World Bank Support for Small and Medium Industry

The Bank began lending for small and medium-sized industry (SMI) in the mid-1970s. From 1977-89, it disbursed $4.8 billion in more than 70 projects in 40 countries to support SMI. A recent OED study reviews experience with SMI lending in Ecuador, Indonesia, Mexico, Pakistan, and Sri Lanka, in 16 completed projects amounting to $1.1 billion, approved between 1978 and 1987.

Projects have reached significant numbers of firms within the target group, economic and financial rates of return are good, and available information suggests that the economic effects of the lending have been positive. Data do not permit a judgment of whether the Bank's resources added to or replaced credit that would otherwise have been made available. In many instances, repayment rates by subborrowers have been poor, because of unethical defaults.

**Background approach**

The views of SMI that came to prominence in the 1970s and helped provide the impetus for the Bank’s lending program partly reflected a rising concern for employment and income distribution. SMI promised to combine economic efficiency and low import intensity with good job creation and positive effects on income distribution. It would be a training ground for entrepreneurs. Further, it was argued, small enterprises would be innovative and adaptable, given the competition among them.

**Bank policy:** The Bank lent to SMI within an industrial policy framework emphasizing prices that closely reflect underlying costs, the mobilization and efficient allocation of capital for private sector investment, and government provision of appropriate infrastructure. The Bank’s direct lending for industrial projects did not reach small businesses, while its indirect lending through DFCs touched them only slightly. Targeting lending to SMI would, it was argued, allow the transfer of more resources to intermediaries that could lend to small enterprises, as well as helping establish or strengthen institutions able to promote SMI and to deliver financial, technical, and managerial assistance.

**Design:** The SMI projects reviewed used the apex system, whereby one financial institution channels funds to several financial intermediaries, usually commercial banks, which assume the credit risk or share it with a credit guarantee institution. This design takes advantage of the regional branch networks of the commercial banks and relies on the apex institution to refinance, guide, monitor, and troubleshoot.

Borrowers in these projects are typically small or medium-sized manufacturing enterprises (for definitions, see Box). Target groups have varied somewhat, reflecting country differences in the size distribution of firms and in prevailing financial and institutional structures.

**Country policies**

When the projects reviewed began to be implemented, the trade and industrial policies of the five countries tended to favor import substitution and to encourage higher capital intensity than was consistent with endowments of labor and capital, producing a bias toward large-scale enterprises.

Not much empirical research has been done on how economic policies affect SMI. Mortality rates are traditionally high among small firms, and some evidence

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* "World Bank Support for Small and Medium Industry in Selected Countries", Report No. 9530, April 22, 1991. OED reports are available from the Internal Documents Unit and from Regional Information Services Centers.
documented by this study suggests that adapting to the more liberal policy regimes of the last decade has been more difficult for smaller than for larger firms, particularly in Ecuador and Sri Lanka.

**Economic performance**

**Target groups:** The Bank aimed for, and has reached, the upper end of the SMI spectrum, rather than very small businesses. Average subloan size ranged from $4,700 in the first two projects in Indonesia to $4,230 in the third project. In most of the countries, average loan size trended upward in constant terms. Nevertheless, reflecting the intention to create employment, most of the subloans went to highly labor-intensive manufacturing activities with low skill intensity.

**Employment creation and its costs:** Evidence from the number of loans to subprojects financed suggests a strong employment creation performance. Figures and responses to questionnaires show that the average number of jobs created per subloan ranged from 5 - 6 in the first two Ecuador projects to 34 in the first Mexico project. Data on actual numbers of subloans are patchy, but suggest, for example, that in Ecuador in the first two projects, about 22,000 jobs have been created through about 6,750 subloans. Investment costs per job created varied, but in most of the projects were between $3,500 and $6,000; this compares with an average cost per job in factory manufacturing of $10,000 to $30,000 (all in 1986 dollars).

Most intermediaries have had guidelines for a maximum cost per job created, but it is not clear how far employment-creating capacity has guided their choice of subprojects. Investment costs per job created are not a good selection criterion: data on these costs are often inaccurate, and the criterion itself can be misleading—low-cost creation of jobs with low productivity is not a legitimate goal.

The experience reviewed shows that SMI can provide quite productive low-cost jobs, and that most SMIs combine good capital productivity with modest labor productivity and low capital/labor ratios.

**ERRs:** Ex post economic rates of return were good: for example, 18 - 45 percent in the first Pakistan project; 15 - 55 percent in Ecuador's first two projects; 08 percent in Mexico's second project; and about 40 percent in the Indonesia projects.

**Earning and saving foreign exchange:** With the general concern over balance of payments problems, contribution to exports has been a goal in virtually all recent SMI lending. This was not so in the earlier projects. The only export-oriented components among the projects reviewed were technical and financial assistance for establishing export houses in Pakistan, and technical assistance to the Export Development Board in Sri Lanka.

From the projects reviewed, only 10 - 20 percent of output was exported. The import-substituting performance of SMI was less frequently monitored and harder to measure, but has probably been substantial.

**Additionality:** Bank resources normally supplied less than half the total investment of borrower entrepreneurs. Subproject borrowers were expected to provide at least 25 - 30 percent of subproject costs in the form of equity.

Only in Ecuador, among the five cases, do data permit a judgment of whether the Bank replaced other sources of credit. While credit to large-scale industry (LD) rose by about 60 percent in real terms in 1981-87, credit to SMI remained roughly constant, and decreased its share of all credit to industry from 7.7 to 4.5 percent. Funds for SMI from other sources declined by about as much as those channeled through FOPINAR, the government-sponsored fund.

**Entrepreneurial development:** One of the goals of SMI lending was to provide opportunities for skilled workers, traders, farmers, and others to set up manufacturing enterprises. Two thirds of the subloans in the first two Pakistan projects went to new enterprises; so did nearly half those in the first two Sri Lanka projects and about a fourth in Ecuador's SSI I and II.

**Poverty alleviation:** The Bank has not tried to monitor the impact of SMI lending on poverty. Too little is known about the family incomes of paid workers in SMI to
gauge how many poor families earn wage incomes as a result of the Bank's SMI lending.

There is no evidence from the projects reviewed that SMI products are purchased disproportionately by the poor or contribute to poverty alleviation by making available consumer goods at low prices.

Regional dispersion: SMI clearly tends to achieve wider regional dispersion than LI. But despite efforts to widen its dispersion, SMI lending remains concentrated in a few economically dominant areas. Without efforts to decentralize government, banking, and technical services, serious handicaps to wider dispersion will remain.

Financial performance

Repayment rates: Indications are that in the Bank's SMI portfolio loan repayment rates are a fairly widespread problem. Subprojects with poor repayment rates are destructive, because they erode the capital of the banks lending for them. Low collection rates reduce banks' profitability and increase lending costs, as banks try to pass on the costs associated with noncollectible loans to new borrowers. In this situation it becomes more and more difficult for banks to lend for SMI.

In Indonesia, Pakistan, and Sri Lanka, for example, commercial bank managers interviewed insisted that collection rates on their commercial and industrial loans from their own resources would need to be in the 85 - 95 percent range; investments that would not generate such repayment rates would not be undertaken. But in the Bank-supported projects in these countries, actual repayment rates seem to have been very low, at 53 - 77 percent, largely because of wilful defaulters. In all three Asian countries, a serious lack of data on subborrowers and on the status of loans led to tardy recognition of major repayment problems, and although collection rates have been raised in recent years, they are still low.

Operating costs: Actual operating costs were 3 percent of total assets in Pakistan, and 4 - 5 percent in Sri Lanka and Indonesia. Given the need to "sell" the idea of SMI lending to the commercial banks, it has been appropriate to accept quite high costs initially and then work with the banks, through technical assistance, to bring costs down. The progress made shows that one of the most effective ways to reduce operating costs is to improve information systems.

Interest rates: Fragmented financial markets in the countries studied make it difficult to determine the opportunity cost of funds. Broadly speaking, at the beginning of Bank SMI lending to the countries reviewed, real interest rates tended to be low in general and lower still on SMI loans. Nominal interest rates were typically raised as part of the financial reforms of the last decade, and the SMI interest-rate advantage shrank. But, particularly in Latin American countries, inflation in the first half of the 1980s tended to make real rates negative.

Experience shows that when interest rates are subsidized, SMI loses more in terms of access to capital than it gains in terms of price. For small borrowers, the speed of loan approval and disbursement, and the duration or grace and repayment periods, are at least as important as interest rates.

Sources of funds: The proportion of resources that are internal to SMI programs—equity and retail bank contributions—may be a good indicator of resource sufficiency and sustainability.

To encourage credit institutions to become more independent in SMI financing, the Bank imposed ceilings on its own contributions to subloans. But SMI programs relied rather heavily on official financial sources (i.e. the Bank and the government or the apex agency) and only modestly on bank deposits and retained earnings or sponsors' equity.

Institutional development

Credit intermediaries: Experience shows that as the channel for credit to SMI, commercial banks have obvious advantages over DFCs (the channel used in most early SMI projects). Even so, commercial banks often proved reluctant to lend extensively to SMI, and especially to the smaller establishments, given the higher risks and administrative costs of doing so.

In several countries, though not in all, the Bank tended to overestimate the capabilities of commercial banks and apex organizations. No comprehensive assessment was made at appraisal of their management quality, organizational structure, and freedom of action, nor of their staff resources, data reporting systems, attitudes toward SMI, or ability to extend TA. The banks lacked experience with helping small entrepreneurs prepare projects, and had limited capacity for supervision.

A basic design deficiency in SMI programs in Asian countries was the lack of clear conditions specifying exactly what was expected of each participating institution. Discussions with apex agencies confirmed they were not completely certain about their roles, but that they saw themselves more as refinancing agencies than as project managers. Had the agreements with the Bank been more specific, they might well have taken a more proactive role.

Technical assistance: Of the lending reviewed, 95 percent was for credit components and the rest for technical assistance (TA). TA to participating credit institutions
was satisfactory and sometimes important to overall project success.

Harder to assess is the TA directed to entrepreneurs. Typical problems arose from inexperience or poor motivation among public sector TA institutions, doubt as to the right types of technology, and difficulty in distinguishing a firm's need for credit from its need for TA. Often, these weaknesses were addressed in subsequent projects and improvements recorded.

**Recommendations**

**Loan recovery:** Repayment rates depend partly on economic conditions, and on borrowers' incentives and willingness to repay. But they also depend on good bank management. With better client selection and better quality, well-monitored subprojects, better repayment records may be achieved. Apex organizations, too, can play an important role in maintaining a satisfactory collection rate and by closely monitoring commercial banks' performance.

Where repayment rates are problematic, the Bank should:

- Urge and assist apex institutions and participating credit institutions to give them priority attention.
- Help develop a more detailed and sophisticated understanding of repayment problems.
- Participate whenever possible in designing better monitoring and collection practices, and continue to finance TA aimed at improving staff capability.
- Take a firm stance on repayment rates in discussions of new SMI credits.

**Interest rates:** The Bank has pushed vigorously and systematically for the adoption of positive, unsubsidized, interest rates in its SMI lending, although in several cases it has accepted less. The broad outlines of its policy are sound.

**Credit guarantees:** Experience shows that credit guarantee schemes are likely to be costly and that their fees do not usually cover claims.

**TA to subborrowers:** For the moment, the appropriate stance on TA to subborrowers is one of cautious support, since the record to date does not show that TA is often a necessary condition for overall project success. This provides some leeway for experimentation and gathering relevant experience before making major expenditures on such TA.

**The case for targeted lending:** As a country's financial sector develops, the Bank's policy nowadays is to phase out directed credit to specific industrial subsectors and replace it with multisector directed credit. But in many countries SMI still faces difficulties in getting access to term credit and in getting the assistance needed to prepare sound investment proposals. These market failures constitute a good case for directing credit to SMI.

**Policy dialogue, sector work:** Because it now seems that macroeconomic, as well as industrial, trade, and labor market, policies are important determinants of SMI growth, SMI concerns need to be adequately reflected in Bank-country policy dialogue. Inclusion of SMI in the policy dialogue will require much more interaction between those responsible for SMI loans and SMI sector work and those engaged in the overall policy dialogue. At present, the information on which to base the dialogue is sparse. The Bank should undertake more analysis of how macroeconomic policies affect SMI and how SMI development contributes to policy goals, such as poverty alleviation, growth, fairer income distribution, and external payments equilibrium.

The changing trade policy setting, with its growing emphasis on nontraditional exports, calls for a more organized search for ways to relate the SMI sector to international trade. To promote export growth and efficient import substitution by SMI will require:

- continued attempts to reduce bureaucratic obstacles to SMI exports and marketing abroad;
- special attention to SMI access to imported inputs and capital goods;
- support for SMI subcontracting with LI or with commercial intermediaries who sell abroad; and
- where relevant, support for efficient import-substituting SMI activities.

**Data gathering and analysis:** Lack of systematically updated information on the SMI sector makes it difficult both to predict credit demand and to do good project evaluation. The Bank's standard documentation does not provide a very satisfactory measure of SMI projects' success or failure.

The lack of indicators for project monitoring and flexible midstream correction reflects a serious design flaw in the projects reviewed. Missions need to be more aware of the types of evidence that help to assess economic performance.