Credit to Small Enterprises: The silent crisis

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A new BIS working paper by Cecchetti and Kharroubi makes a point that is becoming more widely known, especially after the continuing financial crises experienced globally since 2008. This is that the level of financial development is good only up to a point, after which it becomes a drag on growth. In fact, the authors argue that when the focus is on advanced economies, a fast-growing financial sector is actually detrimental to aggregate productivity growth. This is explained by the authors on the grounds that, because the financial sector competes with the rest of the economy for scarce resources, financial booms are not, in general, growth-enhancing.

The recent experience of the United States and now particularly Europe, certainly confirms this - and even established doyens of the world of private finance are now more willing to concede this. But one critical aspect of the failure of financial intermediation is still inadequately recognised and discussed: the inability of the currently constituted private financial system to deliver funds to small and medium enterprises (SMEs), which still account for the bulk of employment not just in developing countries but also in advanced economies.

The remarkable (and unfortunate) thing is that SMEs seem to get short shrift during booms and then get even worse treatment during slumps. In many countries - both developed and developing - it has been found that even during a boom that is often finance-driven in terms of the availability of cheap credit for consumption and investment, SMEs are hard-pressed to access bank loans because of the competing claims of larger corporations, which may be involved in real investment or simply indulging in purely financial activities that are temporarily more profitable. So SMEs get "crowded out" not by public sector borrowing, but by large borrowers (who are often more irresponsible and have larger propensity to moral hazard).

And then, during the slump or extreme crisis, things get even worse for SMEs. This is particularly evident in Europe at present. A survey by the European Central Bank of access of SMEs to institutional credit found a considerable worsening in the availability of such finance over the period from October 2011 to March 2012, with a doubling of firms reporting deteriorating access to finance from their already low levels.

A recent ILO Report on the Eurozone jobs crisis emphasises the significance of this point. SMEs account for over two-thirds of employment in the Eurozone (and even more in the most depressed and crisis-ridden economies). While the majority of SMEs in all Eurozone countries experience some difficulties in accessing finance, the divide between core and periphery is particularly marked in this feature. According to the ECB, the percentage of SMEs reporting no obstacles to receiving financing was only 8 per cent in Greece, 15 per cent in Portugal, 16 per cent in Spain and 18 per cent in Ireland, compared with 58 per cent in Germany and 56 per cent in Austria.

It is already the case that finance-constrained firms tend to hold excess cash to ensure their long-term survival during adverse economic periods. Indeed, the evidence already suggests that firms

in the eurozone have tended to reduce their investment effort (measured as the value of a firm's investments as a percentage of its liquid assets).When to this is added the greater difficulty and higher cost of accessing institutional finance, it is not surprising that the downward recessionary spiral is intensified.

The lack of credit is thus one of the major obstacles to recovery in Europe. So it is not just depressed expectations but the negative feedback loops created by this financial bottleneck that particularly affects SMEs. Indeed, the ILO Report estimates that if credit channels were simply restored and the ratio of investment to GDP brought back to its pre-crisis level, around two-thirds of the jobs lost since the start of the crisis would be recovered.

In fact, it could even be argued that much of the policy discussion of strategies for economic revival, centred as it is around sovereign debt issues and the fragility of big banks, misses this basic point. Without adequate provision of credit to SMEs, the debate over fiscal austerity versus fiscal stimulus will remain sterile.

As the ILO Report notes, "The difficulties for small enterprises to access bank credit are likely to persist even if the solvency of the bank system improves. The refinancing operations put in place recently by the European Central Bank mostly resulted in higher lending to the governments and seem even to have reduced lending to the private sectors. As small firms rely entirely on bank credit for financing their investment, it is important to reinforce credit channels to sustainable small enterprises."

The case for directed credit is already very strong in developing countries, where relying only on market determination of financial allocations is unlikely to bring about the adequate employment generation of the desired economic diversification. But now it seems as if directed credit is also important in advanced economies, if they are to achieve some recovery from the current crisis.

Investment could be boosted by improving the flow of credit to small companies. Measures could include credit guarantees, the deployment of mediators to review credit requests refused by banks and the provision of liquidity directly to banks to finance small enterprises. Indeed, such schemes already exist in countries like Brazil and Germany, which have performed much more successfully in terms of both output and employment through the global crisis.

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