff of 60 banking professionals.

According to the explicit statements laid down in the Bank's official papers, the main mission and goal of the Bank is to give its contribution to the Serbian SMEs development by the means of their crediting.

Conditions of the MFB crediting

- The credits are available for all legal types of firms, even for the small owners of the open-air shops.
- The pre-condition for giving eligibility to any firm is its active business operation for at least six months before becoming qualified to apply for the credit.
- The amounts available are from 500 DEM to 100,000 DEM.
- Repayment periods are the following:
 - up to 18 months, for credits for working capital (amounting up to 20,000 DEM),
 - up to 36 months, for credits for fixed capital (amounting over 20,000 DEM)
- The monthly interests rate is 2.5%.

2.2. THE REPUBLIC'S LABOUR MARKET SUPPORT OFFICE

The very illustrative example could be also the experience of the Labor Market Support Office (LMSP) established by the Republic of Serbia. Activities of that Office have been focused upon resolving the labor problems, providing certain support for the unemployed, helping them to get new job by financing professional reorientation, giving financial incentives to employers to employ new workers, and alike. The funds have been alimeted from obligatory contributions charged from wages and salaries of all employees and its function has been to support the new employment of the unemployed.

In situation of total absence of any other development funds, this fund for a

number of years during the 90-ies appeared to be practically the only Government-sponsored available source for financing SMEs. But generally, the functioning of the Labor Market Support Office, while definitely having some positive effects in financing the SME projects (certainly, rather modest - having in mind the needs), has also been facing lots of problems. According to the complaints, most often stressed by the authentic SME candidates for beneficiaries, the major problem concerned application of non-transparent criteria for project evaluation, as well as of the procedures for project selection, and hence, also of (the officially established) corruptive practices. Largely due to these distortions in operation and funding activities of the Office the support has been often given to economically not viable projects.

Through the whole period of 90-ties, the Fund of the Republic's Office for Labour Market has been practically the only one active fund for SMEs financing in Serbia. The Fund was introduced in 1994 and was relatively active (with the exception of a few months pause during the last political changes in Serbia) throughout the entire period since its establishment.

The Statutory Acts as well as the current reports of LMSP, have explicitly stated several goals as "priorities" that should be achieved in their activities. Those are as follows:

- affirmation of the SMEs' development philosophy and practice;
- supporting the development of a service sector;
- improvement of the existing profitable programs;
- restructuring of the existing SME production and labour, and
- supporting agricultural development.

The goals were (and still are) formulated in a rather descriptive and vague way: there are too many of them and it is not clear what the real (if any) priorities should be. However, by definition, i.e. by the very nature of its activities, the key targets of the LMSP and consequently of its financing of the SME programs were focused upon decreasing unemployment by the following two approaches:

- Employment increase through financing the employment programs in order to change the labour supply and demand structure in favor of professionally trained personnel (especially the young ones) for specific jobs.
- Solving the problem of structural unemployment by opening the new posts for the unemployed and redundant labour - via personnel training, vocational re-training and with a constant innovation of knowledge.

Conditions. The Fund has been releasing money in the form of grants: it is not supposed that it would have to be paid back.

Amounts. At this moment, the amount of DEM 600 - 1.800 is approved for each person, depending on the category:

- | | |
|-----------------------|-----------------------------|
| 1. Unemployed persons | 18.000 dinars
per person |
|-----------------------|-----------------------------|

2. Unemployed parents	24.000 din. p.p.
3. Self-employment of founders	30.000 din. p.p.
4. Unemployment compensation beneficiaries	30.000 din. p.p.
5. Disabled persons	54.000 din. p.p.

Types of investment programs financing. There are two types of investment programs eligible for financing by LMSP fund: the first one is the self-employment programs and the other one concerns the programs for employment of disabled persons. In practice, the second refers to quite a specific situation and is relatively rare: out of 3.365 programs approved, only 75 (or 2.2% of the total number) refer to this type of programs.

In the year 2000, the Labour Market Office took part in financing of 3.365 investment programs, supposedly employing 10.761 persons, totaling 156.300.800 dinars (around DEM 5.2 million). For the year 2001, the plan is to employ 15.000 additional persons through new programs (Table 3).

TABLE 3. DATA ON LABOR MARKET SUPPORT OFFICE PROGRAMS

Program type	No. of programs	No. of persons employed	Amounts granted (dinars)
Self-employment	3.290	10.629	151.606.800
Disabled	75	132	4.694.000
TOTAL	3.365	10.761	156.300.800

The self-employment programs by financing SMEs. This type of program has been focused to help those people that are registered by Labour Office as unemployed (mostly the ex-employees of firms closed for any reason) - to get new jobs through the self-employment schemes. So, the programs financed by LMSP Fund are supposed to create new jobs for those people, and one of their immediate consequences is that those people are supposed to be removed from the register of the unemployed after being granted money for self-employment, i.e. after implementation of the programs.

Self-employment programs include helping in establishment of new micro enterprises and small shops, as well as programs for employment with another employer. In the year 2000, via the realization of 3.290 self-employment programs, total of 10,629 persons were employed. The aggregate value of those programs exceeded 150 million dinars. Out of the total number of people employed through the self-employment programs, 1,586 cases referred to establishing business enterprises and 1,704 programs referred to financing the already operating firms, i.e. their expansion and employment of additional workers.

The share of SME's incentive programs in self-employment programs has been increased from 29% in 1998 and 41% in 1999 to 48% in 2000.

According to the structure of those programs, they support mostly private enterprises operating in:

- crafts industry,
- trade, health,
- personal and other services,
- agricultural sector.

The effects of those self-employment programs are supposed to be multiple – they should stimulate employment of younger people supported to start their private business. In addition, it is expected that these programs would help partly legalizing engagement into a “gray-zone” economy.

The money that has been released within the second self-employment programs is actually granted to employers. However, the grants are always strictly related to the specific unemployed person, i.e. the employer is getting the money for the list of persons and the total amount of money depends directly on the number of the employed persons and their category. The only obligation of the employer is to keep those people at work at least for the period of two years. The employer is supposed to participate financially to the investment with minimum 50% of the total. There are no limitations regarding the investment type or size, with the exception of cases where employment of more than 10 persons is applied. In such cases, an opinion of the Chamber of Commerce is required.

Special attention is oriented towards the categories such as those concerning the unemployed parents or unemployment compensation beneficiaries, so they get larger financial support in order to decrease the number of unemployed who receive unemployment benefits (at the moment, more than 47,486 people).

The procedure of finance approval:

- The employer contacts the local employment office for information (The Republic's Office for Labour Market is organized on a territorial base). Labour Market Office consists of a head office and 24 local offices (out of which, the 3 offices that had been established in Kosovo Province, nowadays do not function);
- The employer makes a business plan, encloses the required documents with a list of people who are going to be employed;
- Local employment office evaluates the study;
- The study is finally evaluated in the Head office;
- The Board of Directors or the managing director (up to 10 persons) makes the decision regarding approval and financing of program;
- When entering a contract, the unemployed person gets a steady job contract;
- During the next 2 years the realization of the contract is subject to monitoring;
- In cases of breaching the contract, the debt enforcement is performed. If that is not possible, the Labour Market Office lodges a legal complaint.

Sources of Financing. The Fund of the LMSP is being “filled up” by the introduced obligatory taxes that are paid by every employer on every payroll paid. The total amount is 1.8% of the payroll (0.9% on the account of employers and 0.9% on the account of employees).

Effects. The information on the effects of the SMES’s financing by this source is not quite unanimous. From the point of view of the LMSP major goals (decreasing of the number of unemployed), they could be considered as relatively good. By the way, the official reports on the LMSP are full of satisfactory expressions referring to the high level of effectiveness (success of over 90% of all programs) and in terms of resolving the unemployment problems at relatively low costs (after receiving the grants, the unemployed persons are permanently removed from the official list of unemployed).

In spite of intentions and verbal statements, there were rather persisting more or less “weak signals” actually questioning the real effectiveness of Fund activities, i.e. the statement presented in public about its effectiveness. There were quite a number of complaints and questions regarding the way in which the programs were selected. Some of the questions and suspicions that have been raised recently, refer among other things to:

- the general lack of transparency in selection of programs;
- the fact that some firms have been repeatedly getting grants for their programs;
- the different treatment of firms in respect to the pressures exerted at them to fulfill their obligations;
- in connection with the last two, there are hints that the owners of some privileged firms might be connected with the ruling oligarchy;
- in addition, the real efficiency of programs approved is not quite evident, because the focus of LMSP is on the number of employed persons, not on the profitability of the firms.

However, the entire concept and idea of LMSP fund activities should not be questioned. In that sense, it is necessary to provide a substantially larger funds for labour market interventions, especially having in mind that this kind of funds usually makes around 2% of GDP in the developed countries as well as in transitory economies. It has been already announced that in a few months the measures for facilitating a very fast privatization process will be introduced, so we could expect a lot of needs for interventions of this kind.

2.3. THE AGENCY FOR SME DEVELOPMENT

A few months ago, the Serbian Government has founded its Agency for SME Development. The major (short-term) goal of establishing that Agency was the need to have an operative governmental body entitled to communicate with foreign financial and other organizations and institutions (e.g.: the European Agency for Reconstruction)² that would be interested to finance the SME development in Serbia.

2

In May 2001, the European Agency for Reconstruction (EAR) announced tender for a project of EURO 10 million for developing the SMEs in Serbia. Part of this amounts would be used for developing the SME Agencies in Serbia (one at the Republic and the rest - at the 3 regional levels). So, the Agencies would be really made capable of performing their assignment (staffed, equipped and getting funds for SME support) during and after the implementation of this project.

One of the first actions of the Agency was to establish the Fund for Financing of SMEs. It has been announced that the Agency and the Zepter Bank (representing the foreign investors)³, according to the public announcement, have provided "... DEM 8 to 10 million ", which is supposed to mean that the money for the Fund is still rising. It has been also said that the Fund is to be serviced by the Zepter Bank and that the Bank would provide the needed bank guarantees.

This Fund is aimed at supporting the SME development in the region of Southern Serbia, which is dominantly motivated by political decisions (to help overcoming the current political crisis in that region).

The Fund operates through the regional consulting Agency – the Center for Southern Serbia. As usual, for this kind of initiative and organization, there are several explicitly stated goals. Those are the following:

- Increasing employment;
- Increasing the level of specialization and level of value added in SME activities;
- Inciting SME export orientation;
- Supporting the SME contribution to import substitution;
- Inciting innovations;
- Introduction of the advanced technologies;
- Energy saving, processing of waste materials and protection of environment.

The conditions for getting a credit are the following:

- Amount available per project is ranging up to 150,000 DEM;
- The repayment periods are from 1 to 5 years, and the Investor is expected to suggest the "optimal" repayment period for his project;
- Annual interest rate is 6% (but additional 2% annually are to be added for the bank's costs, so the actual costs for the Investors total 8% annually);
- The Investor is obliged to provide a collateral in the form of properties (real estates, in kinds, or in terms of rights);
- The submitted application form is evaluated by the Investment Board of the Agency;
- The banking services are provided by ZEPTEK Bank.

Up to now the Agency has approved 3 projects out of 73 submitted proposals. The total value of the projects approved is around DEM 0.5 million.

2.4. THE FUND FOR SMES EXPORTS FINANCING

In April 2001, as a result of an initiative launched by the new Serbian Government, the new Fund for SME Exports Promotion has been established.

The initiative is carried out by the Fond for SME Development. This fund has already existed during the former Yugoslavia and at that time it has been one of the most important funds for financing the development programs all over the country. The focus of the Fund was at financing programs aimed at providing a balanced development of regions (Republics and Provinces).

After the dissolution of SFRY and establishment of FRY, the Fund continued to operate throughout the 90-ies, but it could be said that its main feature was the absence of transparency. Strictly speaking, the conditions and procedures of financing by this Fund were not announced in any unambiguous way, and there were no public tenders.

The mentioned afore initiative established a new fund: The Fund for Supporting Exports Businesses. The Fund is instructed and supported by the Government, which has collected DEM 50 million and entered the new Fund. Additional DEM 50 million have been collected by 13 commercial banks, also instructed and directed by Government. This Fund (amounting up to DEM100 million) is being used now for promoting the exports, and particular attention should be paid to SMEs exports.

Conditions. The conditions for drawing credits, as compared to the general banking conditions in Serbia, are rather (or even: very much) favorable: the credits are being released strictly for the period of 6 months without grace period and with an interest rate of 9% annually. A precondition for getting the credit is an export contract provided by the applicant. Immediately after repaying back the debt, the firm may get qualified for a new credit under the same conditions. The proposals for financing are being prepared by the afore mentioned 13 commercial banks that are also supposed to provide the needed bank guarantees.

Within two months of its operation, the Fund released credits amounting altogether DEM 61 million, out of which certain amount went to SMEs.

The whole program has been developed and introduced as an answer to the urgent need for funding of even the current business transactions. The problems with liquidity in Serbian economy reached such dramatic levels that even this kind of business operations were hard to be carried out. So the idea was to find the way and means to support not only specific firms, but business operations that by all criteria should enjoy all supports: those are the operations covered by exports contracts (first of all, with the partners from the EU and from the rest developed countries).

The currently prevailing conditions for getting any other similar credit are extremely unfavorable. The interest rate is usually higher than 5% monthly, so in case of using this kind of financing, it is practically impossible to realize any export (or any other job) even with a minimum margin of profit.

Since the current market "price" for this kind of financial sources is still very high (around 5% of interest rate monthly), the Fund has been established with the strong support and probably with lots of non-economic pressures, made by the Government upon the involved commercial banks.

2.5. COMMERCIAL BANKS

In 90-ties, during most of the time, the commercial banks in Serbia were unable to finance business activities of firms in standard ("normal") ways, usual for market economies (if there were exceptions - they did not concern the SMEs financing).

This situation was the result partly of the sanctions that were imposed upon Serbian economy within that period, but partly it was a result of the policy that was carried out intentionally by the former regime. The very limited financial funds were under complete control of the Government and the other (we could call them) hidden centers of the power. The approach to these funds was allowed only to a very narrow circle of selected "friendly" firms.

One of the striking examples was the policy of exports support to these firms. They were allowed to buy foreign currency at the official exchange rate, fixed at 6 dinars for 1 DEM, that was in force during t 2000. At the same time, the market rate was several times higher - at the end of 2000 it reached level of 30 dinars for 1 DEM. This was extremely efficient way of "supporting" operations of the chosen firms, particularly having in mind that all other firms were left to compete at the open market and (in the case mentioned) they had been forced to buy foreign currency at the market price (i.e. 4 to 5 times more expensive).

The similar "methods" were used within the limited market of the other financial sources: the dinars-credits were released for the first group of firms at a fixed interest rate. Since a very high inflation was constantly present throughout the whole period, the amounts to be paid back by the selected "friendly firms" sometime got depreciated so much that appeared to be quite symbolic. The only option for the rest of the companies (which presented a large majority of the national economy) - was to get credits at an enormous interest rate (around 10% monthly) that was calculated taking into account the re-evaluated principal amount.

However, at this moment there are still no commercial banks' funds available for financing SME business activities (actually the situation is the same for all the other firms). The banking system is generally in a very bad shape and its total reconstruction needs yet to be performed in the months ahead, as an indispensable precondition for reconstruction of the whole national economy (according some, yet non-official, announcements only 4 out of 74 existing banks in Serbia have passed the Central Bank test of minimum viability).

The only types of SME business financing at this moment are the short-term loans, some drafts for overcoming of the current liquidity problems and alike. Herein are some briefly presented practices of this kind of business financing (just for the sake of illustration). The example is taken from the practice of the bank that is considered to be among the best and the conditions under which the Bank finances its clients are among the most favorable at the moment:

The conditions and procedure for approving short term loans in the commercial banks. The approval decision for the loan request is made and

the conditions are set on the basis of the credit capacity of the applicant, then upon the estimation of the loan risks, purpose of the loan asked for, as well as the repayment period asked, and finally, upon the previous history of relation with banks (punctuality in paying back previous loans, the present liquidity, and alike).

The credit capacity of the applicant-firm. Credit capacity of the firm is evaluated on the basis of the following "check list":

- the firm should have no principal or interest payments towards the Bank, which are past-due more than 60 days;
- the firm's total liabilities should not be larger than its capital;
- the losses recorded in the balance sheet should not exceed 50% of the capital;
- the firms should profit in the current time period, and the documentation asked for should be presented in accordance with the internal regulations of the Bank (those are, among the others: the firm's registration list with all annexes; papers with signatures of persons in charge deposited in the Central Bank; the balance sheet and income statement for the last year as well as for the last semiannual period, statistical sheets, etc.).

The evaluated level of the loan risks is the base for determining of the interest rate, which could be set at the following level:

- risk A: basic interest rate (currently it is set at 5.0% monthly);
- risk B: higher interest rate (currently 5.5% monthly);
- risk C: the highest interest rate (currently 6.0% monthly).

The interest rate A is set under the condition that the applicant-firm is servicing on time all current debts towards the Bank, fulfills all criteria on current liquidity, providing the highest quality collateral, has a certain number of the Bank's shares, has a dinars account in the Bank, carries out all foreign currency transactions via the Bank, the purpose of the credit guarantees itself timely repayment of the credit, the current debts towards the Bank do not exceed 10% of its assets, does not have any contract on rescheduling or delayed payment of its obligations, has positive net cash flow out of currency inflow and outflow, etc.

The interest rate B is set under the condition that the firm-applicant has certain non-paid obligations towards the Bank but the delay does not exceed 15 days; does not fulfill all criteria of liquidity asked for the risk level A; within the last 30 days if it happens that the firm was non-solvent, the period should not exceed 3 days in case of solvency problems; the firm is not able to provide the collateral of the highest quality; the program that is supposed to be financing does not itself guarantee that the loan will be paid back timely; and it does not fulfill all other criteria for the risk level A.

The interest rate C is set when the applicant-firm has non-paid obligations towards the Bank with a delay exceeding 15 days but not more than 60 days; has liquidity level that is not fulfilling the criterion for risk level B; has

a negative cash-flow out of current inflow and outflow; within the last 30 days if the firm was non-solvent more the 3 days and generally it has solvency problems; the current debt towards the Bank exceeds 10% of its assets; the firm could provide only one good quality collateral and does not fulfill other criteria from the risk level A and B.

Before the loan is put at the disposal of the firm-applicant, the Bank is providing one or more instruments for loan assurance, depending on credibility of the debtor and the estimated risk level. Those instruments could be the following:

- bank guarantees,
- letters of credit,
- guarantees of the third persons,
- movable or immovable collaterals,
- dinars or foreign currency deposits,
- others.

Generally speaking, the commercial banks in Serbia at the moment are providing three following basic types of loans for SME (and other firms):

- loans for financing the specific transactions,
- loans for financing of the working capital,
- medium-term investment credits with up to no more than 1 year repayment period.

The interest rates are within the range of 4% to 8% monthly, in spite of the fact that since the beginning of the current year Government and Central Bank run very strictly the policy of stable, i.e. fixed exchange rate of the national currency.

3. THE RECOMMENDED FINANCIAL INSTRUMENTS FOR THE SME SECTOR DEVELOPMENT

At this moment in Yugoslavia (Serbia) there are generally rather great expectations in respect to future development of SMEs (and, within the same frameworks, especially of the privately owned ones). The overall economic situation (around 50% of labor force unemployed, average industrial capacity utilization only between 20% and 30%, the large, unprivatized firms mostly in extremely bad shape in terms of finance, technology, management, organization, etc.) - effectively leaves no alternatives, but focusing all available human and material resources into the priority support to private initiatives and entrepreneurial spirit, as perhaps the only real chance for short-term revival of the economy as a whole.

Even though the main subject of this paper is supposed to focus upon the financial aspects of SME developments, we are strongly advocating the approach in which certain preconditions related to the wider economic environment should be provided prior to or at least together with making the financial sources and appropriate instruments available for the SMEs. This should be considered as an indispensable prerequisite for the effectiveness of any financially relevant measure to be undertaken. After all, there are already very convincing experiences in some of the countries in transition that have shown that focusing only on provision of financial resources has had as a result, as a whole, effects much poorer than expected; not to mention the expenses in terms of wasted money, time and other resources.

The overall social and economic environment in Serbia is at the moment so devastated that there is a need to start from the very beginning and to focus strongly upon the following:

3.1 ARRANGING THE LEGAL AND OVERALL ECONOMIC ENVIRONMENT

First of all, a profound reconstruction of legislation and the entire economic system seems to be indispensable. This task consists of the two though closely connected, but by all means separate jobs: the first one concerns adjusting of the legal system, and the second one should concern the improvement of its implementation - i.e. to take care that the formal rule would be observed in everyday practice. The formal adjustment of the system is relatively easy to perform. The great parts of the legal and economic systems have been already adjusted in their most important elements, following the models applied within the European Union. Most of the unfinished work in that field requires just a rather fine tuning in some segments. Hence, as the task of crucial importance appear to be activities

related to the system implementation, and that would be probably one of the most difficult challenges for the new Government. The entire economy, including the SME sector, has been developed and has been functioning for years under the implicit assumption that the everyday life is based upon the system parallel (and sometimes even opposite) to the officially established legal system.

Within the framework of the overall legal system, arrangements concerning the SME operation and developments, some specific acts containing the direct references to the SMEs are about to be adopted. Among the others, those are specifically the following:

The Act on SMEs

Serbia still does not have a specific Act on SMEs, in spite of the fact that during the past period several attempts have been made. It seems that they have only provoked lots of discussions and spending of lot of energy. The last attempt was made in May 2001 when a proposal of such an Act was presented to the Serbian Parliament for adoption. Unfortunately, the proposal was presented by the defeated Socialist Party and the whole initiative was a part and parcel of the ongoing political confrontation game, in which the SMEs issue has been used primarily as a rhetoric argument. The proposal was refused, even not because of its contents (the explanation was that the area is to be arranged later on within the frameworks of legal initiatives of the new Government). However, it could be expected that later this year the Act regulating and supporting institutionally the SME development in Serbia is to be adopted by the Parliament.

The Draft Bill proposed by the Socialist Party envisaged among the other things introduction of a National Board for coordinating the SME development. The most important innovation was supposed to be the introduction of a National Fund for SMEs and Entrepreneurship development.

The Bill on Agencies

The Bill on Agencies is in a process of adoption as an Act and it has got at the moment the highest priority at the agenda of the Government, exactly because of the plans of the European Agency for Reconstruction (the agency through which the EU performs all its activities of providing aid for Serbia and Yugoslavia) for establishing the Agencies for SME development in Serbia (one at the Republic and two at a regional level).

The role of the Agency would be to attract and provide financial resources for SMEs in Serbia for a variety of urgent requirement issues, like starting-up new, or extending the existing programs, provision of additional working capital, etc. The available resources could be directed into the fund of some selected bank (which first needs to be restructured and then get infusion of "fresh" capital). For some time the idea of establishing a specific Entrepreneurial Fund was advocated very strongly in public (actually, this was an idea of the old Government, but its adoption by the Parliament was interrupted by the events, which took place in the last October). The Fund, if established by foreign private and institutional investors, could have been a convenient "instrument" for attracting foreign capital from a variety of sources (international public and private investors) and its directing exclusively to the SME sector. At the same time, the Agency should play a

very important role in providing schemes for credits guarantees and expert evaluations of investment opportunities and projects.

The Act on Investment Funds

Generally speaking, the issue of investment funds represents in Serbia one of the rather exotic topics – since there have been neither theoretical nor practical experiences in Serbia with that issue. Hence, there are very few people who have some effective knowledge about it. At the same time, the issue of investment funds represents in Serbia, as in the other countries in transition, one of the very intriguing topics, thus attracting lots of attention at the moment: there have been already several regional roundtables, the public discussion has been provoked mostly by the people coming from the Western countries and being interested to initiate this kind of activity.

There are at least two very important reasons that make the investment funds so interesting in the case of Serbia: (a) in a near future (probably by the end of 2001) the privatization process is supposed to get accelerated, so it could be expected that there would be a plentitude of new opportunities for investment funds' activities (like: investing in shares of the well-to-do firms that are to be privatized); (b) there is also announcement that very soon the Central Bank will issue state guaranteed securities based upon public debt amounting up to DEM 7.5 Bn.. and originating from the so called "old" foreign currency savings – this could be also an excellent opportunity for establishing the investment funds' operations on capital market.

Even though there is a plenty of great expectations on introducing investment funds, it is the fact of life that any specific legal regulation concerning the functioning of that financial mechanism has not been introduced in Serbia yet. . Up to now the Serbian Government has not shown any publicly evident initiative concerning introduction of the specific Act on investment funds yet, but hopefully, that is to come very soon onto the agenda - after introduction of some other crucial Acts, like the one on Privatization.

3.2. RESTRUCTURING OF THE BANKING SYSTEM

Banking system in Serbia is in a very bad shape: all major ("big") banks in Serbia are burdened with tremendous debts originating from various sources: DEM 7.5 billion of private savings in foreign currency (all dinars savings and deposits were wiped out by hyper-inflation), the huge (in DEM terms - multibillion debts towards foreign commercial lenders organized within the London and Paris banks' clubs), the large internal debts in terms of current transactions among the domestic firms, etc.

After taking over the control upon the banking system in Yugoslavia the new governors of the Central Bank have announced that the new capital accord for banks in Serbia is US \$ 5 million. According to Central Bank information by the end of March, out of the total number of 74 Serbian commercial banks, only 20 could overcome that hurdle. At the same time, the banks should fulfill all 9 qualitative criteria prescribed by the current Act

on Banks (and harmonized with the Basels banking standards). The problem is that on the one hand the “big” old banks do not fulfill performance standards of banking business, while on the other the small banks, most of which cover those requirements, do not fulfill the capital accord requirement. The deadline for fulfilling all these criteria is supposed to be mid-July and yet it is not known what the Central Bank’s choice in resolving this dilemma will be - since obviously it is a too short period of time for most of the major banks to recover, as well as for most of the small banks to reach the capital accord.

However, a real restructuring of Serbian banking system is planned to start up not later than mid-September 2001. The process is estimated to take at least two years, and this operation would require around US \$ 300 million of external support.

From the standpoint of Serbian SMEs, this means that domestic banks will not be really capable of servicing them (if we do not count the foreign funds for SMEs financing, that might only be serviced technically by the domestic banks) during the next years. However it is expected that foreign banks would fill up this gap. During the past half a year, several banks have been established: the afore mentioned MICRO FINANCE BANK, which has started its operations; RAIFFEISEN BANK that has opened an office in Belgrade and is ready to start its operations any time from now on; the French SOCIETE GENERALE has been present for a whole decade and it is just about to re-activate its operations in Serbia; in addition, some other foreign banks have also announced their interests.

3.3. BUILDING THE CAPACITY OF SMEs FOR RECEIVING (FINANCIAL) SUPPORT

The limited real capacity of SMEs to receive support, especially the financial one has been amongst the crucial problems in all countries in transition. . The issue of capacity refers to the whole chain of activities, starting with the process of applying for financial resources (articulating the entrepreneurial ideas, preparing the business plans or/and feasibility studies, fulfilling all needed administrative procedures and alike), then with preparing and carrying out the tender process for equipment, providing and/or training the human factor needed, starting up the production process, etc. and finally running appropriate financial policy and servicing the debt.

The starting point in successful overcoming this deficiency would be the development of an elaborated network of efficient institutions supporting the SME development. This should be the task of utmost importance and, having in mind the permanent absence of this kind of institutions in Serbia throughout the past periods, it should also represent an initial breakthrough in system development. The most important functions that these Centers should fulfill are as follows:

- Business and other information bases tailored for SME. At this moment, after years of isolation and operating within the closed system, the priority requirement to the SMEs in Serbia is provision of appropriate information base concerning markets trends, technological changes, potential foreign partners, etc. One of the most effective and efficient ways for introducing

this function would be establishing regional and perhaps local units of the already existing international info-centers (which, of course, could be done only with the support of foreign partners). The legal procedure for establishing the first three centers of this kind in Serbia has been already initiated and it is to be completed in June 2001. It is expected that those centers (Euro Info Correspondent Centers - EICC) are to become operative by the end of this autumn.

- Training and education for entrepreneurs and SME managers. Most of the SME entrepreneurs in FRY are self-educated, i.e. they are usually without formal education, so it is rather important for them to get a chance to learn something more on modern management methods and techniques, and to make themselves capable of applying that knowledge in practice.
- Management and business consulting. The new situation with the open market economy, makes the business environment usually much more complicated both in terms of greater opportunities and in greater threats for the SMEs. Hence the greater need for expert support in all segments of the business system: marketing (market analysis, PR, advertising), production and technology development (selecting new technologies, improving the existing technological processes, introducing systems of quality control), as well as financial management (introducing a modern accounting and costs system, preparing business proposals and feasibility studies, etc.).

3.4. DEVELOPMENT OF THE APPROPRIATE SME STRATEGY FOR SERBIA

Nowadays there is an interregnum - the major part of the SME sector is out of the system, so it is possible to make only estimates and assumptions concerning the real situation in the field: the real size of the SME sector, its real problems, needs, and the real potentials in terms of assets and resources (especially human resources: their entrepreneurial and managerial skills, availability of special qualifications, the quality of their development and investment ideas, etc). That is why the first step in activities of formulating an appropriate strategy of SME development in Serbia should be the initiation of research projects in order to supply all interested parties with clear, authentic insights of the present situation and problems of the SME sector in Serbia.

The research should be focused first upon the SME institutional environment in Serbia, which should include especially: (a) Analysis and estimates of effects of privatization process upon the economic position of SMEs (b) evaluation of the legislative and economic system, and their impact on the SME development; (c) identification and evaluation of effectiveness of institutional infrastructure for support of SME development (governmental and non-governmental institutions for SME support, specialized info-and-consulting agencies, etc.); (d) analysis of specific components of the official economic policy measures from the SME development point of view; (e) evaluation of the banking and generally of the SME financing system; (f) evaluation of the fiscal system (its consistency and effectiveness in terms of

incentives and guidance).

The next step of crucial importance has to be the field research that should include: (a) identification of the effective situation in the field: the number of SME , people employed, assets deployed, levels of technology achieved, etc. (b) identification of effective and of prospective entrepreneurs, as well as of the prospective investment projects.

The results of these research activities should become an appropriate basis for initiating broad (but intensive and effective) activities aimed at building awareness of the overall importance of SME development in Serbia. All subjects possibly interested in SMEs development in Serbia (Governmental institutions on different levels: from the Republic to the local ones; entrepreneurs' associations, the Chamber of Commerce, research and other academic institutions, individual independent experts, etc.) should be included into that process. The final outcome of that process should represent the formulation of an effective STRATEGY for SME development in Serbia.

3.5. RECOMMENDED FINANCIAL INSTRUMENTS FOR DEVELOPMENT OF THE SME SECTOR

Providing the Sources of Funds for SMEs Financing

At the moment, a very limited number of financial instruments specifically developed for supporting the SMEs are available in Serbia. At the same time, there is almost complete absence of the required financial resources. On the other hand, the legal and economic infrastructural environment for SMEs is metaphorically (in some cases quite literary) in conditions stretching from the need to construct from bare land, to the need for restructuring the existing facilities.

The first prerequisite for developing any kind of SME financing instruments is, of course, the availability of means (resources, funds), by which those instruments could become effective. In that respect, some rather "initial signals" have become evident (the first supporting banks have been established, some of them started their operation, some other financial institutions get prepared for starting their business, etc.).

These "signals" have provoked rather great expectations in respect to the inflow of fresh capital that is "just about to enter" the national economy. Considerable funds are supposed to be collected via the Donors Conference planned for the end of June - there are some estimates that around US\$ 1.2 bln. could be gathered for this initial occasion. However, at this moment (beginning of June) there are some issues in the country that are disputed very much politically. They have to be solved as indispensable prerequisites for the success of the Conference.

The financial funds for SMEs development in Serbia could come from the sources that are standardly available for this purpose:

1. Public Sources - like governmental budgets and various types of development funds. The new Government of Serbia already tries to do something along those lines: the afore mentioned funds (The Exports Supporting Fund and The Fund of Governmental SME Agency) are formed out of these sources.

2. Sources of the International Specialized (Public and Private) Funds - like the funds of EBRD and WB agencies; investment funds of various types: venture capital funds, financial institution specialized in leasing arrangement, funds specifically created for SMEs and supervised by NGOs and/or professional institutions, etc. Certain types of donations and grants from governmental and non-governmental sources could be included in this group of sources as well. At the moment this is probably the only source that could provide inflow of capital in a reasonably short period of time and in volumes that are needed for reconstruction of the devastated Serbian economy. Unfortunately, this source is under the strongest impact of the still very uncertain political developments at the moment.

3. The Funds of Commercial Banks. Serbian banks (as already mentioned) are generally in a very bad financial shape, with huge debts accumulated (there are estimates that several hundred million dollars would be needed just to recover the banking system). That recovery would take at least a couple of years, so during this period it is not realistic to expect that domestic banks would be able to provide any considerable funds for SME financing.

4. Private Investors' Funds - could come through direct investments or through the mechanisms of capital market. These sources enter national economies usually at the end of the process of opening (following the international financial institutions, first of all the WB, IMF, EBRD and others). Those sources might eventually appear to be the most important among all the others. At this moment, the situation of Serbian economy is under scrutiny performed by the financial community: almost daily the delegations of bankers, financiers and businessmen are visiting Serbia in their missions of fact finding, trying to examine the possibilities and risks for investment in Serbia. Of course, there are still much more announcements than effective investments, and the first interests shown concern the investments in large ("strategic") sectors like telecommunications, cement plants, the power system, etc.

Financial instrument for supporting SMEs

Loan Guarantee Schemes. The Loan Guarantees Scheme is one of the conditions that come prior to financing. Having in mind certain experience from the 90-ies, we may conclude that providing a mechanism of guarantees for SME financing is of crucial importance. The domestic banks have been very conservative - by asking for extraordinary high and usually multiple collaterals (always mortgages on real estates, and usually in addition to them, guaranties of third parties - business partners, banks and others). The guarantees usually include mortgages on real estate properties, specific types of letters of credits and sometimes even very exotic forms like the so called "conditional contracts on real estates purchases", etc. Resorting widely to these kinds of practices could be explained by the fact that during the last decade the general situation was quite irregular: the supply of capital was insufficient thus putting the "providers" (banks and some other financing institutions emerging from the "gray" zone) in privileged-monopolistic position. At the same time the legal system, especially in its segments regulating disputes over ownership, mortgage regulations etc. - was rather poorly and inconsistently applied and enforced.

Credit Lines. The major advantage of credit lines is that they are easy to be understood by entrepreneurs and SMEs in Serbia: they already have experience (even though not so positive) and also certain knowledge of procedures, paperwork needed to be performed, etc. There are quite a number of SMEs that have already done some preparatory works like preparation of Feasibility Studies and are ready to react at the moment when any credit line becomes available. Unfortunately, there are still no international credit lines available (except for the offers by the mentioned Micro Finance Bank, which are still very limited regarding the amounts available, as well as in respect to some other conditions, like interest rates, repayment period, etc.).

The practices of Serbian commercial banks are typical for the absence of any specific selective policy focused on SMEs. The procedure is uniform, i.e. it is identical for all clients (the SMEs are equally treated with the large firms) - meaning to be rather complicated, time consuming and non-transparent.

Leasing Schemes. In earlier times this form of business cooperation between a local SME and a foreign partner was quite widespread. Therefore, this scheme appeared to be among the most favored ones (although it was probably among the most expensive ones). Leasing has numerous advantages, especially from the point of view of the firms coming from countries in transition: financing through leasing model presumes that the debtor avoids the problems with collaterals; the whole procedure for applying and approval of the sources is usually much simpler and quicker, and it is generally much more flexible in respect to the exports-imports regime, taxation regulations etc. Leasing was one of the very rare financing practices that remained preserved during the period of sanctions in Serbia.

There are some signs that leasing operations have been activated again in business practice in Serbia, usually between the old partners that have already prepared their projects, and have just waited for the expected changes of political and economic situation. However, it is still performed at an ad-hoc basis, in the form of individual arrangements between business partners from Serbia and others from some Western country. The second ones usually provide the financial support from financial institutions, and the first provide collaterals, usually not under so rigid conditions (especially not in comparison to the one that are asked by the banks).

Having in mind the mentioned advantages, it would be of utmost importance to establish a specialized leasing institution in Serbia where Serbian SMEs could find everything that is required to perform the leasing operations - from basic information to professional services.

Equity Funds. Up to now there was no practice at all concerning equity financing in Serbia, so there are no domestic experiences in this respect. It is not a surprise, having in mind that Serbia does not have legal regulations regarding investment funds yet. On the other hand, the overall situation in Serbian economy and the obvious necessity of the firms for attracting additional capital could lead to the conclusion that this form of financing might become easily very attractive and appropriate for Serbian SMEs.

Equity financing is the form that by definition involves financing professionals

in business operations that are to be financed: first, they take part in the investment preparation, then in the investment operation itself, and finally in formulating the appropriate investment strategy, to the point of getting involved in the current business operations. This could be of utmost importance, having in mind that Serbian firms, for quite some time, mostly marked by information and communication revolution, were practically excluded from developments most rapidly affecting the international economy.

For those reasons, the equity financing could become one of the very elegant methods to overcome many shortcomings in the current Serbian position in respect to the SME development: primarily for the sake of providing easily the required information on all factors most relevant for SMEs - technology development and selection of the appropriate technology, acquiring new managerial skills and techniques, insuring shortcuts to the main international markets, etc. At the end of arrangement the equity financiers need to go to the capital market and to sell shares of the firm, in order to recover the invested capital, as well as the capital gains. In that way the firm itself (management) gets the opportunity to acquire valuable experience in dealing with operations at the open capital market. At present this is almost completely unknown and even rather exotic activity for Serbian managers, so going through this arrangement would be the easiest and the quickest way for them to master this kind of experience.

Financing Through the Capital Market. The Capital Market in Serbia has already been established at the end of 80-ies, which means that all required legal acts have already been introduced. However, it is almost completely inactive nowadays, i.e. limited to transactions with short-term securities issued by the Central Bank. Shares and obligations or any other kind of securities issued by enterprises are extremely rare to be found at the market - in such cases those securities are issued by the state-owned large enterprises or banks, while the SMEs are simply absent at the capital market.

Anyway, currently there are rather great expectations for this method of capital financing in Serbia. The new Bill on Privatization should be introduced soon, so many Serbian firms are expected to appear at the capital market (within the first wave - probably mostly the largest companies, and then also some SMEs). At the same time, the already adopted Act on resolving the so called "old foreign exchange savings of citizens", which is mostly to be converted to public debt, is expected to become effective during this year. This would release eventually up to DEM 7.5 bln. of securities and potentially this volume would appear in the form of trading securities at the Belgrade Stocks Exchange.

Business Angels. The institutions of "Business Angels" have been completely unknown in Serbia until recently. Hence, there have been lots of misunderstandings concerning the questions: who those "Angels" really are, what they really do, what their goals and missions are, etc. Since last October and after opening-up the country to international business and financial community, first representatives of "the Business Angels" organizations have visited Serbia. For the time being their initiatives are focused upon promotion the idea and providing support within the Serbian business circles (in the country, as well as among the Serbian Diaspora) for

its implementation. However, there are no practical cases of financing some project or SMEs via this kind of financing mechanism yet.

At this moment it is quite difficult to assume how appropriate this financing mechanism could be for Serbian SMEs and (what is more important), how it would be accepted by them. On the one hand the form of "Business Angels" is relatively new even in Europe. On the other hand, some of the features of the "Business Angels" institution are fitted much more to the current situation of Serbia, than the other forms and mechanisms for SMEs financing. Among the other especially important features in this respect, could be the following:

- they are quite informal in their approach, starting with the initial procedures, selection of the project-business for financing, relations with entrepreneurs, etc.,
- they have relatively long-term and flexible approaches,
- the repayment methods are flexible – without insisting on fixed interest rates and fixed repayment period,
- the actual repayment does not necessarily equal the duration of the debt,
- the whole operation is relatively cheaper – the costs of evaluating the project proposal is on the side of the Investor.

Having in mind the rather irregular situation in Serbian legal and economic environment, this approach could appear to be very appropriate and effective. However, it is still a theoretical statement. It depends upon numerous factors on both sides whether this would develop into the practice -: upon the offer by "Business Angels" (they could appear only from abroad since in the country there is no capital and no people who are able to implement the concept), as well as upon the demand, i.e. the readiness of Serbian entrepreneurs and SMEs to accept this unconventional form of financing.

Microcrediting. Microcrediting, as we have shown within the preceding section of the paper, is among the earliest forms of SME financing that has been introduced by foreign financiers to Serbia. Moreover, the first foreign bank to start operating in contemporary Serbia is the Micro Finance Bank. Generally speaking, first experiences are very encouraging and it could be expected that microcrediting would become one of the most important forms of financing, especially the programs for people belonging to the "army" of the unemployed in Serbia, that could become capable of creating jobs and incomes for themselves and their families through this form of financing. The micro crediting could appear to be a very convenient instrument for attracting a lot of people who are now working in the "gray zone" to the legal side of economy and to help them overcome the position of bare survival and grow up to the level of small, but solid businesses.

NGOs and SME Financing. During the last decade the non-governmental organizations (NGOs) have performed lots of very useful tasks, among which supporting the SME has been the very important one. Due to the specific political situation they have focused in previous periods on political, legal

and social issues. Generally speaking, the NGO have acquired a considerable credibility and trust within social and also business (especially the private) communities, and that could enable them to become an important mediator between the financial funds and SMEs entrepreneurs⁴.

This mechanism of SME financing seems to have some very important advantages, as compared to the other forms, especially to conventional ones, where the major, professional parts of the job (like: preparation, evaluation and selection of the program) are usually performed by banks' staff. Another major advantage concerns the ability of NGOs to work in a quite informal way, and to be very close to potential clients and their needs. Usually, they are ready to enter deeper into the situation of SMEs and entrepreneurs and to work together with them for a period of time actually covering implementation of the whole project. So this type of financing is connected with consultancy services that are offered to the SMEs as a kind of support to receive and utilize the financial sources in the most effective way.

4 By this moment, the USAID tender for SME funding projects is about to be completed and the major participants are »coalitions« of foreign and domestic NGOs. The value of the project is cca US\$ 20 million, which is to be the largest fund established specifically for SME financing in Serbia_by now.

4. CONCLUSIONS

Serbia, after being more than a decade outside the transition processes characterizing developments in most of the Eastern European countries, is currently in a very specific situation. Namely, although Serbian firms do have a long standing history of doing business in the market economy environment and of being present at the international competitive market arena, in many areas they should actually start again from the very beginning now.

Any positive aspect resulting from destructions that have taken place during the preceding decade in Serbia might be the fact that Serbian economy has become “spontaneously” restructured. The herein presented data, although incomplete and inconsistent, indicate that the SME sector has already become a dominant economic sector in Serbia. Currently, large companies keep their significance to the policy makers only due to the size of economic and social problems they cause – in place of their assumed superior productivity and the consequent contributions to the overall social well-being.

A recent cross-sectoral comparative analysis of effective resources and immediate development potentials has revealed that practically the only sound, vital and productive organizational form of economic life, which could almost immediately serve as the basis for initiating the process of reconstructing Serbian economy and renewal is the SME sector. If we include the so called “gray” parts of national economy (presently, the quite large ones) in the SME sector, then the arguments in favor of this conclusion will be more convincing.

Namely, it means that the only really active part of Serbian economy nowadays appears to be the SME sector. Having all that in mind, we may conclude that the only effective economic policy of the new Government of Serbia in the short term would focus on the strong support to the SME development.

Provision of indispensable financial resources for supporting this kind of policy is, of course, one of the crucial pre-conditions for such development, that may be effective in the short term. However, the experience of almost all countries in transition has shown that the sheer availability of financial resources, no matter how crucial pre-condition it might be, is not the only indispensable prerequisite. Providing a comprehensive system of mechanisms that would make possible those resources to reach their users, and to be used in the most efficient and effective way is of the same importance.

We are concluding this paper by emphasizing the idea that the whole system supporting the SME development in Serbia should be elaborated as a comprehensive integrity that should consist of the following three major components:

1. The changes in the economic and the legal systems, as well as in the ensuing economic policies.- The policy of SME financing needs to be formulated as a part of a wider approach that would comprise the changes within the economic and legal systems. The corresponding systemic arrangements, and the ensuing policies appeared to be fairly devastating throughout the preceding decade. Therefore, both the system and the accompanying policies nowadays need rather fundamental reconstruction, including introduction of some important new elements into the system. Without these changes, the new investments might easily turn into wasteful spending of scarce capital and other recourses. Here, among the most important system elements, requiring precise regulation in accordance with European standards, seem to be the following:

- The complex of ownership issues (which has been complicated additionally because of the still existing category of the so called “social ownership” in Serbia), and in relation to that the required new regulations concerning the mortgage system;
- Adjusting the fiscal system and policy in order to be more stimulating for SMEs;
- Adjusting the regulations concerning capital market functioning;
- Adjusting the labour market regulations;
- Developing an elaborated institutional network for SME developments (centers, agencies, small consultancy firms, and other arrangements aimed at supporting the SMEs).

2. Providing funds for SMEs financing. Whatever forms and mechanisms of financing are to be introduced in Serbia, first there is the need to provide the “critical mass” of funds, i.e. in volumes that would be large enough to satisfy the bulk of demand. The critical event in that respect, that is expected with great apprehension is the Donor Conference, supposed to take place by the end of June. The volume of funds that are expected to be collected is around the US\$ 1.2 bln. - a considerable amount for any country in the Balkans, hopefully large enough to move forward decisively the economic development of Serbia, which is now still blocked into a grave *circulus vitiosus* of stagnation, unemployment and underpayment. Besides its direct effects, the Donors Conference is expected to yield considerable additional, or indirect effects. Namely, the hopeful success of the Conference should denote also a very explicit and strong signal to the worldwide investors that Serbia (and Yugoslavia) is to become an interesting and even attractive area for safe investments in the future.

3. Providing the wide range of instruments and methods for SMEs financing. After providing the herein enlisted pre-conditions, the appropriate financial instruments could become really effective, i.e. they could give strong incentives to SME development and provide the solid basis for their sustainable and stable growth. Most financial instruments, that are standardly and more or less effectively used nowadays in the countries in transition, are still missing in Serbia, though rather hectic preparations are being made by the authorities for their timely introduction. On the

basis of a quick overview of the present situation, we have registered the following new developments in respect to institutional and instrumental arrangements aimed at creating a favorable environment for the new development cycle:

- Several foreign banks have established their offices in Belgrade and some of them have already started their operations: the MICRO FINANCE BANK has already realized its first credits, the RAIFFEISEN BANK has just established its office in Belgrade, as well as the EBRD. The French SOCIETE GENERALE reactivates its operations, and the BANK DE PARIS has also announced its intention to start operating in Yugoslavia, etc.; It is expected that very soon the conventional credit lines for SMEs financing will be available;
- Microcrediting as a practice already takes place in Serbia, but it is still far from being really widespread; in a few preceding years microcrediting was introduced in Serbia by the UNHCR, but primarily as a specific instrument for providing aid for refugees from other territories of the former Yugoslavia. In the sense of the more common banking practices, microcrediting is being introduced at the moment by the above mentioned MFB;
- The equity financing of SMEs is still not available, but the international financial institutions (first of all the specialized institutions of the World Bank) are expected soon to be present and active in Serbia, hence to initiate this kind of financing;
- The first group of “Business Angels” representatives has announced its plans to introduce this specific type of mechanism for the SME financing. Yet, it is still in the domain of intended plans;
- The Loan Guarantee Schemes, though one of crucial components of the overall SMEs financing practice, seems to be still waiting to reach the agendas of international and domestic financial authorities.

Finally, in respect to the SME financing in Serbia, we can summarize that the crucial components of any substantial support for SME development are still at the very initial stages of being introduced. This judgment holds for each and every of those basic elements: restructuring and forming the appropriate legal and economic frameworks, provision of the badly needed “critical volume” of financial recourses, and finally, developing the appropriate instruments and mechanisms for servicing the SMEs. This judgment probably presents Serbian economic scene in a rather gloomy light, but on the other hand, one could detect (although still through some “week signals”) that the new, promising institutional, economic and social environment for sustainable overall development of Serbia and Yugoslavia is being created - with lots of positive alternatives and chances for the SME development, too.

REGIONAL CONCLUSIONS AND POLICY RECOMMENDATIONS

The major goal of the overall project is to outline recommendations for improving the SME finance in South Eastern Europe, based on the best practices in each one of the countries included, as well as on the expertise of the research team members representing those countries. All recommendations in this chapter are a result of the in-depth analyses of the current situation in respectively Albania, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia, stated above. Since the state of economic development and the stage of reforms differ from country to country, there is no guarantee that some of the approaches for SME financing, which have proved to be successful in one particular country under the particular conditions there, will turn to be successful in the rest of the countries, too. But there are some similar features of the business environment and similar barriers to SME financing, which make it possible to formulate some common regional recommendations on how to improve the current legislation, the policy and procedures, as well as on how to further develop the existing financial markets of the countries in the region.

As far as the improvement of the current legislation and regulations are concerned, there is a need to strictly define the parameters that characterize micro-, small and medium-sized enterprises such as: number of employees, turnover, profit, value of long term assets and others. As EU accession is more or less the short or medium-term goal of most SEE countries, the best approach would be to take into account the recommendations of the European Commission in that sense. This would make defining the dimensions and specifics of the SME sector and in consequence carrying out targeted policy and concrete actions in its support possible. Another step in that direction is the need of regulation that strictly defines the institution(s) authorized to support the SME sector development and its rights, obligations and competence. Next aspect in this direction is the general improvement of those areas in the business legislation regulating the economic environment, in which SMEs start up and further develop their activities. In particular, that supposes legal measures, which concern:

- decreasing the share of gray economy;
- adoption of efficient anti-trust and public procurement regulations;
- optimization of tax legislation;
- setting up rules for the creation and functioning of industry associations;
- creating a framework for public-private partnerships.

At the same time, one of the priorities should be the effort to optimize the legislation in as short period as possible and after that to ensure its consistency and stability, which would make the future situation predictable.

The improvement of the regulations concerning financing should be directed to:

- solving particular problems with collaterals (type, value, size) and mortgage systems;
- decreasing of fixed costs on small-sized loans;
- defining the activities of non-bank funding sources and especially financial NGOs, venture capital funds and capital markets.

The improvement of the current policy and procedures generally supposes series of actions to make the current business environment friendlier to SMEs, to increase the effectiveness and efficiency of public administration supporting SME development and to increase the quality of functioning of banks and non-bank financial institutions, as well as the capacity of entrepreneurs to run successfully their business.

As far as the business environment is concerned, some of the proposed measures are as follows:

- improving the efficiency of the judicial system;
- limiting the unfair competition of the informal sector;
- impact assessment of the current legislation and any proposed changes in it, as well as of the stimulation measures;
- further promoting of free competition;
- creating initiatives to enhance access to technology and information and to encourage innovation;
- promoting exports;
- stricter enforcement of contracts and efforts to decrease inter-enterprise arrears.

The increase in the efficiency of public administration could be reached through:

- better coordination in the efforts of public institutions of the private sector in support of SMEs;
- establishment of an institution, which would be in charge of providing loan guarantees for SMEs, co-financing of banking loan interests, monitoring of loan restrictions and implementation and monitoring, analysis and reporting on effects of the stimulating measures;
- stimulating start-ups through credit schemes, reinvestment allowances, and/or depreciation allowances;
- improving the access to and the quality of business related information such as administrative and market information;
- concentrating grant funding on specific areas such as quality improvement, technology or productivity improvement, environmental control, export marketing, management training, etc.;

- crafting a new improved loan guarantee agency and new Loan guarantee fund system, which could be decentralized one and cover at least 30–40 percent of the risk and never less than 20 percent;
- launching micro-lending programs targeted to support self-employment; focusing the government-funded SME finance on the financially underserved groups with a strategic goal of introducing them into the financial markets;
- stimulating the creation of start-up capital funds and seed-capital schemes;
- supporting the establishment and operation of regional guarantee funds for SMEs and set up a re-guarantee mechanism;
- ensuring stability and consistency in the implementation of support policies; establishing an elaborated institutional network for SME developments (centers, agencies, small consultancy firms, and other arrangements aimed at supporting the SMEs);
- allowing the business community to formulate, articulate, and lobby for the issues relevant to business development;
- establishment of a unique data base about business ideas needed to be financed as a first step to: (i) internationalization of the local businesses and (ii) bringing together potential investors from and out of the region and the “owners” of the proposed business ideas.

The increase in the efficiency of financial institutions supposes:

- support of start-ups and infant micro-enterprises, technology and innovation transfer/dissemination projects, quality improvement and quality insurance systems development, marketing activities, environmental control, energy saving and cooperation among enterprises projects through micro grant schemes;
- modernization of the payment systems in the banking sector.

The increase in capacity of entrepreneurs on the other hand could be reached through:

- expanding business advisory services and efficient usage of international business support programs in that area and in the preparation of the documentation for loan applications;
- improving the skills of SMEs to operate on international markets;
- additional business education and training of entrepreneurs;
- assistance in the area of strategic planning, foreign languages, marketing, business financing, etc.;
- stronger involvement of the business community in addressing issues that are relevant to business financing.

The last and at the same time the most important part of the recommendations of the research team concerns series of measures to apply or to further develop some alternative financial instruments and

approaches and thus to increase the capacity of the existing financial markets. They address banks, as well as non-bank financial institutions.

As far as banks are concerned, the proposed measures include:

- improving the conditions for collateralization of loans;
- establishing unified register of information on SMEs containing credit register, collateral register, market information register, etc. which would lower the credit risk;
- developing track record of credit applicants;
- adopting proper lending technology and proper post-credit control mechanisms; upgrading the risk assessment policy;
- standardization and unification of methodology in preparation and evaluation of business plans and investment feasibility studies for SMEs;
- using new group and individual lending technologies that include frequent repayment intervals, loans that increase progressively in size and duration, rigorous repayment monitoring using sophisticated PC software with rapid follow-up of emerging problems, performance-based pay, and other important design elements;
- promoting the use of bills of exchange and promissory notes;
- training of loan officers and other bank personnel involved;
- introducing small cap banks in rural areas; sharing of information among financial intermediaries/banks/institutions;
- establishing micro-credit schemes and low interest medium and long-term credit schemes for SMEs.

The proposed measures concerning non-bank financial institutions include:

- developing capital markets as a source of non-bank financing of enterprises;
- creating efficient credit unions and NGOs as semi-formal lending institutions;
- further development of in-group lending technology applied by NGOs;
- better coordination among SME fund providers;
- establishment of credit bureaus; improving the lending skills of financial NGOs;
- expanding financing through equity funds – venture capital, that provides not just finance but financial advises to SME venture capital backed, help in crafting and implementing a corporate strategy, producing additional ideas for entrepreneurs, serving as channels of contacts and market information;
- expanding the role of leasing in SME financing as an alternative to bank loans, because it allows access to financing, increases the domestic capital base, provides competition to traditional banks, encourages financial product innovation and helps to develop secondary markets;

- transforming pension, social security or health care funds into venture capital funds intended for investment, accompanied by a package of efficient legal instruments to protect the pledged investment;
- developing mutual credit funds and angel capital networks;
- establishing special nongovernmental funds to finance SMEs; supporting the creation of joint ventures.

All actions stated above are a synopsis of the individual recommendations stated in each one of the case studies. We take into account that their efficiency would strongly depend on the particular economic conditions in every separate country in the region. Our aim is to raise a public discussion based on the results of the regional team research efforts, presented in this book. Representatives of all participating organizations, other NGOs and think tanks, private sector and policy-makers in the region, bi-lateral and multilateral institutions in Bulgaria and coordinators of the Stability Pact will be invited to attend a Regional Roundtable in July 2001 in Sofia. They will have the opportunity to discuss there the presented research findings and the recommendations, as well as to join their efforts in identifying the appropriate mechanisms for overcoming common SME finance obstacles and for improving the access to finance by implementing effective SME finance policies and practices.