CHALENGES FACED BY EU SMEs IN THE CONTEXT OF THE GLOBAL ECONOMIC CRISIS

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Abstract

SMEs play a vital role in economic development. They offer the most economical use of capital in relation to job creation and provide the strongest growth channel for regional development. They are also recognized as the vehicle for growth in today's regionally and globally interdependent and competitive economy.

With a view at the global economic slowdown, it became apparent that economies in all regions of the world have significantly lost momentum which also affected SMEs.

This paper present the main difficulties faced by SME in the EU region on the context of the present global crisis and deliver some recommendation about the reaction governments should take in order to avoid a major crisis in this important economic sector.

Keywords: SME, financing, economic recession, bankruptcy,

JEL Classification: M21, E44, G01

Introduction

The national responses and other publicly available information provide some indications about the effective and expected movements in levels of sales of SMEs. SMEs in most countries report a clear demand downturn, if not a demand slump, in Q4-2008 and Q1-2009 and expect a further worsening to come. The magnitude of the reported shock is severe, but it differs from country to country, in part due to the differences in methods of assessment in each country.

Evidence suggests that the experienced and expected fall in sales is having a strong impact on SMEs. This is further supported by two additional stress indicators:

(a) increased payment delays on receivables which add –together with an increase in inventories - to an endemic shortage of SMEs' working capital and a decrease in liquidity

(b) an increase in reported defaults, insolvencies, and bankruptcies.

The economic indicators of the SME crisis

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Extended payment delays on receivables, especially in times of reduced sales, rapidly leads to a depletion of working capital and may entail frequent liquidity or even insolvency problems. Governments are aware that if SMEs cannot quickly obtain additional funding this will lead to insolvencies.

According to "Insolvencies in Europe 2008/09" (Creditreform), the total number of insolvencies increased by 11 percent between 2007 and 2008. In some countries like Denmark, Italy, Ireland, Norway, and Spain the surge in corporate insolvencies was higher than 25 percent when in other countries it remained stable between 2007 and 2008. These trends have to be interpreted with great caution because legislation on insolvency and bankruptcies differs greatly by country, and so do statistical reporting methodologies – which means that the figures may not capture short-term changes. In order to have a proper reading of such figures, they should be put in longer-term perspective.

The response of the surviving SMEs to the double pressure of falling sales and extended payment delays in a general context of bleak medium-terms perspectives is - in theory - three fold:

(a) cost-cutting to restore profitability and adjustment of production to lower demand levels, measures that materialize mainly in a reduced wage bill;

(b) search for additional sources of liquidity (extending own payment delays, reducing or suppressing dividends - if any);

(c) postponing of investment and expansion plans, when possible (including M&A activity for the small subset of high- growth SMEs). In case of entrepreneurship, this could simply mean the postponement or even the cancellation of new business ventures.

Among the possible SME responses to the demand shock for goods and services, cost-cutting and lay-offs and the subsequent labor market impacts are some options.

SME and credit availability in the new context

In October and November 2008 extensive surveys have been undertaken as well in industrialized and in less developed Countries on the impact of the financial crisis on credit policy by lending banks and the wider impact on the near future of SME business, exports, investments and development.

As a general result of such surveys approximately one third of the SME entrepreneurs briefed, stated that they are currently experiencing a tightening of credit policy by their banks (extreme restrictions have been decided e.g. in Iceland and in Central and East European Countries) and two third expect that in the short and medium term it will be more difficult to obtain credit – at least at economically acceptable conditions – for their business.

The assessment of credit demand is difficult from the methodological point of view. Some countries use the Bank Lending Survey (BLS) method to capture changes in demand as perceived by bank officials. These responses are weighted according to the relevant bank's market share and presented as a balance of opinions: the weighted percentage that sees an increase in demand minus the weighted percentage that see a decrease in demand. The evidence from countries applying this methodology clearly shows:

(a) the overall slump in credit demand is being experienced in all countries but one in Q4-2008 and is expected to last in Q1-2009 even if its severity varies from country to country;

(b) in all countries the reduction of credit demand for investment or acquisition purposes is extremely severe (50% or more of respondents);

(c) SMEs' demand for credit in Italy, and to a lesser extent Germany, did not change so dramatically when compared to their French, British and US counterparts.

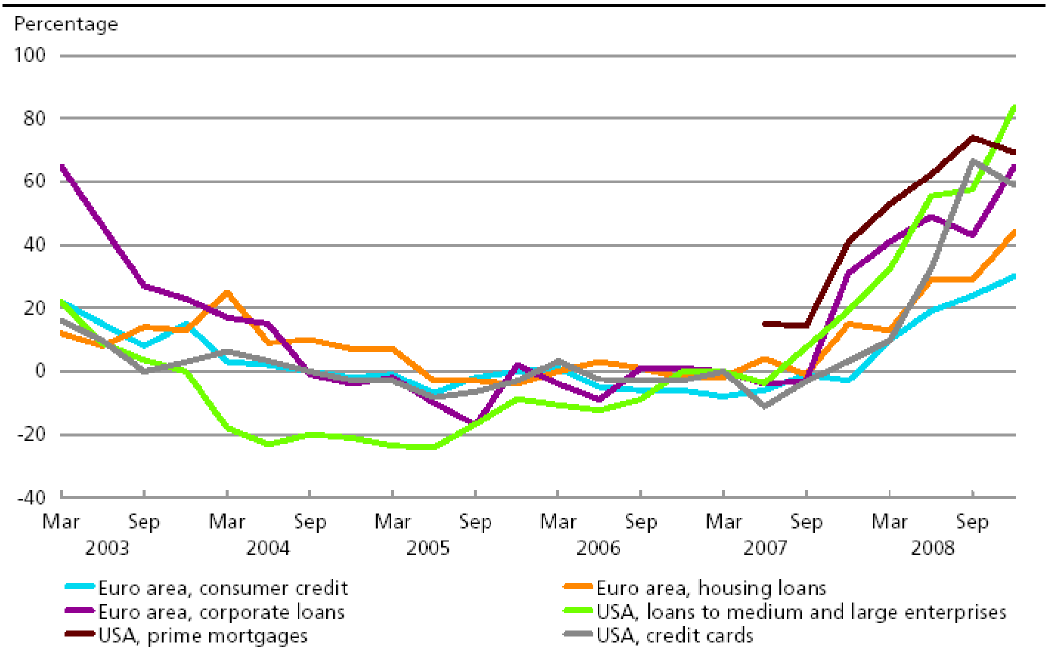
In countries either not using or not publishing BLS results, the evidence provided refers to the many SMEs that feel frustrated in accessing credit and not to changes in the level of demand as such: in the Netherlands, one out of five SMEs was looking for additional funding in 2008. In contrast, in Finland less than 10 percent of SMEs were facing major difficulties in obtaining working capital or investment funding.

The overall SME reactions that emerge from the available information suggest that entrepreneurs are not willing to increase their indebtedness despite the fact that sales fall and payment delays increase. Facing an uncertain future, this reaction is fully rational especially when these enterprises are confronted with tightened credit conditions imposed by banks and other creditors.

Loan conditions encompass many dimensions among which the most important are the spread between the banks and other financial intermediaries' cost of funds and interests levels, the commissions, the difference between the amounts granted and those demanded by the enterprises, the level of collateral required, the duration of the loans, and processing delays.

Figure 1 shows changes in banks' lending conditions derived from the BLS methodology for both the euro area and the US. It reveals that except for euro area lending to corporations, the present tightening in bank loan conditions does not have any recent precedent.

Figure 1: Banks with tighter lending conditions



Note: Calculations based on Senior Loan Officer Opinion Survey on Bank Lending Practices from the Federal Reserve System and the Euro Area Bank Lending Survey from the ECB. In these surveys, a number of high-ranking employees within the banks respond, on a quarterly basis, to a number of recurrent questions about the credit standards of their banks. The index is calculated as the percentage stating that they have tightened conditions.

Source: EcoWi n, in "Danmarks National Bank", Monetary Review, 4th Quarter 2008.

Indications from all countries converge and show a general tightening of credit conditions. Reductions in credit actually granted as compared to previous periods are visible for Denmark, the Czech Republic, and Belgium.

The above mentioned evidence suggests that:

(1) SMEs (and enterprises in general) have strongly reduced their investment projects financed by credit;

(2) SMEs demand for working capital and short-term loans has been reduced in some countries but not as dramatically as for investment purposes;

(3) banks have tightened their lending policies in terms of guarantees and amounts, but not exclusively towards SMEs;

(4) in some countries banks and other financial intermediaries have substantially increased the cost (and spread) of credit to all their clients, which may appear paradoxical in a situation of a general fall in interest rates.

In consequence, this evidence suggests that in addition to the demand shock described above, conditions under which SMEs can access credit have significantly worsened in some reporting countries. If this is true, then the enterprises in general and SMEs in particular are, de facto, exposed to two different shocks reinforcing each other: a demand slump or downturn and a financial shock due to banks and other financial intermediaries' reluctance to lend.

Three factors may have exacerbated the banks and other financial intermediaries' attitude towards lending to SMEs:

(a) poor SME economic prospects

(b) the stagnation in inter-bank lending and the increased cost of capital and

(c) balance sheet constraints.

In all EU countries, banks and other financial intermediaries are under pressure and are trying to preserve or strengthen their capital base. As part of this strategy they are seeking fully collateralized transactions that minimize the use of their economic (as opposed to regulatory) capital. In consequence, by choosing to keep only the strongest among their existing clients, banks and other financial intermediaries are contributing to a polarization process. In some countries, banks have reduced lending not just because risk has gone up, but also because they are having difficulty raising funds overseas and are directly affected by the substantially reduced access to short term inter-bank funding at other than very expensive rates resulting from a significant deterioration in banks' confidence in the banking sector's general level of solvency and credit rating.

The stagnation in lending is true even of banks in countries where governments have deliberately strengthened banks' balance sheets to allow them to grant additional credit to SMEs and/or where credit guarantee schemes exist. Most countries have not only recapitalized their banks but also extended the funds and guarantees available for SME financing. But the effects of the incentives to lend to SMEs put in place by governments in some countries (such as the provision of additional capital) have not yet yielded the desired results.

Some governments are closely monitoring this situation or have put in place "credit mediators" to ease the flow of credit to SMEs.

Alternative sources of financing

Confronted with worsening access to credit, SMEs are exploring alternative sources of finance such as mobilization of reserves and self-financing; self-financing and factoring. Although private equity and venture capital markets have not contributed to the global financial crisis, the extent of the impact the crisis has and will have on entrepreneurs, entrepreneurial firms and SMEs access to equity financing around the world remains unknown.

In terms of venture capital and private equity, the information provided is largely anecdotal and for many countries there are no official statistical data available covering 2008. However, new anecdotal information indicates that entrepreneurs, entrepreneurial firms and SMEs find it increasingly difficult to access financing for new projects.

The financial crisis has had a three - fold impact on venture capital and private equity markets:

1. exit opportunities are reduced.
2. fundraising activities seem to be shrinking.
3. invested capital has stagnated or even slowly started to decline, especially investments in new projects.

It is expected that invested capital will see further declines in the coming period.

The global fundraising activity has also slowed down between 2007-2008. The current economic situation and the global downward pressure on prices are expected to influence the future prospects for fundraising in the markets in the long run. Institutional investors providing funding will simply be less willing to supply new funds with fresh capital. As a result, the number of new venture capital funds could be lower than expected before the crisis.

If the private venture capital and private equity funds do not raise sufficient capital, they will have to reduce the number of investment managers. For many markets this will mean a significant setback in investment and have a negative impact on the development of investment expertise in the markets, and thus make it even harder for entrepreneurial firms and SMEs to survive and grow – in the longer run as well.

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

Policy responses of governments

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

The anti-crisis packages and accompanying measures address, in many countries, more specifically the financing problem of SMEs. The measures put in place by countries can be classified in three different groups depending on the aspect of the

SME financing problem to which they are geared. Three main groups of measures can be distinguished:

(a) measures supporting sales, cash flows, and working capital;

(b) measures to enhance SMEs access to liquidity, mainly to bank lending;

(c) measures aimed at helping SMEs to maintain their investment level and more generally their capacity to respond in the near future to a possible surge in demand.

Despite the fact that in many of the responses, some of the largest banks have been recapitalized with public funds, the evidence from the economy suggest that banks have significantly tightened their credit policy. In order to alleviate the effects on SMEs of the twin shock of falling sales and more difficult access to funding, governments are using two different approaches to increase availability of credit:

(a) on the incentive side, the creation and extension of guarantee schemes for loans to SMEs, or direct public lending;

(b) on the discipline or sanction side, providing banks that have been recapitalised by public monies with specific targets concerning SMEs lending, putting them under administrative monitoring or putting in place specific procedures to solve problems between individual SMEs and banks.

Incentives: the loan guarantee schemes

Extension, diversification of public guarantee schemes or, in some cases, even direct lending by public institutions, are among measures being widely used by reporting countries. These policy measures aim at dealing with one of the key reasons that may explain banks reluctance to lend to SMEs that is, their constraint in terms of their capital requirements. Public guarantee schemes for SME credit are expected to be an incentive for bank lending to this segment of clients. For European Union member countries, the potential leverage effect of public guarantees on SME bank lending has been further extended by the decision of the European Commission to temporarily authorize Member States to ease access to finance for companies through subsidized guarantees and loan subsidies for investments. Almost all EU countries have enhanced, or put in place, a credit guarantee scheme either focused on SMEs or a general one.

In some countries, the governments have found the response of the newly recapitalized banks to the needs of SMEs unsatisfactory or insufficient. These countries have resorted to discipline measures that in some cases complement the incentives, in order to pressure banks to continue lending to enterprises. Belgium and France have appointed a credit mediator, who at regional and central levels, may intervene to soften and help solve divergences between enterprises that are seeking bank funding and banks.

Strengthening pro investment measures

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

Strengthening the capital base, private equity and venture capital

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

Table 1: Policy responses in EU countries

	A. Measures supporting sales, cashflows and working capital (Annex 5)				B. Enhancing SME access to liquidity, especially to bank lending (Annex 6)		C. Strengthen-ing pro-investment measures (Annex 6)	D. Strengthen-ing capital base and private equity and venture capital (Annex
	Export facilitation	Alleviating working capital shortage in the	Easing tax payments	Easing procure-ment payment procedures	Creation and extension of loan & guarantee schemes	Mediation and monitoring		
Austria	•				•		•	•
Belgium			•		•	**Mediator**		

Czech Republic	•				•		•	
Denmark	•		•					•
Finland					•			•
France		•	•	•	•	**Mediator**	•	
Germany	•				•		•	
Greece					•			
Hungary					•		•	•
Italy	•	•	•		•	**Monitoring**	•	
Luxembourg	•				•			
Netherlands	•	•	•	•	•			
Spain	•				•		•	
UK				•	•			•
Estonia					•			
Romania					•			
Slovenia	•				•			•

Source: OECD survey Nov.2008

Conclusion

Clearly, SMEs experience additional difficulties today in achieving adequate levels of liquidity, but it is still unclear to what extent they are willing to borrow, on what terms and to what extent they are credit constrained. Indeed, increased borrowing today may result – in case of prolonged poor sales - in over indebtedness tomorrow. In such a situation the current liquidity problem would be transformed in the medium-term into an insolvency one.

Obviously, the banks' attitude towards lending is an important component of the issues addressed in this paper. Compelled to revise their business models and lines of activities, most banks are constrained by their poor capital base and sensitive to the fact that investors are putting a premium on the shares of financial institutions that are better capitalized.

In the new situation, some governments have had insufficient time and, in most cases, insufficient information, to base their interventions and measures on a solid diagnosis of the problems that SMEs – in their extreme heterogeneity of size, form and mode of operation – are facing. This being said, other governments, regardless of the incomplete evidence gathered on SMEs' financial difficulties, felt that the extraordinary circumstances required tailored responses, and they have adopted a number of measures to ease SMEs' financing conditions.

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

In terms of venture capital and private equity markets, worsened exit opportunities and declining fundraising activities are slowly resulting in lower investment levels. It is expected that investment levels – in particular new investment – will decline further in the coming period. In terms of policy interventions on the venture capital markets, it is uncertain whether the newly introduced policy instruments have been designed following the crisis or planned prior to crisis and since adapted to the new situation.

From the analysis of the data on the situation of SMEs and entrepreneurs regarding access to finance and the accompanying policy responses we consider the following recommendations:

Improving cash flow

- Governments could consider improving SME cash flow and working capital through such measures as accelerated depreciation, tax measures, factoring for receivables and improved methods for reducing payment delays. For example, some governments have cut their payment delays to ten days.
- While SME liquidity can be increased through lending and fiscal measures, ultimately it is the revival of demand that will sustain SMEs. Therefore, Governments could design their stimulus packages to ensure that they will have more direct and timely impacts on SMEs.
- Public procurement should be considered more systematically as a demand-side instrument to support R&D and production of innovative goods and services by contracting out to SMEs (in particular in the environmental, energy and IT areas).

Facilitating access to credit

- While guarantee programmes are a commonly used measure by governments, there appears to be a problem in their uptake by banks. Governments could consider making their guarantee programmes more attractive through more appropriate risk-sharing with private lenders.
- To ease the access to bank lending, particularly for SMEs, Governments could keep under review the role of credit mediators and monitoring and adopt such mechanisms if appropriate. Any revisions in Basel 2 should also be reviewed for

their impacts on SME lending

Fostering investment

• Due to worsened exit markets and declining fundraising activities, Governments could consider policy instruments aimed at improving exit markets and enhancing the supply of venture capital.

• Public equity funds can operate so as to help catalyze and leverage the provision of private risk capital. Governments and international organizations could establish or increase public equity funds to leverage private risk capital to prevent the complete collapse of new venture capital and its consequences for start-ups and innovative SMEs.

Promoting business services and SME engagement in the design of relevant policies

• To help SMEs confront the current financial and economic crises, Governments could improve their provision of information on SME-related government measures to business service providers or business associations. They could also facilitate the provision of business services to SMEs to assist them in their negotiations with banks and other financial intermediaries and in resolving their cash flow problems.

• In times of crisis, the managerial competencies of SMEs – especially in the field of finance –have to be supported. In order to improve the level of financial knowledge of SMEs, Governments could support, in the short-term, business development services and training programmes.

• SMEs should be engaged in the design of relevant policies from the outset, to ensure that their perspectives and needs are well understood and taken into account. Governments could communicate and consult regularly with the representatives of SMEs to assess both the extent of the impact of the crisis and the effectiveness of existing measures and programmes in helping SMEs survive.

Promoting the availability and diffusion of timely information

• There is a need for more timely and SME specific data on financing. The bank lending survey methodology appears as a possible best practice, especially if it could be extended to cover all other financing sources available to SMEs. Governments could also consider improving transparency in bank lending by encouraging the timely public disclosure by banks of the composition of their loan portfolios by size of firm.

• In order to be in a position to better distinguish – in times of crisis as today - what problems are extra-ordinary (i.e. linked to the present crisis) and, in consequence, could possibly be addressed by extra-ordinary measures, and what are the *usual* ones to be left to *"usual"* measures, Governments could put in place a policy oriented "SME Financing SCOREBOARD" based on different observation methods so as to obtain a comprehensive real-time picture that would also capture early warning signals. In order to support and nourish the "SME Financing Scoreboard", Governments could develop a set of sophisticated observation methods such as SME panels and cohorts.

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