

Four Proposals for Improved Financing of SME Development in ASEAN

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Small- and medium-size enterprises (SMEs) are of great socioeconomic significance although their long-term growth and competitiveness have been compromised by the chronic and often acute constraints on their access to formal-sector finance, among other systemic and institutional problems in developing countries, including the Association of Southeast Asian Nations. Largely as a result, SMEs' share of financing resources is disproportionately less than their relative importance in domestic employment and, to a lesser extent, value added. Proposals to address financing problems on the demand side are made relating to more systematic disclosure of information on finance and governance, and better business planning by SMEs. Parallel capacity building efforts on the supply side include greater reliance on credit information systems, and SME risk scoring and competitiveness benchmarking.

I. INTRODUCTORY OVERVIEW

Small- and medium-size enterprises (SMEs) are the backbone of virtually all economies in the world, including those within the Association of Southeast Asian Nations (ASEAN).¹ Notwithstanding various definitional issues and data problems, SMEs number in the hundreds of thousands and account for upward of 90 percent of all nonagriculture firms in most parts of ASEAN. They also employ

¹For example, SMEs in the European Union (with 250 workers as the upper threshold for medium-size businesses) account for about one half of the total value added and two thirds of the domestic workforce (European Union 2002, 118). Comparatively, small businesses with less than 100 employees in the United States are the source of about one third of both domestic employment and sales value (Velasco and Cruz 2001, 19). SMEs contributed between 40 and 50 percent of manufacturing output in Japan; Republic of Korea (Korea); and Taipei, China in the mid-1990s (UNCTAD 1998, 17-9). Meanwhile, SMEs in Central and Eastern European economies in transition are also found to be more dynamic than state-owned enterprises (SOEs) as a source of output growth and employment generation (Klapper et al. 2002, Svejnar 2002).

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an overwhelming proportion (mostly in the 75-90 percent range) of the domestic workforce, especially young persons and women.² On the other hand, SMEs contribute a disproportionately small share—in the range of 20-30 percent to gross sales value or manufacturing value added, and 10-20 percent to export earnings in the region.³ However, their actual share in total exports is considerably larger because of the participation of many SMEs as subcontractors to export-oriented local firms and transnational corporations (TNCs).⁴ Nevertheless, the range of direct exports from the SME sector remains typically narrow and their value added relatively limited.⁵

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

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

³For further details, see Hall (2002); Harvie and Lee (2002); Lee and Tam (2002), Richards et al. (2002), Tecson (2001), Regnier (2000), and Tambunan (2000).

⁴See, for example, Rodriguez and Berry (2002), Wattanaputtipaisan (2000a), Borrus et al. (2000), Regnier (2000), Tambunan (2000), Levy et al. (1999), Liedholm and Mead (1999), Altenburg et al. (1988), and Humphrey (1998). A detailed discussion on the diverse global and regional patterns of enterprise clusters and interfirm networks and alliances, involving SMEs, can be found in Berry et al. (2002), Boari (2001), UNCTAD (2000), Liedholm and Mead (1998), Porter (1998), UNCTAD and Gate (1993), and Schenberger et al. (1990).

⁵Featuring prominently in SME exports from Indonesia, Philippines, Thailand, and Viet Nam are food products, textiles and garments, leather and plastic goods (including toys), furniture items, handicrafts, jewelry and, to a lesser extent, mature-technology automotive and consumer electronics parts. For further details, see Hill (2002 and 1995), Richards et al. (2002), Rodriguez and Berry (2002), Steer and Taussig (2002), Regnier (2000), Tambunan (2000), and Tecson (2000).

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

of workers and numerous SME entrepreneurs displaced by the 1997-1998 crisis as well as for persons ready to enter the workforce or resume risk-taking activities.⁷

Furthermore, there is now a new development context or a paradigm shift to be managed by all business firms regardless of size. Firstly, the liberalization of global trade and investment flows has created vast demand opportunities but has also engendered fiercer competition from global and regional suppliers of goods and services. Indeed, many SMEs in South Asia and Southeast Asia have already felt intense competitive pressures from the People's Republic of China (PRC) in a wide array of manufactured goods. Besides, the PRC has gained a larger foothold (including in clothing, footwear, and telecommunication equipment) in the most important export markets for both ASEAN and the PRC.⁸ Secondly, consumer preferences and market demands are changing constantly as well as becoming more exacting. At the same time, such nonprice parameters as product quality, health and safety in consumption, social equity in employment and production, and ecological implications of products and processes have become more important as a determinant of business advantage. All these have necessitated the adoption of new and innovative business and industrial organization models, and the upgrading of production and marketing processes by most SMEs (Wattanaprutipaisan 2002b, Momaya 2001, Altenburg 1999).

As such, the promotion of SME growth and competitiveness in ASEAN countries can be expected not only to yield increasing social and economic returns domestically but also to empower the private sector in its ongoing integration into the global economy. However, the process has long been constrained by the limited availability and accessibility of financial resources to meet a variety of operational and investment needs within the SME sector. Both demand-side and supply-side factors have contributed their share to this financing problem in the region. These factors, together with four proposals for enhancing SME access to finance as well as institutional capabilities in SME financing, are discussed with special focus on the banking sector in ASEAN.

⁷Between 1997 and 1998, for example, the rate of unemployment more than doubled in Malaysia and Thailand, and rose by more than fourfold in Indonesia. The number of unemployed persons went up to 0.6 million in Malaysia, 1.5 million in Thailand, and 20 million in Indonesia. Female workers suffered particularly severely because they were concentrated in the most precarious forms of low-skilled wage employment. In addition, during the high-growth era of 1980-1996, female participation rate in the labor force had expanded from 38 to 41 percent in Indonesia, and from 34 to 37 percent in Malaysia (UNESCAP 1999, 114-21).

⁸The trade patterns between ASEAN and the PRC during the 1990s are examined in ASEAN (2001) while a detailed analysis of the gains, issues, and implications associated with the proposed ASEAN-China Free Trade Area can be found in Wattanapruttipaisan (2003). The patterns of the PRC's penetration into the G-7 markets are discussed at some length by the Organisation for Economic Cooperation and Development (2002, 138-42).

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

II. ISSUES AND CONSTRAINTS IN SME FINANCING

SME financing problems have to be seen against a more general context. Firstly, financial resources for development (whether of domestic and/or external origin) are in short supply in virtually all developing countries. Secondly, government has become “leaner and meaner” and new and innovative policy measures have to be introduced to widen and deepen investor interest and the investment base. Thirdly, financial intermediation and the related infrastructure and facilities (both financial and nonfinancial) can be improved and made more sophisticated in ASEAN as part and parcel of the development process itself.¹⁰

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

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

Fourthly, SME financing difficulties also reflect other systemic and institutional issues, such as the underdeveloped legal and regulatory infrastructure (both hard and soft) and the prevalence of nontransparent practices.¹¹

A. Limited SME Share in Domestic Financing

Bank finance has remained the dominant source of capital and credit for domestic business in most developing countries, including those in ASEAN.¹² It is also the main source of SME financing in both developing economies and even in financially advanced countries such as the United States.¹³ Bond financing is not a viable option for most small businesses, due to the substantial cost in the underwriting and distribution of paper securities, while equity financing has its own limitations, especially in terms of the tight market listing requirements and the possible loss of control to external investors (Takagi 2002, 74-5). Generally, concerted efforts have been made in ASEAN and elsewhere to encourage commercial banks to lend to SMEs by means of loan quotas, interest subsidies, tax breaks, guarantees against default, and so on. These efforts have also been supplemented by a variety of other measures such as the establishment of development financial institutions (DFIs) for agriculture and industry, and other specialized banks. Moreover, the qualified or targeted SMEs are also provided with financial support under various business development services (BDS) ranging from training, export

development. An extensive survey of literature on this subject can be found in Levine (1997, 688-726).

¹¹Weaknesses in the legal and regulatory framework governing creditor rights, collateral matters, and bankruptcy and exit procedures have combined with legal system inefficiencies and overloads to constitute another barrier in the case of SME financing. This barrier is prevalent in many developing countries, particularly among transition economies in Central and Eastern Europe (Klapper et al. 2002, 8-11) and in Asia such as Viet Nam (Richard et al. 2002, 117-8 and 122-5). This is because institutional designs, and the related provision of incentives and sanctions, is a process of trial-and-error and of searching for workable ways to adjust most effectively and promptly to changing circumstances. Shifting between coordination and enforcement mechanisms in many economic and social spheres is necessarily a lengthy and complex process (Postma 2002, 98-100).

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

¹³In particular, corporate equity and debt securities were equivalent to 115 and 53 percent, respectively, of the combined GDP of the group of seven richest countries in the late 1990s. However, the corresponding figures for Indonesia, Malaysia, Philippines, and Thailand were 56 and 6 percent, respectively. In addition, the stock of outstanding bank loans in these four ASEAN members was about 92 percent of their combined GDP, compared to about 45 percent in the two major emerging economies in Asia (India and Korea) and 4 percent in Central Europe (World Bank and International Monetary Fund 2001, 363-6).

marketing, participation in trade and technology fairs, to interfirm linkage promotion.¹⁴

1. Overview of SME Financing Issues

On balance, direct and indirect intervention in the financial sector has not been able to compensate for the various biases against the SME sector unintentionally introduced into, or inherent within, the domestic policy and regulatory framework. Firstly, there is the (scale-based) “perverse” incentive syndrome whereby tax, financing, and other benefits and privileges are granted by the government in exchange for certain minimum or baseline requirements to be undertaken by the enterprises concerned as regards investment size, employment volume, and/or export quantities and values.¹⁵ Secondly, import substitution policies in several ASEAN countries used to protect sectors dominated by large-scale and capital-intensive firms. Thirdly, the complex legal and regulatory environment has often combined with opaque discretion to raise significantly the transaction costs on SMEs on account of their limited size and resources (Hallberg 2001, 9-11).¹⁶ Fourthly, SMEs are not well or adequately represented in private-public interaction and dialogues. Lastly, social perceptions and administrative attitudes in economies in transition are not yet wholly judicious to private enterprise, including SMEs (Richards et al. 2002, 117-8 and 122-5).

By and large, financial and other support measures, and the massive subsidies involved, in SME financing have not been as successful as originally intended; there are also a variety of unfavorable trade-offs and negative external-

¹⁴There is a relatively extensive literature on various government assistance programs in favor of SMEs in Indonesia (Hill 2002, Urata 2000); Malaysia (SMIDEC 2002); Philippines (Viloria 2001); Singapore (Hew 2002); Thailand (Brimble et al. 2002, Mizutani 1999); and Viet Nam (Richards et al. 2002). A checklist of SME assistance programs among 21 APEC members, including seven from ASEAN, is presented in APEC (2002, 88-99).

¹⁵According to Regnier (2000, 65), about 70 percent of the big, locally owned and joint-venture firms enjoyed various incentives and privileges from the Board of Investment in Thailand during the 1970s to the early 1980s. In textiles and garments, for example, some 80 percent of the large enterprises receiving public-sector assistance between 1960 and 1976 were in joint venture with Japanese firms. Another trade-off from the scale-based syndrome is the implicit constraint on foreign direct investment (FDI) in local SMEs, and on the formation of linkages between these local enterprises and overseas firms. Thus, these SMEs are deprived of valuable opportunities to obtain crucial technological and financial inputs, and market access associated with such FDI or interfirm linkages.

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

ities so generated in the process.¹⁷ Indeed, limited outreach at disparate cost to stakeholders is the perennial weakness, although at varying orders of magnitude, of SME financing from the formal financial sector in a large number of ASEAN countries (Hill 2002, Tescon 2001, Sahami-Malmberg 2000). Indeed, the persistent constraints on SME financing, and the restrictive terms and conditions on approved loans, are virtually a universal and significant problem among developing countries (UNCTAD 1995, 7-10). However, this unsatisfactory state of affairs is not wholly due to the limited supply of finance because there are examples of significant underdisbursement of public-sector resources allocated to SMEs within the system itself (more later).

Although many analytical studies have been carried out on SME financing problems, there exist very few comparable data or empirical surveys on the nature and extent of SME participation in commercial bank financing across ASEAN.¹⁸ Besides, most of the studies and surveys so far undertaken focus on a few, and often individual, ASEAN members while many surveys are additionally plagued by a number of methodological problems, making cross-country and cross-sectional comparisons less reliable.¹⁹ Even with such limitations, it is apparent that to meet

¹⁷These include slow progress in the development of sustainable financial schemes, the structural diversification of financial institutions, and the emergence of a “non-repayment culture” among enterprises, especially if the resources concerned are regarded as part and parcel of poverty reduction efforts from the public sector (Hallberg 2001, 12). More generally, many financial and technical assistance programs from government are perceived by SMEs as of limited impact and relevance, with the possible exception of market information dissemination and assistance in trade fair participation (Hill 2002, Berry et al. 2001, Holtmann et al. 2000, Regnier 2000, and Webster 1991).

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

¹⁹Among the major weaknesses are the small and nonrepresentative sample of firms within the same or in different industries, underreported or mismeasured data (including those from follow-on interviews), limited controls over local or industry-specific factors that may impact on the perceptions and responses, absence of regular or time serial surveys, and lack of cross-sectionally comparable questionnaires. In particular, enterprises are frequently selected on a nonrandom basis, and this bias “overstates” the degree of SME participation in bank financing (or in the focal areas of attention) since the surveys concerned, for reasons of accessibility, tend to cover better performing firms or SMEs that are in the top segments of their class in terms of size, growth, and outward and networking orientation. In all fairness, however, it should be noted that selection bias is perhaps unavoidable. As indicated earlier, the number of nonagricultural SMEs is massive—ranging from 50,000 in Singapore; 100-350,000 in Thailand and Viet Nam; 800,000 in Philippines; to some 16 million in Indonesia (APEC 2002, 37). In addition, SMEs are widely found across domestic regions, provinces, and urban and periurban areas. Moreover, private enterprise is a relatively new phenomenon in economies in transition to a market-based system.

various financing needs, between 75 and 90 percent of SME entrepreneurs in the region rely largely on their own savings, internal resources of the firm (such as retained earnings and other enterprise funds), short-term (unsecured) borrowings from relatives and friends (also known as business angels or informal equity investors), and grey-market loans.²⁰ In addition, bank finance does not often cover all the financing needs of SMEs. In Malaysia, for example, funds from commercial banks met, respectively, 62 and 21 percent of working capital and long-term investment requirements from the surveyed SMEs; the corresponding figures for SMEs in Thailand being 57 and 37 percent. Public financial institutions and private finance companies remain a minor source of SME financing in both countries.²¹

Furthermore, on the basis of survey results in developing countries outside ASEAN, it can also be expected that the financing constraint is particularly severe in start-up enterprises and relatively young firms (some three years old or less), as well as on smaller firms in lower-income developing economies in the region. For example, only 10 percent of start-up firms in Ghana can obtain bank loans but medium-size enterprises and older firms (presumably with a good credit history and hence relationships with banks) are provided with start-up credit three times more often than their smaller counterparts. These results are, by and large, confirmed by a survey in Sri Lanka and Tanzania where 80 percent of firms with 16 or more workers and with 6 or more years in operation are able to access bank loans—compared to the success rate of around 55 percent in the case of smaller firms (6-15 employees) of similar age, and less than 10 percent for firms with 5 or fewer workers, regardless of age.²² Another survey in the PRC shows that the

²⁰A similarly heavy degree of reliance on internal sources of funding for enterprise operating and investment needs in the PRC is also obtained by the International Finance Corporation (IFC) from a survey of 628 firms in four major cities (IFC 2000, 48-9), and by the Asian Development Bank from a survey of 724 firms (with an average number of 228 workers per enterprise) in five major cities (ADB 2003, 73-7).

²¹The survey was conducted in 1999 by Japan Bank for International Cooperation and involved a sample of 221 and 642 relatively large firms within the SME sector, which were still operating after the crisis in Malaysia and Thailand respectively. It provides further confirmation that the larger and older SMEs are better placed to obtain bank finance. Additionally, public-sector financial institutions are only a minor source of SME financing, and this issue will be discussed further in the text. The same is also true for private financial companies that provided respectively only 7 and 16 percent of working capital and investment needs of Malaysian SMEs in 1999. The corresponding ratios in the case of Thai SMEs were just over 1 percent in each instance (Urata 2002, page 4 and table 4). As regards the PRC, bank loans are equivalent to just 10 percent or less (or over 50 percent) of the needed capital of 63 (or 6) percent of the enterprises with access to institutional credit (Asian Development Bank 2003, 95).

²²Aryeetey et al. (1994, 18-9) conducted a survey of 133 firms, of which 76 had less than 10 workers, in various industries in Ghana in the early 1990s. Levy (1993, 69-71) surveyed 38 firms (with 15 having 5 workers or less) in the leather industry in Sri Lanka, and 20 firms (with six of them having 5 workers or less) in the furniture industry in Tanzania in the late 1980s. In

share of bank loans increases with the size of the firms although it still remains relatively low, ranging from between 20 and 35 percent of the required capital of the (relatively large) enterprises concerned (IFC 2000, 51).

2. Patterns and Characteristics of SME Financing

It is very difficult at present to obtain comparable indicators of the total amount and relative share of institutional or bank finance secured by SMEs in ASEAN and elsewhere. Despite concerted efforts, APEC is able to estimate the financing share of SMEs for just seven economies (out of 21 members) with four being developed countries and Indonesia being the only ASEAN economy with some available estimates (APEC 2002, 74-5).²³ By and large, suggestive evidence indicates that the SME sector may share only one fifth or less of the institutional credit extended to all businesses in the late 1990s (APEC 2002, Vitoria 2001, Berry et al. 2001). This relative stake, which may be subject to a margin of error both ways, is slightly lower than SME contribution to aggregate production. However, it is certainly much less than the relative importance of SMEs in domestic employment generation.

A number of implications can now be explored briefly. First, Indonesia registers perhaps the fastest expansion in formal-sector financial services (especially branch banking) within the region.²⁴ Yet, only 12 percent of SMEs are estimated

comparison, Klapper et al. (2002, 20) found a positive correlation between younger SMEs and bank financing, as well as between these enterprises and profitability, in a sample of 79,723 SMEs in various industries in 15 Central and Eastern European transition economies for 1999. SMEs had emerged from the break-up and/or privatization of SOEs in the wake of economic transition some 10 years back; they have also benefited considerably from international assistance programs. As such, many SMEs in Central and Eastern Europe tend to have easier access to bank finance because of their dynamism and profitability.

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

²⁴For example, the number of private commercial banks (and their offices) jumped from 63 (and 559) in 1988 to 144 (and 4,150) a decade later. Foreign banks, including joint-venture banks, numbered 11 and 44, respectively, during these two benchmark years. Meanwhile, state-owned commercial banks almost doubled their network over the same decade, from 815 offices in 1988 to 1,527 in 1997. Earlier, interest rate controls and credit ceiling fixed annually for commercial banks had been removed in 1983 (Simanjuntak 2001, 31-2).

to have access to bank finance in the country (APEC 2003, 5). Meanwhile, almost two thirds of the surveyed SMEs in the garment industry have accounts at commercial banks in Indonesia but less than 20 percent have ever applied for and actually obtained a bank loan. As regards SMEs in the wood furniture industry, the corresponding figures are 47 percent and less than one tenth (van Dierman et al. 1998). These comparatively low ratios are, in part, reflected from the institutional side with a very low ratio of SME loans to deposits, implying thus some resource transfer to other borrowers.²⁵ Indeed, it has been colloquially remarked that bank credit is just a flower added to the brocade, instead of being charcoal in snowy weather (Asian Development Bank 2003, 110).

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

However, it is access to finance (rather than the cost of finance as such) that has constrained SME development and competitiveness. Furthermore, because of location or sectoral specialization, many firms within the SME sector are growing beyond the size that informal sources of finance can support and institutional credit is the only feasible option for upward movement to them (Asian Development Bank 2003, Hill 2002, IFC 2000, UNCTAD 1995). Additionally, many firms will gladly accept and carry bank credit at double the going (institutional) rate because financial sector interest rates are still far below those from the curb or grey markets.²⁶ Rates from these markets may be up to 30 percent per month on a “short-term” monthly loan, and between 5 and 10 percent a month for “long-term”

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

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

loans of a year's maturity (UNCTAD 1995, Aryeetey et al. 1994). These sheer magnitudes illustrate the remarkable productivity of capital in the SME sector in many low-income countries.

Third, DFIs have played only a minor financing role: in Malaysia, for example, about 4 percent each of SME credit for working capital and long-term investment came from these institutional sources in 1999; the corresponding percentages were 4 and 2 percent in the case of Thailand (Urata 2002, 4 and table 4; Regnier 2000, 25). Indeed, the performance of public-sector institutions with a SME funding mandate often leaves much to be desired. A detailed review of the 33 World Bank projects (noted earlier) shows that the average loan size (US\$130,330) and the average cost of job creation (US\$12,721) from DFIs were, respectively, four times and three times larger than the overall average. Yet, the repayment rate achieved by these institutions was only 62 percent, compared 80 percent overall (Webster 1991, 24-5 and 35).

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

Fifth, the spread effects of macroeconomic stability and vibrant economic growth in the two decades before the 1997-1998 crisis offset considerably the adverse impact of the disproportionately low share of financial resources channelled to the SME sector (Hill 2002, 174; Urata 2002, 10; Berry et al. 2001, 378; Tecson 2001, 74; Regnier 2000, 25-6). On the other hand, large segments of SMEs will be pushed to the forefront of the domestic economic recession with any serious reversal of macroeconomic economic and financial fortune.²⁷ There is, in particular,

²⁷In particular, the SME sector in ASEAN was hard hit through the direct and spill-over effects of a sudden collapse of demand and high inflation, a hike in input costs (due to steep currency depreciation) and in the prices of goods with a sizable import content, and the even more acute shortage of finance and the very high cost of loan funds. However, the nature and magnitude of the crisis's impact on firms depends on the degree of their export orientation, sectoral concentration of production, ownership structure (such as joint venture firms), extent of exposure to formal-sector financing, and operational scale or size itself. Generally, survey data indicate that around 70-80 percent of SMEs in the manufacturing sector were adversely affected

considerable evidence of a sharp decline in business loans to SMEs, and their greater reliance on grey-market funds, during the crisis period of 1997-1998. The falling or negative rate of growth in credit persisted in the later part of the 1990s due partly to the high level of nonperforming loans within the financial system and the banks' preoccupation with troublesome, large borrowers (APEC 2002, Urata 2002, Regnier 2000). For example, the seven state-owned banks and specialized financial institutions in Thailand disbursed only 52 percent of the allocated resources for SME financing totalling 70 billion baht (US\$1.6 billion) during 1999 and the rate of disbursement for the first half of 2000 was largely at the same (slow) rate as that in the previous year.²⁸

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

The unsatisfactory outcomes as regards SME financing, as reviewed above, are due to a variety of adverse factors of both a systemic and institutional nature.

1. *Most financial institutions have not been able to operate profitably with SMEs as their sole or major debt clientele, despite the interest premium based on higher risk and transaction cost.* Even in developed countries such as the US, small-business loans are regarded as opaque assets, constituting thus the main component of credit risk (Carey 2001, Moody's Investors Service 2000). In addition, commercial bank funds are essentially short-term while long-term lending to SMEs can be sourced from DFIs that are set up by government to provide finance to new entrants and for investment purposes. However, DFIs' lending resources (from local and donor funding) are much more limited than those from commercial banks due to their typical lack of an adequate and independent resource base.²⁹ Besides, most DFIs do not have an extensive branch structure or a diversified

by the unexpected sharp drop in demand in many crisis-hit or affected countries in East and Southeast Asia. For example, about three fifths of SMEs in Thailand experienced a serious liquidity problem, compared to one half in the Korea and 30 percent in Malaysia. For more details, see Abdullah (2002), Harvie and Lee (2002), Urata (2002 and 2000), Berry et al. (2001), Tecson (2001), Regnier (2000), Tambunan (2000), and van Dierman et al. (1998).

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

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

range of institutional products and services on offer in many ASEAN and other developing countries (UNCTAD 1995, Webster 1991). As a result, many commercial banks and DFIs are reluctant to implement SME-related lending programs initiated by government and aid donors; they also tend to concentrate their services on the most obviously creditworthy businesses and large-scale enterprises, as discussed previously (Asian Development Bank 2003, UNCTAD 1995, Levy 1993, Webster 1991).

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

3. *Bank lending decisions are traditionally based on the availability of fixed assets on offer as collateral, a sound business plan and, to a much lesser extent, a personal guarantor or mutual guarantee fund for loans, and machinery and equipment to be purchased by the loans under application being offered as partial security.* Land and buildings are most often required (at least in 8 out of 10 cases, for instance) but few SME entrepreneurs have clear and good titles to real

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

estates, especially those in low-income developing countries and economies in transition (Miller 2001, IFC 2000).³¹ In addition, real estate collaterals have become more problematic in ASEAN following the sharp decline in prices after the 1997-1998 crisis. However, the crisis-induced reforms have led to a better legal and regulatory framework in East and Southeast Asia, which has reduced somewhat the level of credit risks and improve the management of such risks. Nevertheless, there are still significant difficulties and delays in the exercise of contract rights to possess collaterals and liquidate non-paying businesses, and persistent problems in contract enforcement and legal system overloads render the whole process unaffordably complex, costly, and time consuming to all but the largest creditor firms.

Collateral requirements by commercial banks in developing countries have been a contentious issue in SME financing. However, 92 percent of all small-business debt to financial institutions in the US are secured (IFC 2000, 54). Even in some successful micro-loan schemes (with loan sizes averaging US\$400) charging market interest rates, some collaterals are still required on top of an upfront (returnable) deposit as penalty for late repayment (Holtmann et al. 2000, Webster 1991). Real estate collaterals provide an incentive and justification to lend and repay, as well as a means to offset losses in case of default (Otero and Lopez 2001, Aryeetey et al. 1994). As collateral, a business plan provides the roadmap and benchmarks for loan appraisal and the monitoring of business activities under implementation. This helps to minimize diversion and other misuses of borrowed funds that are a clear possibility without demonstrated financial discipline by SMEs and close supervision from banks (Asian Development Bank 2003, 29). As regards governance and succession, most SMEs are owned and operated by the (founding) entrepreneurs and their extended family members. As such, SME access to institutional finance is further constrained because of the excessive dependence on the

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

founding groups, the understandable reluctance to go “public”, the lack of clear managerial targets and succession plans, and the very high rate of defaults and insolvency, a problem attributable to SMEs’ low capital base and limited internal reserves to meet unexpected adverse developments.³²

4. *The successful operation of supplementary financing is predicated on the existence of a relatively sophisticated financial system, efficient intermediation processes, and credit data registries and credit information analysis similar to those in the developed or high-income developing economies* (Holtmann et al. 2000, 6). Credit enhancement arrangements include credit guarantee, export and import bridging finance and refinance, venture capital, equipment leasing, inventory financing or factoring, and credit risk insurance.³³ They are clearly needed in developing countries, including ASEAN, to widen the investment base and funding opportunities for SMEs and other businesses. Credit guarantee operates with reasonable success in developed countries and, among the various credit supplementary schemes, its utilization is comparatively more widespread among developing countries. Guarantee arrangements are especially important as a means of enhancing access to finance for SME entrepreneurs with viable projects but without adequate collateral requirements (Asian Development Bank 2003, 35). Nevertheless, a detailed review of 33 completed SME projects funded by the World Bank (noted previously) indicates the limited success of credit guarantee arrangements, and the consequent distrust among the involved stakeholders (including retail banks and entrepreneurs) in many developing economies. Partly as a result, commercial banks continue to require collaterals and guarantees on SME loans, among others (UNCTAD 1995, 20). These outcomes confirm an earlier finding by

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

³³For a concise discussion on the merits and disadvantages of credit enhancing arrangements and additional sources of fund in relation to SME financing, see Rodriguez (2002), Sahami-Malmberg (2000), Levitsky (2000), and UNCTAD (1995). Aylward (1988, 2-21) presents the outcomes from a survey of about 410 investment projects made by 53 venture capital funds in 19 developing countries in Asia, and transition economies in Central and Eastern Europe.

Levitsky and Prasad that there are certain conditions that have to be met for these schemes to achieve their design objectives.³⁴

5. *Lastly, several attempts have been made to establish an equity market dedicated to SMEs, although with limited success so far.* The Philippine Stock Exchange, for example, started a nationwide campaign in July 1998 for an SME capital market in favor of young companies with an outward orientation and/or high potential for growth. However, the subsequent response from SMEs has been less than enthusiastic due to the tight listing requirements.³⁵ Similarly, the Stock Exchange of Thailand was not able to open a second or alternative board for SMEs in 1999. Some 68 SMEs with capitalization from 40 million baht (just under one million US dollars, or in upper segment of small firms) to 100 million baht (or about US\$2.5 million, or in lower segment of medium-size enterprises) had originally expressed an interest in listing. They were subsequently deterred by disclosure requirements that were largely the same as those for companies listed in the main board (Regnier 2000, 82). Other more general reasons for the reluctance of SMEs to “go public” include the

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

³⁵The requirements include (i) authorized capital of US\$0.4-2 million with paid-up capital of at least one quarter of the authorized amount; (ii) two years of positive net operating income; (iii) minimum offering size of one fifth of the authorized capital; (iv) lock-up period of three years; (v) existing owners to retain 51 percent of equity holding; and (vi) a minimum of 50 shareholders. Additionally, SMEs must undergo a nomination and listing process before they can join the SME capital market. Considerations are now given to the establishment of a separate exchange for SMEs so as to better cater to the special needs of these enterprises (Vilorio 2001, 150-1).

relatively tedious and costly procedures for regulatory issues of papers as well as the small number of underwriters for them, and the large fixed costs in underwriting and distribution (IFC 2000, 22). Taxes on initial share offerings and on share transactions are another disincentive. Lastly, it does not help that many equity markets are subject to a significant degree of speculation (Takagi 2002, Vilorio 2001).

III. FOUR PROPOSALS FOR ENHANCING SME FINANCING

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

Clearly, ways and means (especially capacity-building measures) have to be in place to foster gradually the most competitive allocation and utilization of scarce financial resources by all the stakeholders on both the demand and supply sides. The following proposals are made because there are few, if any, viable options in the long run. The financial sector has to be upgraded and become more sophisticated not just to enlarge and deepen investor interest and the investment base (Takagi 2002, 68-9). As noted earlier, financial sector development is an essential response to the impulses and imperatives from the increasing volume and complexity of business transactions as ASEAN economies and enterprises develop and integrate regionally and globally in the coming decades. Corporate governance is important in this context, and incidences of imperfect information, plus the related need for due transparency and accountability, are directly ad-

dressed or implicitly embodied in the four proposals to be discussed below.³⁶ These suggestions can be regarded not just as a credit appraisal technique but also as a practical tool for financial management in the long term (Connelly 2001, 21).

A. Financial Information Disclosure by SMEs

Inadequate financial record keeping, and the consequent failure to make good use of available financial information, is characteristic of microenterprises and many small businesses in developing economies. Microenterprises are mostly sole proprietorships that tend to have a less distinct separation between the finances of the entrepreneur's business activities and those of his own personal household transactions (Holtmann et al. 2000, 2). The absence of proper financial accounting among many small and even medium-scale firms may be due to various reasons, ranging from the reluctance to reveal critical information to competitors, to nontransparent practices to minimize the tax burden. Nevertheless, it precludes the establishment of long-term bank-client relationships that are part and parcel of the reputation collateral. Furthermore, the availability of good information on enterprise finance and governance structure is a prerequisite for the preparation of a bankable business plan which, as indicated earlier, can be used as a partial substitute for fixed-asset collaterals on the financial supply side. Shortcomings in information disclosure can, therefore, be viewed as evidence of management weaknesses and financial indiscipline by institutional analysts and loan appraisers (Kao and Tan 2001, 55 and 157).

Adequate disclosure of useful financial information on financial accounts and enterprise ownership means the presentation, in a fair and transparent manner, of the firm's credit footprint as well as the track record on governance. It applies to both form (standardized format and timely availability) and substance (reliability, relevance, compatibility, and understandability). Standard accounting rules and norms already contain sufficient disclosure to meet those criteria in the three main components of the firm's financial transactions during the budgetary pe-

³⁶Corporate governance has become a matter of significant concern, especially against the backdrop of the 1997-1998 financial and economic crisis in East and Southeast Asia. Corporate governance relates to institutions that govern and regulate the agency problem associated with hidden action (the investors and stakeholders are not aware of all the actions taken by management), or hidden information (management has information that the investors and other stakeholders do not have), or the relationship between stakeholders and shareholders as mediated by corporate supervisory and nonexecutive boards, and the top management of the organizations concerned. See Shleifer and Vishny (1997, 737-83) for a literature survey on corporate governance. A detailed examination of governance issues in the crisis-related, Asian context can be found in the collection of conference papers in UNESCAP (2001) and Zhuang et al. (2000).

riod.³⁷ As such, financial accounting and control systems are very important for small businesses, especially at the start-up and development stages when SMEs' needs for investment and working capital are greatest. However, these are also the times when institutional credit is comparatively much more difficult to obtain by them, as was discussed earlier. But financial and accounting information is also useful for other purposes, including the diagnosis of possible problems or hidden advantages.³⁸

Due diligence is an obligatory process for financial institutions and there is a larger issue in the context of disclosure. For practical reasons, the post-crisis reform in corporate governance has a primary focus on publicly listed companies; these constitute just a very tiny fraction of the business world within ASEAN and elsewhere among most developing countries, however. Thus, parallel attempts will have to be made to foster adherence to the building blocks of good enterprise governance, even if such compliance is largely on a voluntary basis by sole proprietorships or family businesses (Simanjuntak 2001, 56-7).³⁹ Financial institutions, and commercial banks in particular, can be a powerful proponent and enforcer of good governance as they, too, are also under great and constant pressures to comply with the principles and practices of good governance. For example, banking institutions can interface more strongly with borrowers, including SMEs, on the disclosure of the governance structure of their firms as well as on issues of good corporate governance. This consideration takes on special significance in well-supervised and governed banks, given the almost complete absence of capital markets for SME financing where much tougher requirements on financial and governance disclosure are attached to equity and bond issues, as indicated previously.

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

³⁸Financial statements from an SME, for example, may reveal a low debt-to-equity ratio. In this case, either management is highly conservative or the benefits of leverage may not have been fully appreciated. On the other hand, operational expenditure may be relatively higher than the norm among business firms in the same industry. This may have implications (for remedial purposes) regarding the inadequate levels of operational efficiency and effectiveness of the SME concerned—especially in the combination and utilization of inputs, the current application of technologies, or the implicit needs for skills base and technological upgrading. Footnote 41 contains a definition of firm-level efficiency and effectiveness.

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

Regarding financial disclosure, the data and information required is not that extensive or onerous on SMEs, those of medium size or in the upper layer of the small-firm segment especially. In addition, good record keeping is an inexpensive proposition given the ready availability and affordability of electronic means for information storage, processing, and retrieval as well as the ancillary, specialized computer software programs.⁴⁰ Moreover, recent advances in information and communication technologies (ICTs) have led to the development of dedicated software on standard accounting programs, manuals, and exercises geared to the needs of small businesses. These programs are widely available from SME-related stakeholders—including public support agencies, bilateral donor organizations, and private BDS providers. They can be encapsulated and distributed widely in CD-ROM format as an ICT-based system package of modular toolkits to ensure the most cost-effective dissemination and outreach as well as to promote self-reliant capacity building and troubleshooting by the concerned SMEs themselves.

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

B. Business Plan Preparations by SMEs

Another point of consensus is that SMEs must have better and more effective channels and modalities for communication with credit providers for funding purposes, including from venture capitalists and government programs. Almost invariably, this takes the form of a plan for business start-up or development,

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

which, as mentioned earlier, can ease collateral requirements if loan financing is also based on commercial project feasibility. But a well-conceived business plan can serve also as a blueprint and roadmap for entrepreneurs in the operation of their business activities, and in the mobilization and allocation of the available resources (financial, technological, and human) in an effective, efficient, and flexible basis.⁴¹ Additionally, an integral part of any business plan is the disclosure of information on enterprise finance and governance in such a way as to provide a sound basis for an informed assessment by all stakeholders of the feasibility of the proposed business project and the suitability of the associated corporate governance.

Substantively, a (full-dress) bankable business plan can go to hundreds of pages and, depending on the scope and technical complexity of the business activity or service under consideration, its preparation tends to be complicated, daunting, and time-consuming. In particular, a large number of details and estimates will have to be given on a wide range of subject matters—from market surveys and projections pertinent to the particular industry or sector, elaboration on development and operational plans, to detailed specifications as regards management objectives and financing matters.⁴² In addition, the plans themselves have to address the needs of specific users which, in most cases, are commercial bankers. Nevertheless, some variations and adaptation are necessary for the typically rare occasions when a business plan is used, for example, to raise venture capital or to bid for funding support from SME-related programs from government or civil society organizations.

On the other hand, a dehydrated business plan (5-10 pages in length) can be drawn up largely within the firm to cover only the key aspects of the proposed business activity or service. Such a plan is required for initial or exploratory funding discussions with potential investors or financiers and it may be adequate in the case of small loans or when SME entrepreneurs are reasonably well known to the

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

⁴²Timmons (1990, 377-97), and Kao and Tan (2001, 57-85), for example, provide details of a typical business plan along with some practical exercises for illustration. They describe how to prepare the executive summary; conduct market research and analysis; identify production and productivity issues to prepare the product design and development plan, and the manufacturing and operations plan; and finally, how to deal with management and financial matters through the management plan and financial plan, the latter including the company's proposed offering relating to (i) the desired structure and terms of financing, (ii) offering sequence, (iii) capitalization details, (iv) proposed uses of funds, and (v) estimated investment returns.

lenders or investors. For bankers, it can emphasize financial safety, reasonable short-term earnings, plus the possibilities of building up a long-term relationship (a key part of the reputation collateral). In SME-related programs within the public sector, the business plan can show the full realization of program objectives and the long-term contribution to government development and investment priorities (IFC 2003, Kao and Tan 2001). However, for venture capital, the plan has to indicate a high rate of return plus the opportunities for a fast exit for the capital providers. A review of some 300 projects with venture capital in developing countries of Asia and Central and Eastern European economies in transition shows an expected average rate of return of 39 percent, and around 30 percent for start-up and expansion business projects (Aylward 1998, 17).

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

- (i) Executive summary (4 pages)
- (ii) Brief history and main characteristics of the industry concerned (2 pages)
- (iii) History of the company and its products, including mission statement and business philosophy (2 pages)
- (iv) Market research on the proposed activity, product or service, and a brief analysis of SWOT (strengths, weaknesses, opportunities, and threats) (2 pages)
- (v) Economic and financial aspects of the proposed business activity, product or service (2 pages)
- (vi) Marketing plan, including distribution and sales schedules (3 pages)
- (vii) Design and development plans (3 pages)
- (viii) Manufacturing and operations plans (3 pages)
- (ix) Management team including structure and personal profiles of the principal executives and managers, plus their responsibilities and targeted achievements (3 pages)
- (x) Overall planning and production schedules (2 pages)
- (xi) Critical risks, problems, and assumptions (2 pages)
- (xii) Financial plan (including ownership, equity structure, and proposed company stock offering, as appropriate) (3 pages)
- (xiii) Attachments and appendices (as needed)

A good business plan is of critical importance for new, young, or small firms because of their typical lack of real asset collateral, equity capital, and credit

track record (Jappelli and Pagano 2000a, 8). However, the preparation of a plan to the bankable stage is also a learning exercise requiring considerable perseverance and as such, many SME entrepreneurs do not find business planning a congenial preoccupation while many others fail to plan altogether (Kao and Tan 2001, 54-5). On the other hand, the kinds of plans taught in many business management schools may impart state-of-the-art know-how but they often have little to do with what is needed and practical for SMEs, especially those in the low-income, developing economies. Generally, therefore, the skills for designing and constructing a business plan are another important weakness in the SME sector and a large number of entrepreneurs will require assistance and coaching in the process. All these considerations account for the considerable emphasis under the International Finance Corporation's (IFC) Private Enterprise Partnership on building up the skill base of both SMEs and DBS providers in financial analysis and modern business plan writing, among other focal thrusts in capacity building.⁴³

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

C. Strengthening Institutional Capabilities in SME Credit Evaluation

Capacity building is also needed on the supply side, in particular, institutional facilities and expertise in applicant screening and loan project appraisal in

⁴³Established in May 2000, the Partnership is the technical assistance arm of IFC in the former Soviet Union. It is jointly funded by donor countries and IFC (US\$50 million during 2000-2003) and provides technical assistance in various areas of business enterprise financing, management, governance, linkage, regulation, and development (IFC 2002, 61-7).

the credit rating process.⁴⁴ Credit risk, the most common cause of bank and financial institution failures, has motivated financial regulators worldwide to prescribe minimum standards for risk management (Greuning and Bratanovic 2001, 135-44). Thus, the integrity and credibility of bank lending depends greatly on an accurate, transparent, and accountable assessment of an acceptable level of existing and potential risks in relation to the expected returns.⁴⁵ The sound management of credit risk, including that associated with SME lending, is critical to the performance of banking institutions, which itself is monitored and rated by the supervisory authorities on a number of criteria, including the quality of assets and sensitivity to market risks.

Institutional due diligence means careful loan appraisal and credit history screening, processes that become even more complex when SMEs are involved. On one hand, small business loans are still regarded as an opaque asset class largely because of the lack of risk benchmarks with wide industry usage and acceptance within the financial sector, the main reason for the limited securitization of such loan portfolios. On the other hand, the margin between incoming and outgoing cash flow is typically so thin, while the leverage is often so high in most financial institutions that small differences in asset quality can affect their solvency, and through the cascading (or contagion) effect, the stability of the financial system itself (Moody's Investors Service 2000, 14). Given adequate disclosure of financial and governance information in the SME business plan as suggested earlier, however, the risks internal to the firm can be assessed through (i) record of profitability, such as returns to assets and shareholders' capital (if already in operation) or expected returns after start-up; (ii) capital and ownership structure; (iii) liquidity and cash flows, and retained earnings (current or projected); (iv) size; (v) activities; and (vi) growth or start-up history. For assessment

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

⁴⁵As can be seen from the 1997-1998 crisis in East and Southeast Asia, the availability of credit rating facilities, and public credit registers and private credit bureaus will not eliminate actual loan defaults or default risks to lenders. However, the probabilities of nonrepayment and loan delinquency can be lowered through the operation of such facilities and systems. This is because, other things being equal, the likely loan defaulters and other bad credit cases will be "on-screen" statistically (as with credit risk scoring or Altman's Z-scoring technique, for example) or through their credit footprint. In this connection, an illustration of a variety of poor credit risks can be found in Greuning and Bratanovic (2001, 141) while the economic effects of credit information sharing are examined in some detail by Jappelli and Pagano (2000a, 10-6).

purposes, the first two parameters tend to be given greater weights (up to one half of the total).⁴⁶ There is, however, no hard and fast rule for a typical SME loan to equity ratio; such a ratio has been a matter of significant concern in the wake of the 1997-1998 crisis.⁴⁷

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

⁴⁶Bringing all the elements together, a typical file for loan appraisal contains the (i) SME borrower's names and contact addresses, and lines of business or industries or sectors; (ii) date of credit or overdraft approval, and uses of the disbursed loans and overdrafts; (iii) loan maturity date, amount, and applicable interest rates (and currency denomination); (iv) principal sources and amounts of repayments; (v) nature and value of collateral or security (on a market valuation basis in the case of fixed assets); (vi) total and current liabilities, including principal and interest due; (vii) estimated real and contingent liabilities (in case the institutional lender is absorbing the credit risk); (viii) record of delinquency, arrears or nonrepayments, if any; (ix) brief description of the monitoring activities carried out (within the organization) for the loans or overdrafts; (x) borrower's related financial information—including trends in the structure of assets and liabilities, retained earnings to current liabilities, and other financial ratios with total net assets as the denominator; and (xi) notes on sources and uses of outside credit information and information referral services concerning the borrower (Greuning and Bratanovic 2001, 133).

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

⁴⁸By and large, private credit bureaus are voluntary (as opposed to legally imposed), cooperative entities. They are basically information brokers who rely on the reciprocity principle in the collection, filing, and dissemination of information supplied voluntarily by a coalition of lenders and bureau members. The information collected is largely consumer-oriented. Public credit registers, on the other hand, are data banks created by government primarily for supervision purposes. They are mostly managed by the central banking authorities. Information is supplied by lenders who, in return, obtain the pooled data for use in their credit rating and lending decisions. Because of the reciprocity arrangement, public registries are less likely to provide access to their information than their private counterparts. More comparative details on these two credit information systems in a cross-country survey conducted by the World Bank can be found in Miller (2001, 42-4).

financial markets.⁴⁹ Cross-sectional evidence also suggests that bank lending tends to be higher, and credit risk lower, in countries where lenders have access to quality information on loan applicants (Jappelli and Pagano 2000b, 21-6).

Several private credit bureaus operate in individual ASEAN members (including Malaysia, Philippines, Singapore, and Thailand) although there are fewer public credit registers in the region (e.g., Indonesia, Malaysia, and Viet Nam). Information from these registers is typically limited by the high reporting threshold and selective sectoral focus, thus leaving the middle-market segment, including SME lending, and various sources of consumer finance to credit bureaus. These credit reference agencies are comparatively a recent phenomenon (except notably in Singapore since 1978, and Philippines since 1982), and their data banks are understandably more oriented toward consumer (or household) credit rather than toward commercial lending, as is also the case in most other countries (Miller 2001, 43-4). Moreover, the utility of credit bureau information for SME applicant screening in ASEAN is further limited by the very low proportion of small entrepreneurs with access to bank funding, and their heavy reliance on internal sources of funding and grey market loans, as discussed earlier.

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

⁴⁹Credit information and information exchanges among institutional stakeholders, firstly, permit a more accurate prediction of repayment problems and default risks by improving lenders' knowledge of applicants' character over time, thus speeding up the appraisal process; secondly, reduce the information "rents" that banks can extract from borrowers (superior knowledge entails lower interest charges), thus raising clients' net returns and incentives to perform better; thirdly, serve to discipline borrowers, thus strengthening the incentives to pay and perform, and reducing moral hazard problems in the process; and fourthly, discourage demand-side overborrowing and excessive debt/equity leverage and financial overcommitments systemwide. For a more detailed discussion on these matters, and related implications, see (Jappelli and Pagano 2000a, 10-4).

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

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

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

D. SME Credit Risk Scoring and Competitiveness Benchmarking

The availability and accessibility of credit information may induce financial institutions to shift gradually from a purely collateral-based lending to a largely information-based one, with a greater emphasis on the loan applicants' track record and project financial viability. In fact, a cross-country survey by the World Bank indicates the preference of many financial institutions to have access to good credit information over collateral because of the adverse publicity, and costly steps in possession and disposal in case of default (Miller 2001, 44). More immediately, however, operational efficiency and effectiveness (including better risk pricing and lower transaction costs) can be further enhanced with the introduction of modern risk management techniques. Pertinent in this connection are the credit scoring system, based on credit and other information, and Altman's z-scoring, derived from selected financial ratios. Both systems facilitate process automation, provide meaningful benchmarks to both lenders and investors, permit more timely and consistent decision making, and have proved useful as a man-

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

agement tool. All these lead, in turn, to better service, higher asset quality, and increased productivity (Stein 2001, 2).

1. SME Risk Scoring Techniques

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

A credit scoring model assigns different weights to different characteristics (criteria) of a loan applicant to predict the likelihood of repayments (and arrears) over the loan duration. These weights vary in accordance with the influence or impact of specific subsets of these characteristics on the outcome; the weights and levels of influence are statistically predetermined from large-sample testing and validation. The criteria are many, ranging from age groups, number of dependents, residence status, total assets, types of business and years in business; to negative file information (thus negative score). The overall score represents the sum of the applicable weight values (or rank orderings) given to the pertinent criteria. Continuous tracking of the scoring system and its performance will interactively provide further improvement to and validation of the criteria and their weights. In particular, credit scoring permits lenders (and investors) to trade off a higher accept rate (from 75 to 89 percent taken from an actual scoring sample analysis) against a higher default level (from 1.7 to 2.3 percent), and vice versa. This greatly facilitates the planning and management of a superior strategy in lending

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

⁵³The Small Business Scoring System, for example, comprises several models that are used by 350 institutional lenders in the US to make some 900,000 lending decision a year (Jennings 2001, 6).

as a quick response to changing economic conditions or geared to specific categories of industries or clients, such as SMEs.⁵⁴

Credit risk scoring depends on the quality of information on the applicant's personal credit footprint. Suitably developed, it can be a useful and efficient tool for SME lending and the system has, in fact, been introduced in several developing countries, including for micro-lending purposes (Otero and Lopez 2001, 19-20). Altman's z-score model (Altman 1968, 593-606), however, relies instead on the corporate financial profile extracted from financial statement data. The bounds for scoring applicability extends from around US\$100,000 in asset size of manufacturing enterprises up to publicly traded or privately held large companies; the lower boundary is well within the upper layer of the small-firm category or the medium-enterprise segment in many ASEAN countries. The z-score is the sum of the (weighted) products of five ratios—namely working capital to total assets (X1), retained earnings to total assets (X2), earnings before interest and taxes to total assets (X3), market value of equity to book value of total liabilities (X4), and sales to total assets (X5). The original model has subsequently been revised to take account of privately held companies (with the book value replacing market value of equity in X4, and denoted as z'-score), and nonmanufacturing firms (with X5 omitted). A second generation (and proprietary) Zeta model was jointly developed by Altman with other collaborators in 1976 and in 1995, the original z-score system was collaboratively modified to create a scoring model for emerging market economies.⁵⁵

The scoring operation is simplicity itself. The five variables (or four in case of nonmanufacturing companies) are assigned with their relevant weights, or coefficients, which were previously estimated and validated statistically.⁵⁶ If the z-score exceeds (or is lower than) a certain value or cut-off point, such as 2.9 (1.81), then the publicly traded, manufacturing enterprise concerned falls into the financially healthy (bankrupt) zone; any z-score in between these two cut-off points is in the gray (or ignorance) area, requiring further analysis in loan decision making.

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

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

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

FOUR PROPOSALS FOR IMPROVED FINANCING OF SME DEVELOPMENT
IN ASEAN 95

Models based on z-scoring have correctly predicted 82-94 and 68-72 percent of corporate defaults and bankruptcies one and two years, respectively, prior to the events in various subperiods during 1969-1999. The accuracy of predictions can be improved by 15-20 percent with a tighter or more conservative cut-off score (Altman 2000, 22-3).⁵⁷ Indeed, comparative surveys have consistently given an edge to these models despite the challenge of changing times and the parsimonious data requirements.

As a result, z-score models have assumed not only a benchmark status in the literature (including textbooks) on accounting and financial analysis (Moody's Investors Service 2000, 15). Scoring based on these models is now commonly used by auditors, courts of law, and management consultancy firms; z-scores also form an integral part of many data banks used for domestic and external loan pricing, lending decision and investment screening, particularly in developed countries. Its relevance and applicability deserve careful consideration by financial institutions in ASEAN, among other stakeholders concerned with corporate financing, including SME lending. However, credit risk and z-scoring indicate what is likely to happen over the loan duration but they do not provide the larger picture on the factors and forces, both inside and outside the firms, which have contributed to the scores so obtained. These factors and forces must also be imputed into (institutional) financial projections and analysis as they can affect asset quality, and market and systemic risks (Moody's Investors Service 2000, 41).

Thus, information and data banks will have to be set up by, or accessible to, financial institutions on such variables as

- (i) nature, relative size, technological dynamism, and competitiveness of the industries or markets of importance in terms of loan exposure;
- (ii) structure and characteristics of enterprises, and their profitability or loan default and bankruptcy rates in these industries or markets;
- (iii) dominance or concentration ratios plus enterprise structure and characteristics in complementary and/or competing industries or markets; and
- (iv) exposure to, and linkages with, foreign industries and markets (on both the supply and demand sides).

⁵⁷Needless to say, there are several other models and empirical studies on corporate defaults and default risks in the literature and from financial institutions, including Moody's series of (proprietary) Risk-Calc models for private companies in different sectors as well as for different countries. It should also be noted that the outcomes of risk scoring are still far from uniform. Retail trade, for example, has the highest default rates in Moody's rating but one of the lowest among smaller companies according to Dun and Bradstreet, another major credit rating agency in the US (Moody's Investors Service 2000, 41).

2. Supplementary Benchmarking of SME Competitiveness

Currently, however, there are virtually no systematic and regular surveys of, let alone comparable and up-to-date data banks on, the evolving dynamism and competitive potential of the top layers of SMEs even in priority sectors and industries within ASEAN. Such an information-gathering exercise is overdue not just because, on one hand, it helps to relieve somewhat the structurally chronic and acute shortage of data and information on SMEs in this region, as noted earlier, but also, on the other hand, learning what a country and its enterprises are, or can be, good at producing, is a key challenge to sound financial management and sustained economic growth (Rodrick 2002, 7a).

The periodic benchmarking of SME competitiveness is particularly relevant in the above context.⁵⁸ It permits the construction of best-practice standards (or scores) for the sectors or industries concerned, or for the best-in-class groups within a specific sector or industry, against which the performance of individual or groups of SMEs (as current or potential borrowers) can be matched and evaluated. The observed performance deviations (whether progressive or regressive) over time may be due to differences in the evolving capabilities and competitiveness within the enterprises under consideration. Such deviations should thus be reflected by commensurate adjustments in credit scoring, loan pricing, and lending conditions by financial institutions themselves. However, the revealed deviations may be attributable to changes (negative or otherwise) in the pertinent sector or industry, or in the local or international economic and financial environment. In these cases, responsive action and remedial measures are needed from government and other domestic and external stakeholders.

Competitiveness has a foundation at the micro level, whether or not it is measured and benchmarked at the industry, sectoral, or national level (Porter et al. 2001, Meyer-Stamer 1995). To be credible, the data and information for monitoring and benchmarking purposes have to be obtained in an objective, systematic, periodic, and (statistically) robust manner. Given the relatively large-scale requirements and the frequency (or periodicity) in information gathering and analysis, the proposed survey of SME capabilities and competitiveness should preferably be carried out as a joint undertaking by public-private stakeholders, including the financial institutions concerned, for resource pooling and cost-sharing purposes. The periodic results so obtained can be shared, processed, and analyzed

⁵⁸In business management, national competitiveness refers to the extent to which the overall domestic environment (policy, institutions, infrastructure) is conducive to entrepreneurship, innovation, and business initiatives. Industry-level competitiveness is the extent to which an industry or sector has the potential to grow and/or to generate an attractive return to capital. At the firm level, competitiveness is the effectiveness, flexibility, and efficiency in the production and delivery of goods and services at lower costs than those of the competitors, or at a price premium over those supplied by other enterprises.

in accordance with the specific needs and interests of different partners in the exercise. The detailed proposal and framework for the measurement, comparison, and benchmarking of SME capabilities and competitiveness over time, made by Wattanapruttipaisan (2002a, 70-8 and 84-5), can be modified with reasonable ease to yield comprehensive information and data of direct relevance to institutional financial analysis and projections, including for SME credit risk scoring purposes.⁵⁹

Briefly speaking, SME capabilities and competitiveness are conceptually grouped under seven categories:

- (i) the overall environment in which SMEs operate, denoted as “Nature and readiness of firms” (with 12 questions and a proposed relative weight of 12.5 percent of the total)
- (ii) the driving force of firms, whether large businesses or SMEs, denoted as “Entrepreneurial characteristics” (13 questions and 20 percent weight)
- (iii) “Capabilities” (10 questions and 12.5 percent weight) indicative, by and large, of the initial conditions and circumstances of the SMEs concerned
- (iv) “Competitiveness” (10 questions and 12.5 percent weight) being indicative of the initial conditions and circumstances of the SMEs concerned. In a way, (iii) and (iv) together represent an approximation of the CCI in the WEF Global Competitiveness Report (GCR).
- (v) “Production organization” (11 questions and 15 percent weight) to serve as a proxy of the potential for productivity upgrading and competitive growth of the pertinent SMEs. This category mirrors the GCI, which has been introduced by WEF in the annual GCR from the 2000 issue.
- (vi) “Finance” (11 questions and 15 percent weight).
- (vii) “Human resource development” (11 questions and 12.5 percent weight).

⁵⁹The survey framework is derived, firstly, from the constituent survey questionnaires for compiling the Current Competitiveness Index (CCI) and (since 2000) the Growth Competitiveness Index (GCI) from the World Economic Forum (WEF); secondly, from the common parameters and prerequisites for SME competitiveness and growth as discussed in Minoza-Gatchalian (2001), Ranases (2001), Regnier (2000), Tambunan (2000), and Altenburg (1999); and thirdly, from various SMEs-related surveys and questionnaires available in APEC (2002), Momaya (2001), Tambunan (2000), and UNCTAD (1998). However, these surveys and questionnaires are both shorter in length and more limited in scope than the assessment framework being proposed for competitiveness benchmarking.

IV. CONCLUDING REMARKS

The development of SMEs has long been constrained by a share of institutional financing far from commensurate to their critical socioeconomic importance in most developing countries. Such an outcome reflects, in part, the various biases against the SME sector, which are inherent or still remain in the domestic policy and institutional framework. There are a variety of systemic and institutional constraints on SME funding as well. But as was also discussed at length above, SME financing problems cannot be resolved just by lending not least because of the limited amount of financial resources available for development. These problems have to be viewed against a larger backdrop of financial sector growth and modernization as a response to the impulses and imperatives arising from the increasing complexity of business transactions associated with economic development and global integration over time. However, such a response can be sped up and made more innovative by the adoption of a wide range of remedial measures, four of which are the focus of the analysis in the text.

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

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

institutional asset quality and risk exposure. Regular surveys of SME competitiveness for benchmarking (or scoring) purposes are another proposed option to provide additional, high quality information for institutional analysis and projection of SME credit risks, including those from financing proposals falling in the grey or review zones in scoring exercises.

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FOUR PROPOSALS FOR IMPROVED FINANCING OF SME DEVELOPMENT
IN ASEAN 103

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