Report

MSME Finance Gap

An updated Estimation and Evolution of the Micro, Small and Medium Enterprises (MSME) Gap in Emerging and Developing markets: Annex

MARCH 2025

IFC International Finance Corporation WORLD BANK GROUP

Annex 1: COVID Case Studies

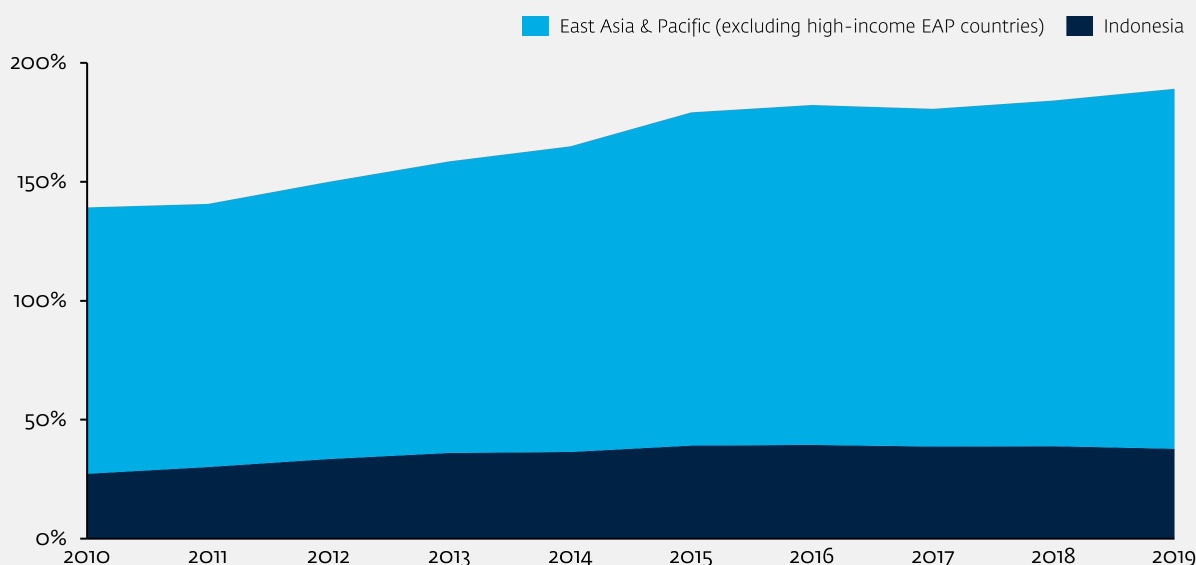
8.1 Indonesia

Introduction

As of 2019, there are over 65 million MSMEs in Indonesia, comprising 97 percent of total employment, and 60 percent of GDP (Asian Development Bank 2021). Most of the MSMEs (98.7 percent) are classified as microenterprises. They are concentrated primarily in the wholesale and retail trade sectors, and have been a key driver in Indonesia's development over the past fifty years, as the country underwent a process of industrialization and urbanization.

Indonesian MSMEs historically face significant hurdles in accessing formal finance. Part of this may be due to the shallowness of the Indonesian banking sector, lacking the financial depth to facilitate inclusive growth across both commercial and consumer segments. Even prior to the global pandemic, private sector credit growth had started declining from a peak of 39.4 percent of GDP in 2016 to 37.7 percent of GDP in 2019, well below the regional average for countries at the same income level (figure 43).

Figure 43: Indonesia: Domestic Credit to Private Sector (percentage of GDP)



Source: World Bank

Compounding the challenges of a still maturing financial and banking sector, when Indonesian financial institutions do extend credit to MSMEs, they often charge higher interest rates and institute more stringent collateral requirements than for larger firms. Although MSMEs are at the heart of Indonesia's economic body, formal finance typically flows to larger and state-owned enterprises, leaving MSMEs largely underserved. Furthermore, a 2018 survey by the Bank of Indonesia showed that 93.5 percent of small enterprises used their own money to finance their business operations, and only 6.7 percent of surveyed firms reported having access to bank loans (Bank of Indonesia 2018). According to the latest round of the Enterprise Surveys, the number of small firms with a bank loan and/or line of credit is less than half that of large firms (World Bank 2016).

Table 2: Asset Allocation of Indonesian Banks (percentage of banking assets, 2016 Q3)

	Large corporate	MSMEs	Mortgage	Retail
Total	52.5	19.8	9.1	18.6
Private banks	60.1	17.4	8.1	14.4
Of which: foreign bank subsidiaries	57.1	12.7	17.4	12.9
State owned banks	46.4	26.3	11.9	15.4
Regional development banks	13.1	16.3	6.6	63.9
Foreign bank branches	89.9	0.7	0.4	9.0
Domestic – Systemically Important Banks (D-SIBs)	51.0	22.5	11.3	15.2
Medium-sized banks	62.0	11.3	4.4	22.3
Small-sized banks	50.5	15.5	5.9	28.2
Micro-sized banks	32.8	33.5	3.5	30.2

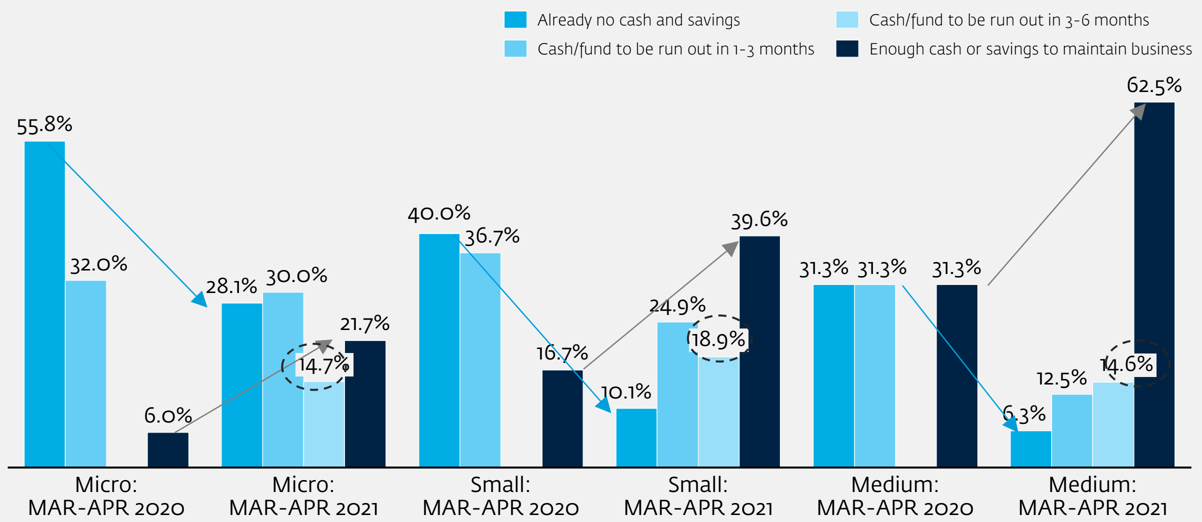
Note: Figures are expressed in terms of percentage of banking system assets as of 2016 (Q3)
Source: International Monetary Fund and World Bank`

With a narrow credit channel, in 2019 it is estimated that Indonesian MSMEs face a financing gap of US$235 billion. MSME finance supply caps out at 7 percent of GDP, which is below its neighbors, such as Malaysia (21 percent); Thailand (26 percent); and China (27 percent). It is also below average for the entire East Asia and Pacific region.

Demand Side

In mid-March 2020, with social distancing measures beginning to take shape in Indonesia, MSMEs — many of them already in a precarious financial situation — began to feel the financial and economic strain stemming from the pandemic as cash flow and working capital began to dry up (figure 44). This was particularly severe for micro firms, which initially reported already having no cash or savings pre-pandemic. They were then forced to smooth the exogenous shocks that the COVID-19 pandemic precipitated.

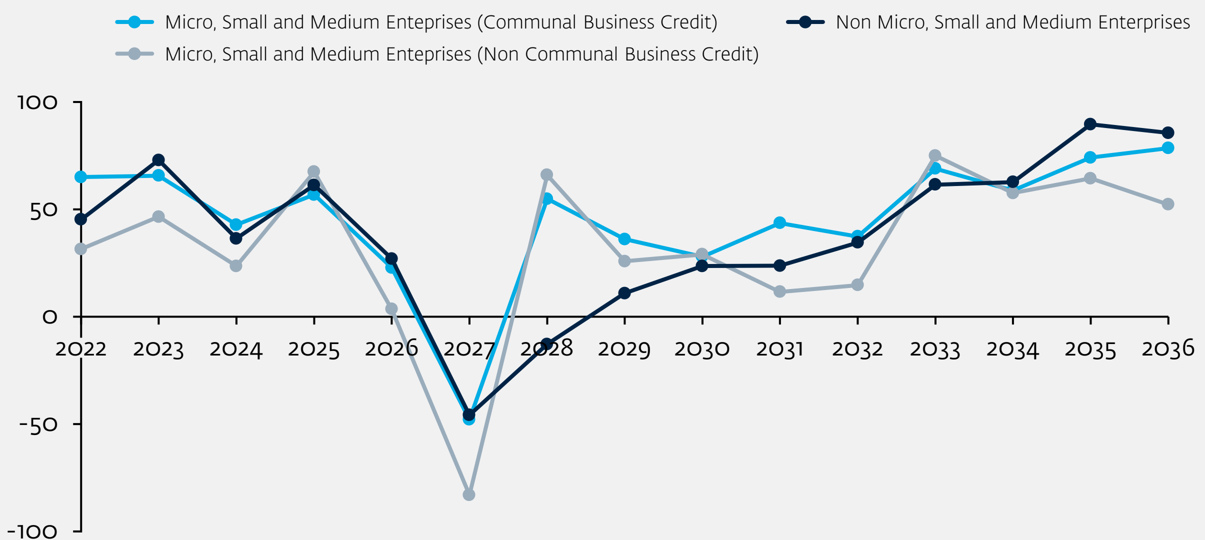
Figure 44: Financial Condition of MSMEs in Indonesia



Source: Asian Development Bank

The government was quick to act to alleviate the financial strain, announcing on March 31, 2020 an Indonesian Rupiah (IDR) 70.1 trillion (~US$4.8 billion) package of tax incentives and credits for enterprises, as well as an additional IDR 150 trillion (~US$10.3 billion) set aside exclusively for economic recovery programs, including credit restructuring and financing for MSMEs (The Jakarta Post 2020). Nonetheless, with both the domestic and global economy stunned by the sudden and sharp downturn in consumer spending and consumption, the immediacy of the economic challenges of the pandemic spilled over to financial markets. Credit markets followed a cyclical pattern and also saw a sudden decline. This may explain why credit demand among firms of all sizes declined precipitously in the second quarter of 2020, and then sharply rising in the following quarters.

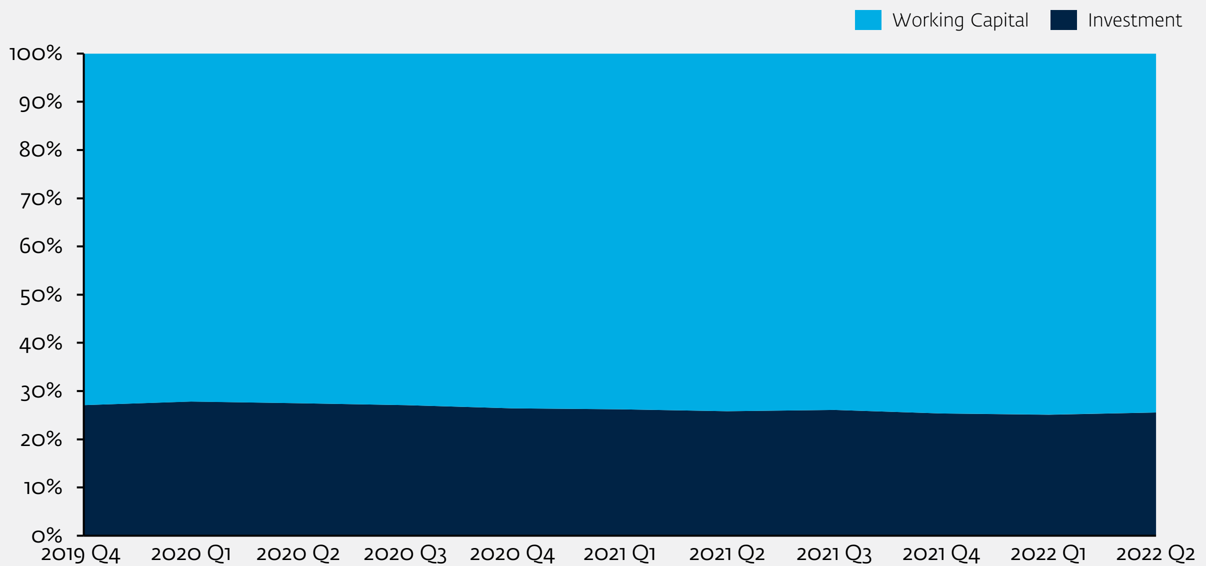
Figure 45: Indonesia: Demand for New Loans (weighted net balance)



Source: Bank of Indonesia

Across all commercial segments, working capital was the predominant loan type in demand during the two years following the pandemic. The demand growth rate quarter-over-quarter for investment loans only exceeded working capital once in the third quarter of 2021 (figure 45). Nonetheless, working capital loans, quarter-to-quarter, typically outweighed investment loans by roughly a ratio of 3:1 in terms of MSME credit disbursements (Otoritas Jasa Keuangan 2022). The persistent demand for working capital reflects the day-to-day challenges smaller firms face in financing their operations in the aftermath of the COVID-19 pandemic in lieu of investment loans, which typically have longer tenors (figure 46).

Figure 46: Indonesia: Total MSME Credit Based on Type of Use

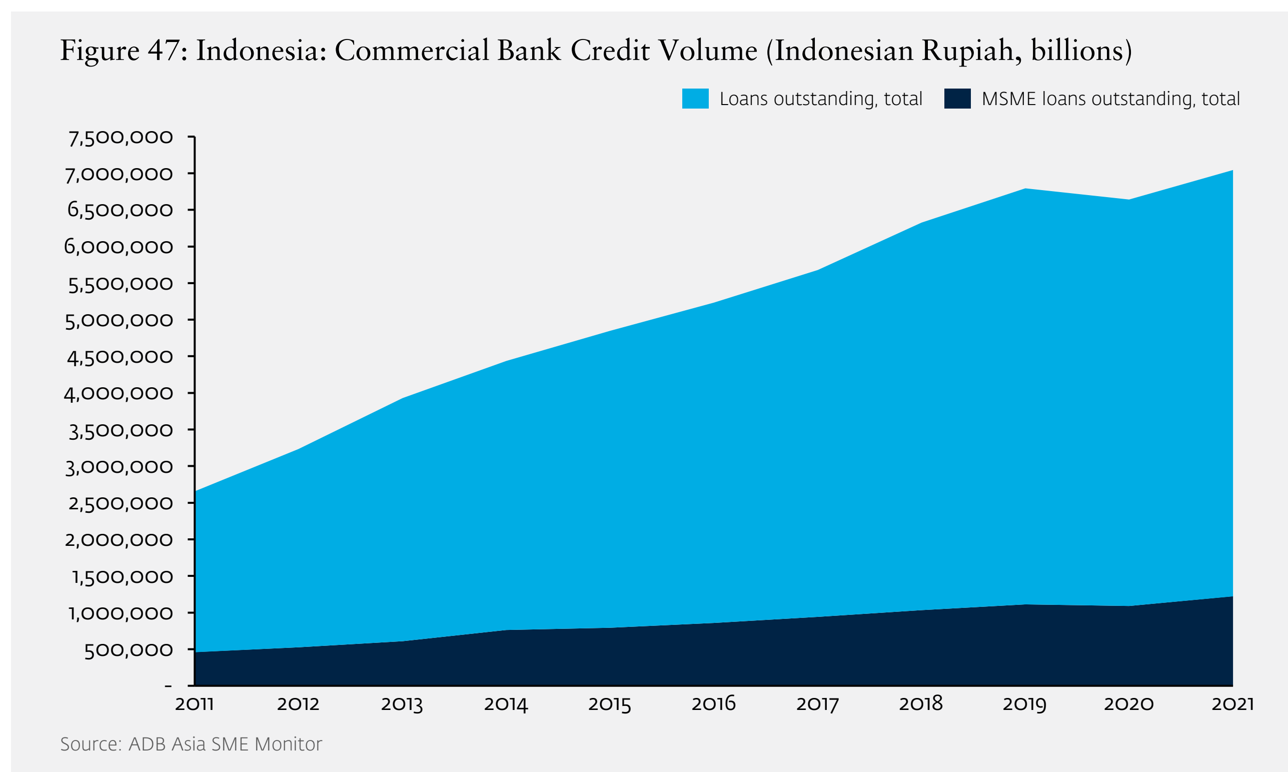


Source: Bank of Indonesia

Supply Side

Whereas credit demand, particularly for the financing of day-to-day business operations, has remained at elevated levels throughout the course of the pandemic, the formal supply of credit has lagged somewhat (figure 47). Private credit grew relative to GDP in 2020. However, due to a steeper decline in GDP growth than in credit growth, both total commercial and MSME lending declined slightly in 2020 and remained below pre-pandemic levels in 2021 (Asian Development Bank 2021). In total, outstanding loans to all businesses declined 2.4 percent year-over-year in 2020, and less than a percentage point year-over-year in 2021 (Asian Development Bank 2021).

Figure 47: Indonesia: Commercial Bank Credit Volume (Indonesian Rupiah, billions)



Source: ADB Asia SME Monitor

Interest rates declined for both MSMEs and large firms in 2020, specifically, from 21.76 percent to 20.27 percent and 14.71 percent to 13.65 percent, respectively (OECD 2022). This may be influenced by the role of the Bank of Indonesia in reducing its benchmark rate, as well as the introduction of measures to ease liquidity conditions in the early stages of the pandemic. The Kredit Usaha Rakyat (KUR) Micro Credit Program saw growth rates of 8.8 percent in 2020 and 8.2 percent in 2021 in terms of outstanding guaranteed loans (figure 48). These loans worked to mitigate risk for commercial lenders amid the pandemic uncertainty (Asian Development Bank 2021). Furthermore, The Bank of Indonesia worked to increase MSME financing supply. In August 2021, it introduced a new regulation requiring banks to disburse at least 20 percent of their loans to either MSMEs, MSME supply chains, and/or low-income earners starting in 2022, with this ratio growing to 25 percent in June 2023, and eventually to 30 percent in June 2024 (Reuters 2021). The increase in MSME Loans to GDP as a proportion of Total Commercial Banks loans to GDP in 2021 is noteworthy (figure 49).

Figure 48: Indonesia: Loan Growth (year over year)

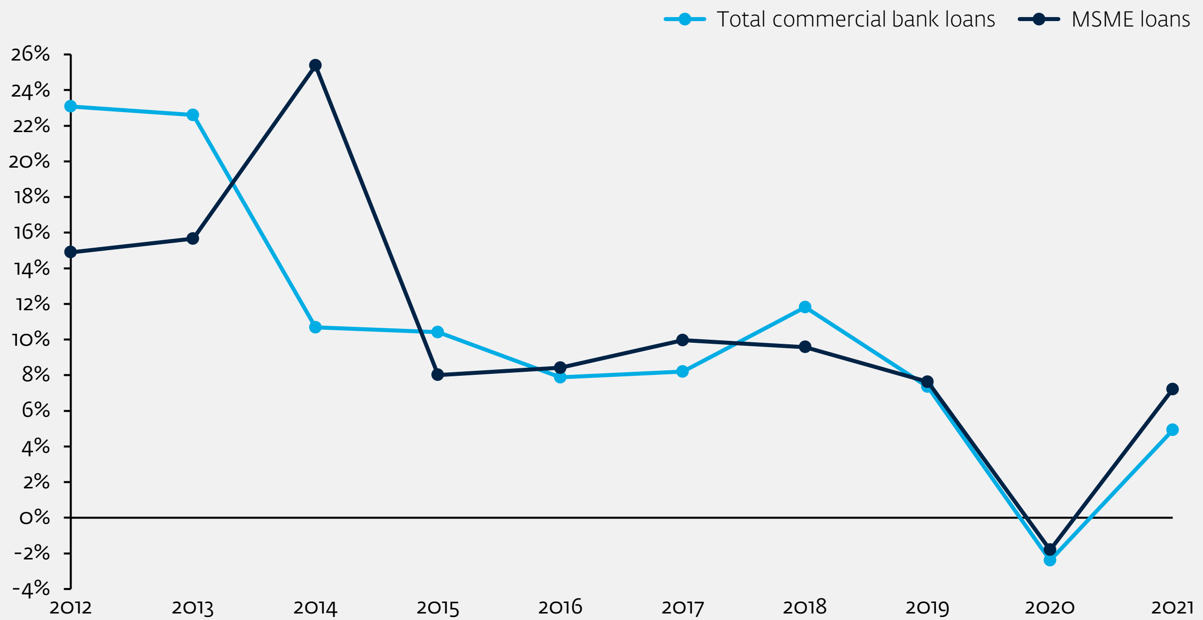
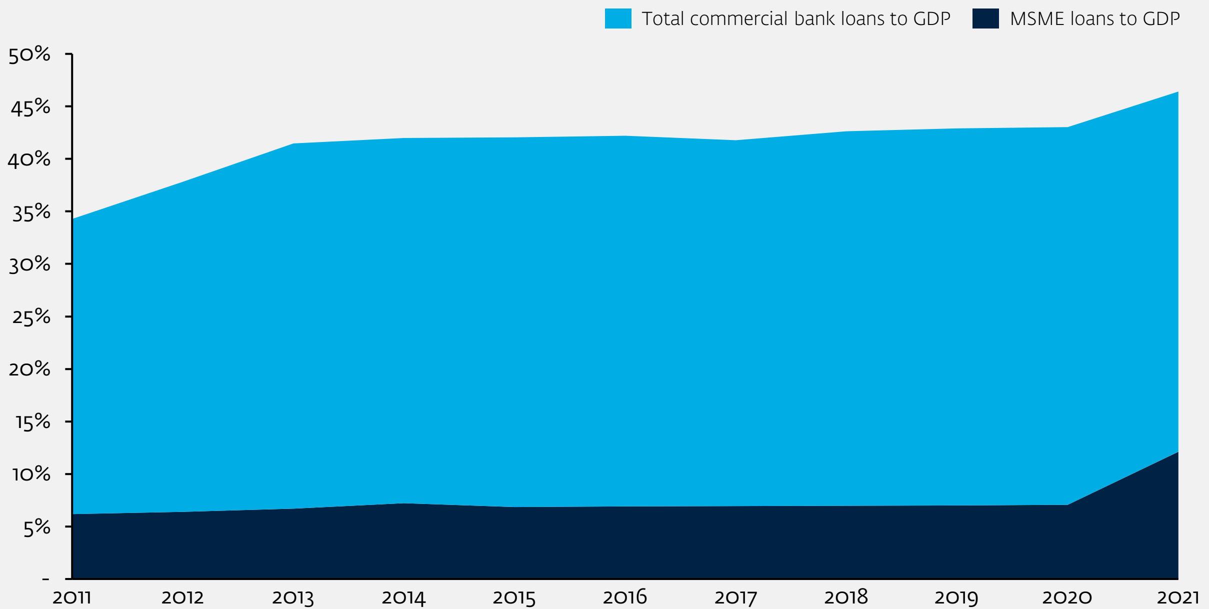


Figure 49: Indonesia: Loans to GDP (%)



Source: ADB, Asia SME Monitor

Macroeconomic Policy and Regulatory Environment

As noted, the government was quick to respond in the early stages of the pandemic by announcing an US$8.1 billion stimulus package on March 13, 2020, which included relaxing government restructuring of bank loans to MSMEs (IMF 2021d). The National Economic Recovery Program (PEN) included interest subsidies, credit guarantees, and loan restructuring funds for MSMEs. Furthermore, to support credit markets and facilitate credit creation, the government and the Bank of Indonesia enabled banks to increase leverage and guaranteed working capital loans via state funds, while concurrently reducing the benchmark interest rates several times over the course of 2020 and 2021.

Further measures were put in place to cushion the economic strain for MSMEs. These included an unconditional cash transfer program for ultra-micro and micro enterprises; an unconditional cash transfer as an income substitute for ultra-micro and micro enterprises; and credit restructuring and an interest subsidy for micro enterprises, which provided credit restructuring options through banking and financing companies (OECD 2020b).

Prior to the pandemic, only one in five MSMEs were economically secure, with the expansion of MSME credit being one of the top priorities across Indonesians of all income levels (World Bank 2020). As noted, MSME credit declined in the two years subsequent to the outbreak of the pandemic. However, the rate of decline was not as great compared to the overall portfolio. The ability to prop up the MSME credit market amid the global economic turndown can be attributed to the role of the Indonesian government and the Bank of Indonesia in injecting liquidity and supporting credit creation via policy measures, such as credit guarantees, cash transfers, and lower interest rates.

Conclusion

The COVID-19 pandemic resulted in an economic slowdown in Indonesia, which also impacted the MSME sector. Demand for credit shifted from long-term loans to shorter term working capital loans. There was also a drop in demand in the early half of 2020. However, it is likely to have reverted to pre-pandemic trends, given the limited scope of the lockdowns. Future firm surveys will be needed to better understand if there have been further changes in the sectoral distribution of MSMEs or heightened entry/exit behavior. In terms of the supply of financing, banks tightened their credit to MSMEs. However, in the first half of 2020, there was growth in bank lending, which continued well into 2022. This was accompanied by conducive government policies that helped to cushion any decrease in the supply of financing to MSMEs. Overall, given the current data, the COVID-19 pandemic did appear to have a significant impact on the MSME financing gap, and the supply of credit appears to be recovering to pre-pandemic levels.

8.2 Jordan

Introduction

MSMEs in Jordan comprise 99.4 percent of private sector entities, and 62.3 percent of total employment. As such, they are key to job creation and economic growth in Jordan (Jordan Department of Statistics 2019). In total, MSMEs account for the overwhelming majority of private enterprises and employment in the country. Although the Jordanian economy is heavily MSME-centered, in contrast to their larger counterparts, smaller firms have consistently faced greater barriers in accessing formal finance. Smaller firms in Jordan have lower rates of checking and/or savings account holdings, bank loans, or lines of credit. When they are able to receive a loan, the proportion of loans requiring collateral and the value of the collateral needed for a loan are higher than for larger firms (World Bank 2019b). Domestic credit to the private sector (as a percentage of GDP) in Jordan is relatively high, and almost twice the regional average (World Bank 2022c). However, MSME financing has not kept up. Outstanding MSME loans from commercial banks (also as a percentage of GDP) in Jordan are lower than in neighboring countries of the same income level, notably Lebanon, Morocco, and Tunisia (IMF 2022b).

Unlike its neighbors, Jordan's economy is not focused on natural resource exports. Instead, the services and manufacturing sectors comprise about 96 percent of GDP, with both sectors heavily dominated by MSMEs. Expanding MSME financing has been difficult as the GDP per capita has been rather stagnant over the past decade. The country also has a persistent negative credit rating, hampering its credit worthiness and presenting challenges in servicing its debt. In total, lending to MSMEs has persistently remained a sliver of overall commercial lending in Jordan.

Demand Side

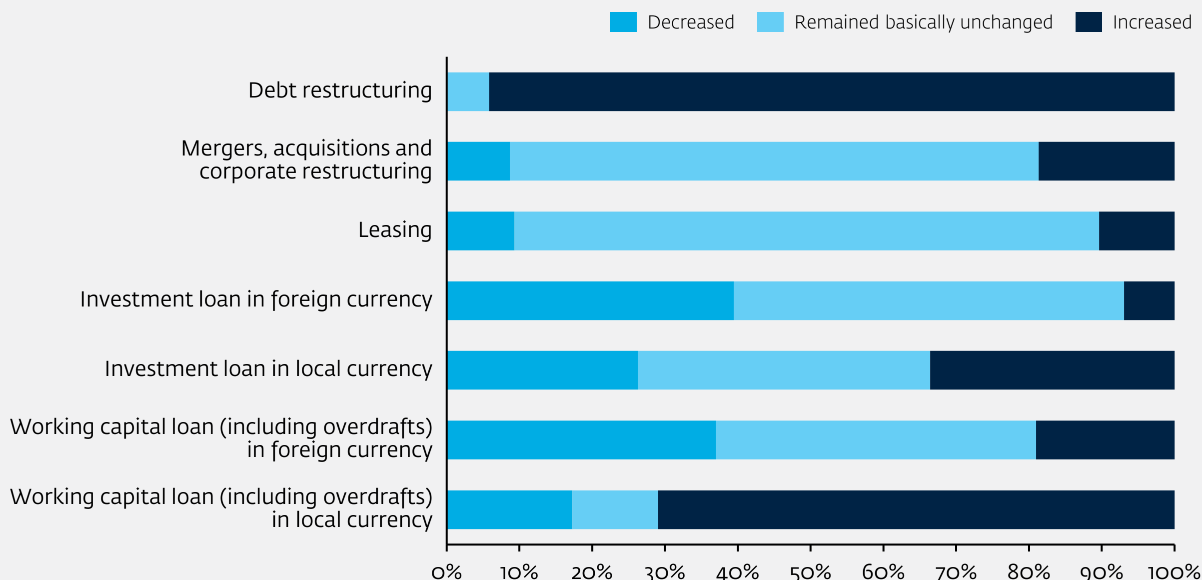
The national lockdown and border closure imposed in the early days of the pandemic curbed both physical and commercial activity. Accordingly, enterprises felt the brunt of the challenges as many reduced their business activities or closed completely, reduced work hours and wages for employees, and/or needed to implement layoffs to mitigate the effects of the shutdowns. Jordan's initial measures were successful in halting the spread, and by mid-April 2020. the kingdom began to roll back some restrictions. Nonetheless, the initial economic shock of the pandemic had been severe for Jordanian enterprises.

Small firms seem to be disproportionately more affected by the crisis, particularly in the early stages. Although all firms across all sizes have seen steep declines in liquidity and cash flow availability, small firms have reported decreases of ten percentage points higher than both medium- and large-sized firms (World Bank 2022a). Additionally, smaller firms reported higher rates of business closures, and they also closed for longer durations, resulting in greater drops in sales, and stronger declines in their workforces.

With cash flow severely constrained, enterprises of all sizes turned to lenders for liquidity injections to support their business operations. A joint survey conducted by the European Investment Bank (EIB) and the Central Bank of Jordan (CBJ) found that the evolution of credit demand was strikingly similar between

MSMEs and larger corporates, particularly with regard to working capital loans and debt restructuring. The influx of demand highlights the needs of firms to address acute liquidity shortages through short-term financing in lieu of longer-term capital investments (figure 50).

Figure 50: Evolution of MSME Demand in Jordan



Question: Please rate the extent to which demand from MSMEs has changed over the last 12 months.

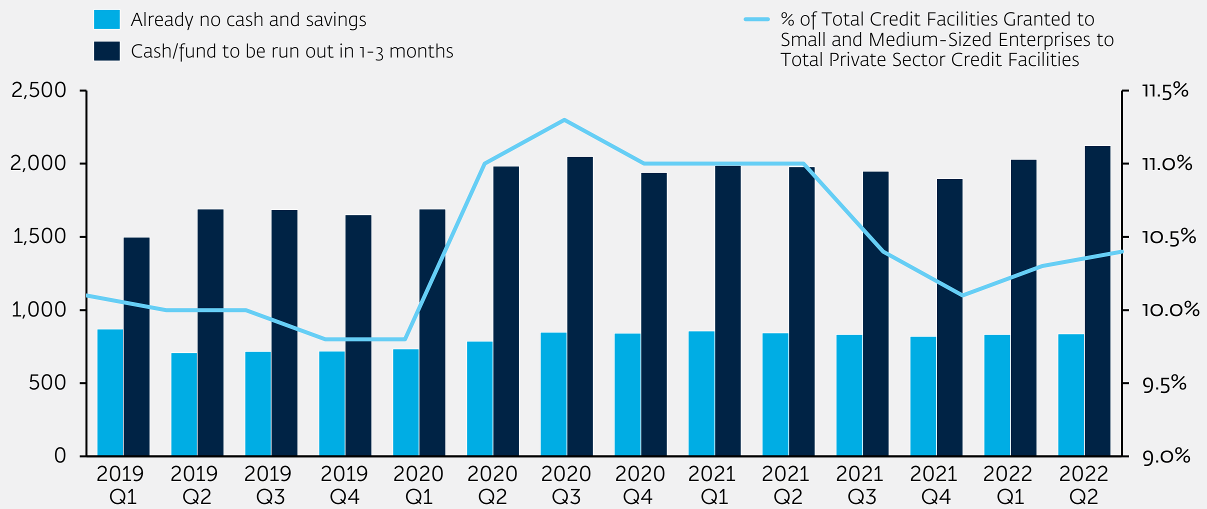
Source: EIB Bank Lending Survey

To support increasing demand on the part of enterprises, the CBJ pumped liquidity into banks through a JD 500 million (~ US$705 million) SME lending program in March 2020 (Central Bank of Jordan 2019). With liquidity shortages persistent throughout the year and into 2021, the CBJ increased the volume of the scheme up to JD 700 million (~US$987 million), while concurrently reducing the reserve ratio on deposits for banks, slashing the benchmark interest rate, and extending the duration of the loans by a year. Although the CBJ has provided ample support to businesses, with a particular focus on MSMEs, Enterprise Survey data shows that in December 2021 over half of all surveyed firms reported decreased liquidity or cash flow. Since the previous survey rounds, a majority of firms are overdue on obligations to financial institutions. Furthermore, one out of five surveyed small firms confirmed that they are now permanently closed.

Supply Side

With credit demand surging across all firms, how did Jordanian lenders respond to help businesses stay afloat? With the help of the CBJ's intervention, increases in credit to private enterprises were able to keep up with heightened levels of demand. With the implementation of the MSME lending program, total credit facilities granted to MSMEs grew by 17.2 percent year-over-year in 2021 Q1, with the percentage of total credit granted to MSMEs growing from 9.8 percent to 11 percent over the same time span (Central Bank of Jordan 2022). However, the share of credit facilities granted to MSMEs had declined somewhat by the end of December 2021, and then ticking up slightly again in the first half of 2022 (Central Bank of Jordan 2022).

Figure 51: Jordanian MSMEs: Access to Credit Facilities (Jordanian Dinars, millions)

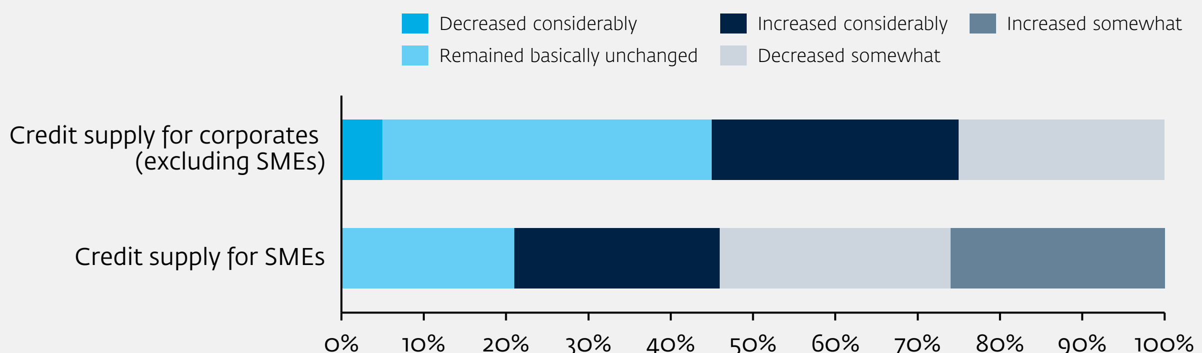


Source: Central Bank of Jordan

The aforementioned EIB and CBJ survey reports found that banks did report a tightening of credit standards for MSMEs throughout the reporting time. However, the extent of tightening has been less severe compared to larger firms (59 percent for MSMEs, and 79 percent for corporates). The role of regulatory support and the availability of local currency funding are the two most-often cited factors in the looser credit standards for MSMEs (European Investment Bank 2022).

Alongside the MSME lending program, banks were able to facilitate increased demand through a reliance on external credit guarantees via the Jordan Loan Guarantee Facility (JLGF). With creditworthiness a consistent deterrent to expanding access to finance for MSMEs in the eyes of the lenders, the JLGF provides partial loan guarantees to mobilize financing for underserved MSMEs. The JLGF also raised the percentage of insurance coverage from 70 percent to 85 percent (Central Bank of Jordan 2020). With lending programs and credit guarantees expanded, Jordanian banks actually reported a greater decline in credit supply to corporates (45 percent) compared to MSMEs (25 percent). Additionally, three-quarters of surveyed banks reported increasing credit supply to MSMEs (as evidenced by increasing credit facilities granted to smaller firms) (figure 52).

Figure 52: COVID-19 and Related Spillovers on Jordanian Banks



Question: Please rate the extent to which the COVID-19 pandemic and related spillovers are estimated to affect your bank.

Source: EIB Bank Lending Survey

For banks that reported a tightening of MSME credit standards or that were denied loan applications, the reasons are typical of the perceived risks of MSMEs in the eyes of the lenders. For instance, banks report insufficient or lack of capital and collateral and poor credit histories (European Investment Bank 2022). Although Jordan's lenders and policymakers have done well in supporting MSME financing needs throughout the course of the pandemic, MSME lending as a share of total credit stood at a mere 10 percent by the end of 2021. Thus, the continued expansion of access to finance for MSMEs now and during the recovery stages must be of utmost importance in promoting sustained economic growth and inclusive prosperity in Jordan.

Macroeconomic Policy and Regulatory Environment

As noted, at the onset of the global pandemic in March 2020, the CBJ was quick to implement measures, particularly to support firms. These measures totaled about 8 percent of GDP (IMF 2022)a. The creation of the MSME lending scheme, the raising of the borrowing limits under the scheme, the extension of the terms of loans by an additional year, and a 150-basis point decrease in the benchmark interest rate seem to have been effective in propping up credit markets and providing ample liquidity. Indeed, domestic credit to the private sector grew from 76.9 percent of GDP in 2019 to 83.1 percent in 2020 (World Bank 2022c). With the COVID-19 pandemic extending into the new year, the CBJ's increase in the subsidized MSME lending program in 2021 by 40 percent helped to increase the MSME share of lending to 11 percent. However, credit growth and uptake of the MSME lending program slowed later in 2021.

Even before the onset of the pandemic, the Kingdom of Jordan took steps to address the improvement of MSME access to formal finance, particularly in the Jordan Economic Growth Plan 2018 – 2022. The Plan aimed to double the volume of MSME lending from 10 to 20 percent by the end of 2020, as well as to increase loan guarantees for MSMEs via the JLGF (The Hashemite Kingdom of Jordan. 2018).The CBJ's interventions have continued to facilitate access to firms in dire need of working capital and liquidity, helping them to stay afloat throughout the past two years. However, firms across all sectors and sizes report that it will take them possibly between 9 to 13 months to return to their pre-pandemic level of sales and business activity (World Bank 2022a). Thus, continued support for Jordanian firms in the recovery stages is crucial to help them survive and thrive in the future.

Conclusion

As the initial credit crunch has been mitigated by heightened levels of financing support that propped up credit supply, the Jordanian credit sector has proved resilient. Indeed, credit quality remained healthy and the non-performing loan (NPL) ratio remained in the single digits (European Investment Bank 2022). The measures put in place were key to preserving the healthy flow of credit and protecting the quality of credit portfolios, thus helping Jordan to navigate the crisis better than other emerging market counterparts. In December 2021, Fitch Ratings upgraded its outlook for Jordan's credit from negative to stable (Trading Economics 2022a). The banking system remains resilient to shocks. Positive spillovers from the region and continued post-pandemic recovery contributed to the Jordanian economy growing in 2022-23. (IMF 2022d)

Nonetheless, threats exist on the horizon that can challenge the MSMEs' increasing access to finance. These include declining international reserves; short-term external debt; government deficits; and rising inflation and commodities prices. These can push lenders to tighten the purse strings, especially as COVID-related measures continue to unwind. Mobility restrictions stemming from the pandemic have decimated Jordan's promising tourism sector, which has been an engine for job growth and economic activity. As it stands, almost one in four adults and one in two youth are currently unemployed (Trading Economics 2022a). Finally, the spillover from neighboring conflicts and slower-than-expected recovery in neighboring economies could potentially threaten the rebounding Jordanian economy.

8.3 Mexico

Introduction

As with many emerging market developing economies, MSMEs are central to Mexico's economy. There are 4.9 million firms across the country, comprising 78 percent of private sector employment and 52 percent of GDP (Mexican National Institute of Statistics and Geography 2019). MSMEs in Mexico are a key driver of the country's modern growth and development. As these firms are integral to employment and national output, their performance reflects the overall health of the Mexico economy. However, they have unmet financing needs, with approximately only one of every ten firms utilizing bank credit due to a lack of access and affordability (World Bank 2022).

In total, across all individuals and firms, Mexico also lags in terms of financial inclusion. Only 35 percent of adults have bank accounts as of 2017, and only a third of MSMEs reported having access to a loan. Both rates are significantly lower than many countries with similar levels of development (World Bank 2022f). Concurrently, while smaller firms and households experience lower levels of financial inclusion and access, the greater financial sector in Mexico remains shallower compared to its peers. Credit to the private sector and deposits remain below average, both across regional neighbors and countries of comparative income levels. Credit to the private sector as a percentage of GDP for Mexico is 36.6 percent, compared with the Latin America and Caribbean (excluding high-income economies) median of 50.7 percent, and the income group median of 125.8 percent (World Bank 2022f).

These lower levels of financial intermediation can be traced back to the residual effect of recent financial turbulence. Domestic bank credit to the private sector contracted considerably following the Mexico peso crisis in late 1994. Although its growth eventually picked up again in the mid-2000s, as noted, bank credit to the private sector currently remains low by regional standards. As a result, lending to perceived "riskier" market segments, such as MSMEs, is particularly scarce. Only 12 percent of microenterprises received some source of external finance, and 32 percent of small and medium-sized firms needed external financing but could not access it due to financial constraints (World Bank 2022a). According to the latest economic census, credit to MSMEs represents only 11 percent of commercial bank loan portfolios (Mexican National Institute of Statistics and Geography 2019). The combination of access and affordability issues on the firm side along with shallow financial depth on the supply side turns into a lack of capital flows to smaller firms, thereby inhibiting their potential to finance both short-term working capital and larger, long-term investments. These constraints have had a knock-on effect of handicapping the efficiency and inhibiting the greater productive growth of the larger economy.

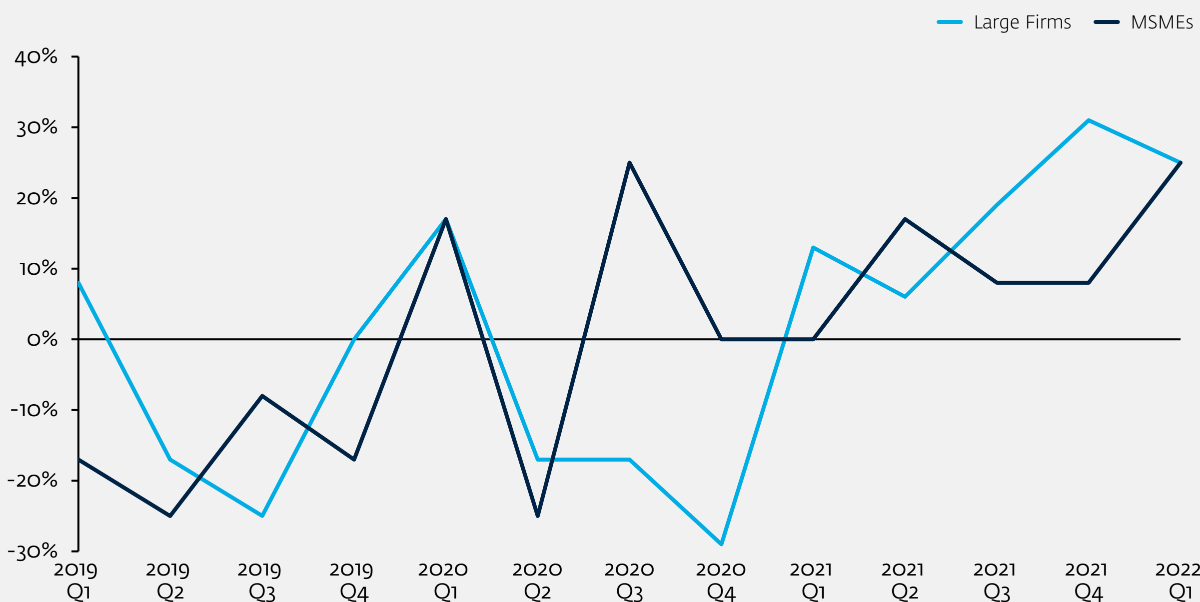
Demand Side

In the wake of the turbulence emerging from the early days of the spread of the COVID-19 pandemic, the containment measures used to mitigate the spread inflicted damage across the Mexican economy, leading to 12.5 million in job losses in April 2020 — with no substantial recovery until the end of the year (United Nations Economic Commission for Latin America and the Caribbean 2021). Historically, MSMEs have faced elevated levels of financial constraints. The COVID-19 pandemic exacerbated these pre-existing issues in the commercial finance supply chain. As liquidity tightened in the marketplace, the challenges of accessing

formal finance at an affordable cost was one of the first fall-out effects of the pandemic-related economic slowdown (Elizundia and others 2021).

MSMEs experienced particular vulnerability, as firm working capital was constrained amid a tightening of external liquidity — concurrent with the lockdowns in place. With lower cash buffers, a concentration among fewer clients, and elevated debt levels, MSMEs had lower capacity and ability to sustain their operations. In the early pandemic stages of April and May 2020, 10,000 formal and 12,000 informal businesses were forced to permanently close (Mexico Daily News 2020). As most MSMEs in Mexico have ten or fewer employees (95 percent) (Elizundia and others 2021), the crisis emerging from the wake of the pandemic highlighted in particular the heightened existential risk faced by smaller firms. With the central role that MSMEs play in the domestic economy, the crisis faced by MSMEs represented a larger risk to the overall stability of the Mexican economy. Of the 4.9 million MSMEs in existence prior to the pandemic — and the closure and creation of firms during 2020 — the amount of MSMEs remaining by the end of year decreased by 400,000 (Elizundia and others 2021).

Figure 53: Mexico: Demand in the Banking Credit Market (relative to previous quarter)



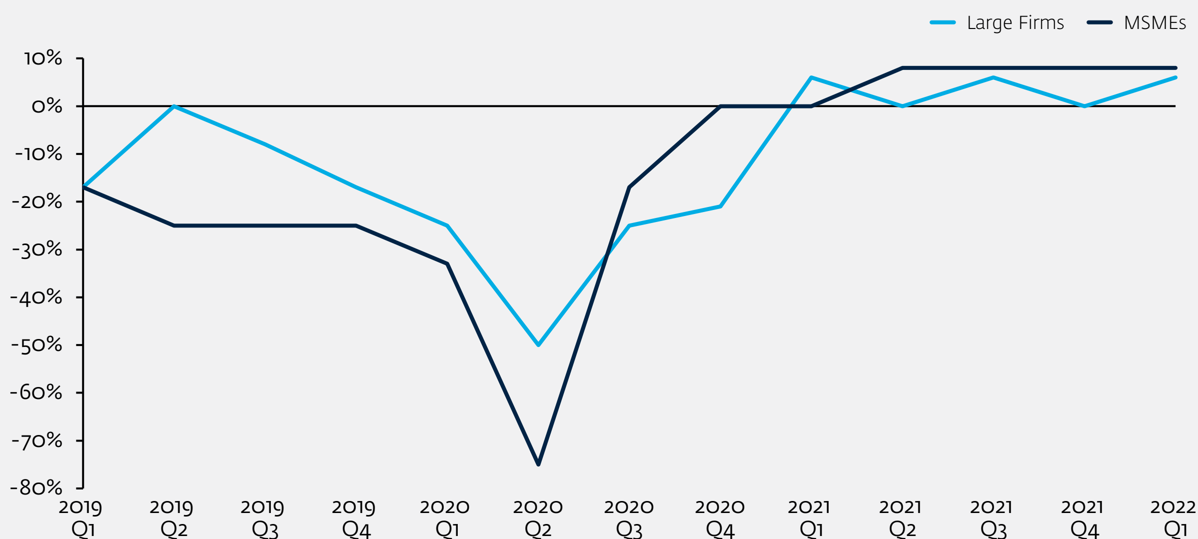
Source: Banco de Mexico

The existential threat that the pandemic created within small firms is evidenced by changes in demand for finance by firms (figure 53). Following sharp contractions for both large and smaller firms in the Q2 of 2020, demand for finance from commercial banks has remained elevated for MSMEs throughout the past two years. Compounding the need for finance, as proxied by the heightened credit demand levels, concentrations of MSME loans over the past two years are more sensitive to a deterioration in the economic outlook. By the end of July 2020, the Mexican banking sector's Tier 1 capital ratio was 14.2 percent, the lowest since 2009, with profitability concerns becoming particularly more serious in smaller banks with lower capital buffers (IMF 2020b). Similar to patterns reflected across both advanced and emerging markets over the course of the pandemic, commercial banks have limited appetite for lending to MSMEs, absent credit guarantee provisions provided by central authorities.

Supply Side

While demand for credit rose precipitously on the firm-side, approval rates for commercial credit dramatically declined in Q2 2020, following the primary stages of the COVID lockdown-related measures (figure 54). Although approval rates did begin to improve over the following months, by December 2020, commercial bank lending to companies and individuals for business activities fell by 4.5 percent year-on-year. In total, financial system credit provided to the non-financial private sector decreased from 10.8 percent of GDP in 2017 to 1.5 percent in 2020 (IMF 2021c).

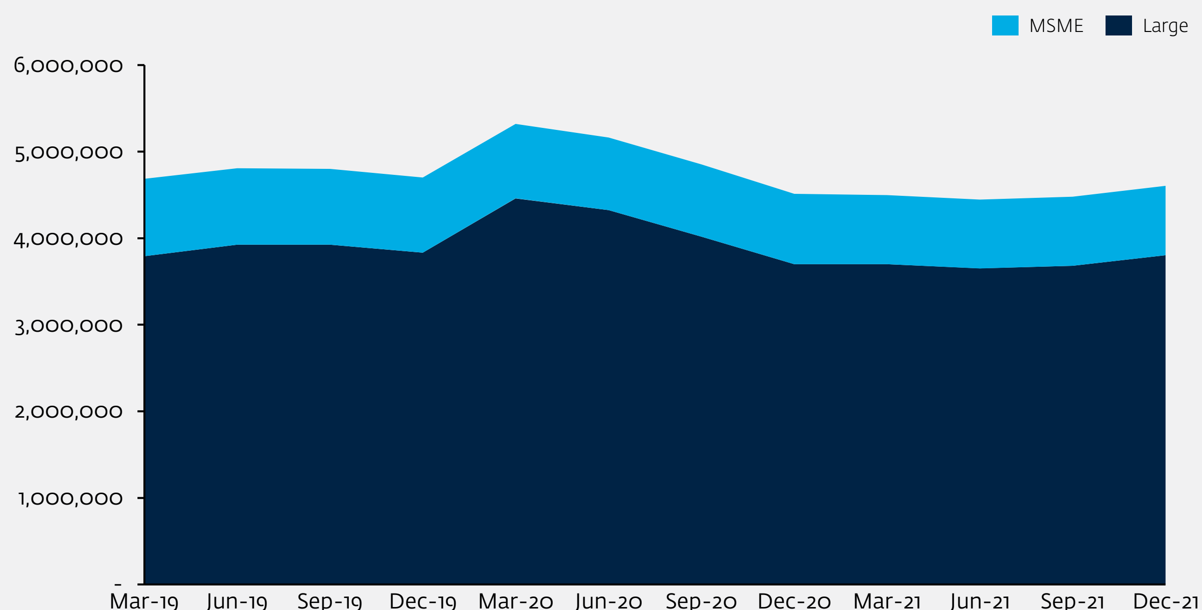
Figure 54: Mexico: Standards of Credit Approval (relative to previous quarter)



Source: Banco de Mexico

With commercial lending depressed by pandemic-related effects, the Bank of Mexico reduced its benchmark interest rate by 25 basis points to 4.00 percent in February 2021 to facilitate lending. However, in June 2021, the Central Bank redirected its course of action with a 25-basis point increase, as inflation pressures began to arise. That same month, the commercial bank outstanding private credit portfolios hit a nadir, falling 11.8 percent year-on-year, led by a 16.9 percent drop in lending to companies and individuals with business activities (figure 55) (United Nations Economic Commission for Latin America and the Caribbean 2021).

Figure 55: Mexico: Total Commercial Lending (Pesos, millions)



Source: Banco de Mexico

Although the tier 1 capital ratio did improve from July 2020 — and it was in a position of general strength (reached record high of 16.8 percent) — lending conditions for firms remained tight. This was especially the case regarding credit to MSMEs, which contracted by six percent year-over-year as of July 2021 (IMF 2021c). By then, most of the Central Bank's liquidity and credit support facilities had expired. At the same time, NPLs peaked in early 2021 following the expiration of credit relief programs. As of the end of 2021, with government support measures ceasing to be in place, the trend of commercial lending across micro, small, and medium-sized firms and MSMEs, remains below pre-pandemic levels. Indeed, it remained flat in terms of growth over the course of 2021.

Macroeconomic Policy and Regulatory Environment

Like its fellow emerging market economies, Mexico pursued fiscal policy to provide support to MSMEs through measures, such as liquidity support and credit guarantees. However, Mexico was much more conservative in its support expenditures, with direct budgetary support in 2020 amounting to only 0.7 of GDP. This is in contrast to fellow emerging market economies that provided an average of 4.1 percent of GDP (IMF 2021d).

Regarding MSMEs, guarantees and loans provided to such firms were also modest compared to fellow emerging market economies (1.2 percent of GDP compared to 2.6 percent of GDP) (IMF 2021c). In the early days, the Mexican government rolled out a credit program (Crédito a la Palabra) in April 2020 that provided roughly US$1,250 per business to be paid out over three years, including an initial three-month grace period. However, only about 650,000 companies were eligible for the program, with only a quarter of them being approved. Additional research found the loan amount to be insufficient for MSMEs, as it would only cover the salaries of 2.5 formal workers for one month (Elizundia and others 2021).

As a response to the pandemic, authorities extended additional lending to firms in both the formal and informal sectors. The Ministry of Economy provided approximately US$200 billion worth of loans with optional repayments to segments, such as MSMEs, that maintained employees on the payroll. For its part, the Central Bank cut its benchmark interest rate by 300 basis points at the beginning of the pandemic (IMF 2021d). Additional liquidity support measures included a reduction of the mandatory regulatory deposit by about 15 percent. This was done to support the flow of credit. It occurred alongside the opening of financing facilities for commercial and development banks (~US$17 billion) to channel resources to MSMEs.

Conclusion

Following a contraction of 8.1 percent of GDP in 2020, and 4.8 percent in 2021, the recovery to pre-pandemic levels of activity slowed amid the uncertain global economic headwinds. As in both advanced and emerging markets, the Mexican economy is currently facing the challenges of rising inflation and commodity prices, continued supply-chain disruptions, as well as the deleterious effects of the Russian invasion of Ukraine. This combination of factors has pushed the Bank of Mexico to revise GDP estimates down to 2.2 percent for 2022, which is lower than its previous estimate of 2.4 percent. It also moderated its 2023 forecast from 2.9 percent to 2.4 percent (Averbuch and de Haldevang 2022). Mexico suffers as the lone major regional economy to not be a net commodity exporter. Thus, it has not benefited from heightened commodity prices that have been a major driver in increased prices across consumption baskets.

The government has introduced voluntary price agreements with the private sector, while suspending import tariffs for staple goods and facilitating access to fertilizer for small food producers (World Bank 2022h). Elevated inflation levels are a central driver of these revised estimates. Inflation rose 7.9 percent through June 2022, exceeding the 21-year high of 7.7 percent reach in April 2022. Across the entire region, inflation has risen well above central bank targets. With inflation more than double the central bank's three percent target, the Bank of Mexico had initially increased its benchmark interest rate by 75 basis points multiple times, reaching 8.5 percent in August 2022 (Reuters 2022b). As of December 2022, the Bank of Mexico had set its key interest rate to a record 10.5 percent, (O'Boyle and Esposito 2022) with potentially more rate hikes if necessary. Further increases may dampen investment prospects.

Even before the global pandemic, smaller Mexican firms faced challenges in terms of the gaps in access to and affordability of formal finance. The now concurrent threats of elevated inflation and global economic uncertainty are having a significant impact on the productivity, growth, and health of Mexican MSMEs in their post-COVID recovery. The Bank of Mexico and other policymakers have implemented reforms targeted at deepening the financial sector and expanding access for both firms and individuals alike. However, in the context of the COVID-19 pandemic, the experience of the past two years highlights the need to facilitate a more expansive, sustainable, and resilient financial infrastructure for firms to finance day-to-day operations over the short and medium term, while also enabling greater investment in higher productivity gains over the long term.

8.4 Pakistan

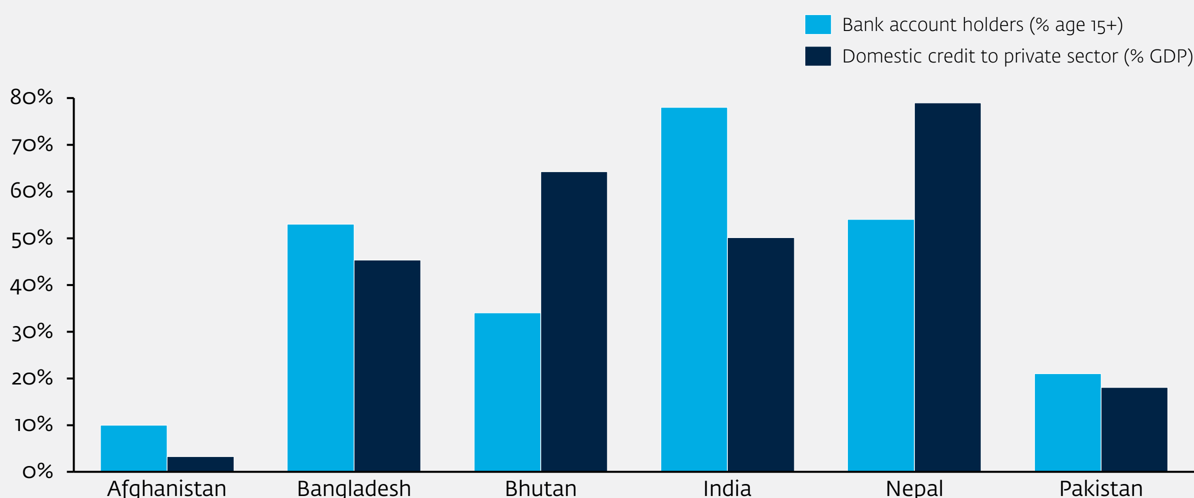
Much like other emerging markets, MSMEs are central in all sectors of the Pakistan economy. The estimated 5.2 million MSMEs comprise an average of every nine out of ten Pakistani firms. They produce over 40 percent of annual GDP, 80 percent of the non-agricultural labor force, and 25 percent of all exports (Pakistan Bureau of Statistics 2005). Pakistani MSMEs are particularly concentrated in the services sector, which is the sector that contributes the most to Pakistani GDP (over 60 percent) (Pakistan Bureau of Statistics 2022). Taken as a whole, the success of MSMEs is integral to the overall success of the Pakistani economy. Indeed, they are engines of economic growth, job creation, and poverty reduction.

Despite their centrality in terms of output and employment, Pakistani MSMEs are underserved and constrained in their financing needs, with current supply meeting only 20 percent of potential demand. In contrast to their larger counterparts, these smaller firms also exhibit lower levels of having checking or savings accounts, lines of credit, and/or bank loans (World Bank 2015).

At the country-level, compared to their fellow middle-income neighbors —Bangladesh, China, and India — outstanding SME loans from commercial banks were below average at 1.27 percent of GDP (as compared to Bangladesh at 9.56 percent, China at 36.18 percent, and India at 6.26 percent from 2017-2019) (IMF 2021b).

Historically, Pakistan has exhibited low levels of financial inclusion, and not just for MSMEs. According to the latest Findex data, as of 2021, only 21 percent of adults in Pakistan had access to a formal bank account, which is lower than its regional neighbors, including: Iran (90 percent); China (89 percent); India (78 percent); Nepal (54 percent); and Bangladesh (53 percent). IMF (International Financial Statistics) and WDI data further emphasize the limited uptake of formal credit in Pakistan, which also lags regional peers, except for Afghanistan. However, with a GDP per capita that is 5 times higher than Afghanistan and higher than Nepal, Pakistan's low ratios of uptake of financial services underscores the challenges that MSMEs face in tapping into formal channels of credit (figure 56).

Figure 56: Financial Inclusion in Pakistan Relative to Peers



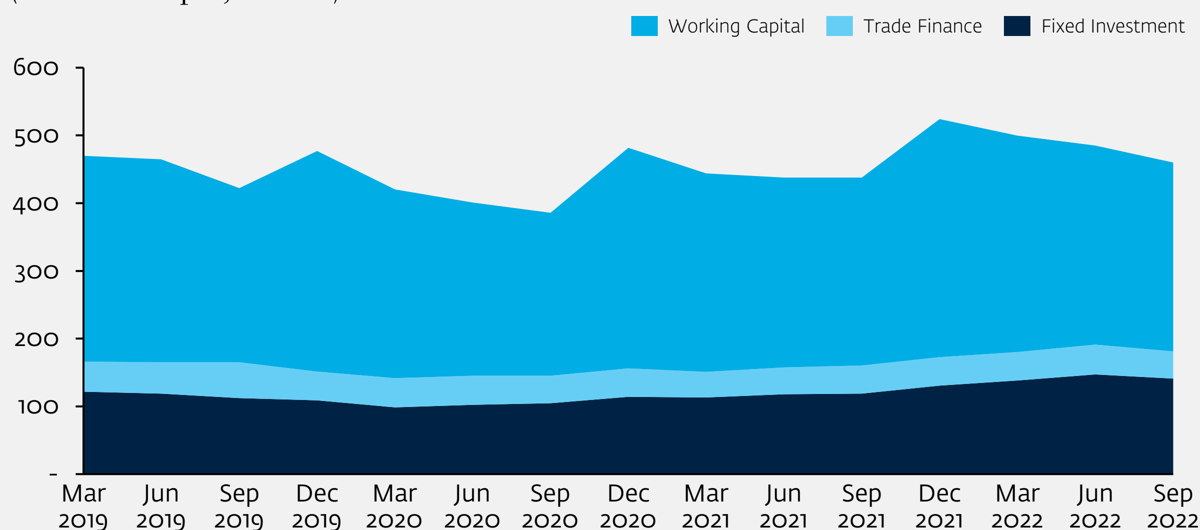
Source: World Bank

The deleterious effects of the COVID-19 pandemic have subsequently magnified the difficulties and constraints faced by MSMEs in Pakistan in their access to financing. To understand their difficulties in accessing formal financing, it is useful to understand the three components of MSME financing: the demand side (MSMEs), the supply side (lenders), and policy and regulation (government).

Demand Side

Analyzing quarterly data collected by Karandaaz reveals that the financing needs were most acute for smaller firms. In disaggregating the outstanding portfolio by financing type (fixed investment, trade finance, and working capital), working capital is clearly the dominant facility utilized by MSMEs, typically ranging from two-thirds to three-quarters of the MSME portfolio (figure 57). This persistent trend of working capital comprising overall financing suggests that MSMEs are typically utilizing funds to cover day-to-day operations rather than investing in long-term goals. The volume of fixed investment is typically two or three times smaller than working capital on a quarter-to-quarter basis.

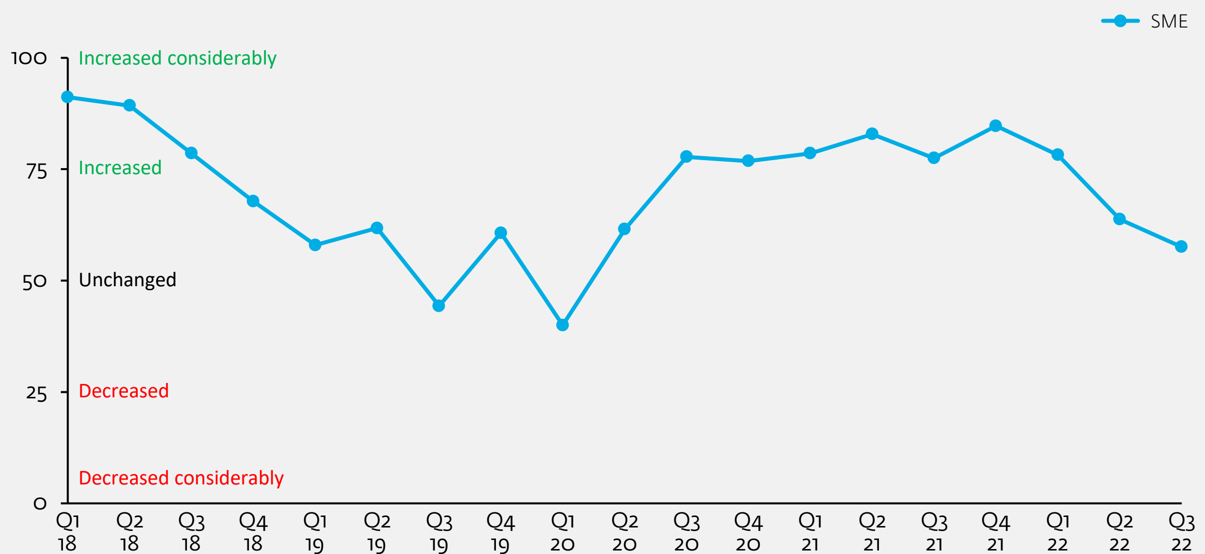
Figure 57: Pakistan: Outstanding MSME Portfolio by Financing Type (Pakistani Rupee, billions)



Source: Karandaaz

According to the opinions of bank officials in quarterly bank lending surveys, the overall current demand for loans has remained persistently strong for MSMEs over the time series of collected data (figure 58). Survey results are presented in a Diffusion Index (DI), which is normalized between 0 and 100 (a DI < 50 indicates decline; DI= 50 indicates unchanged; DI > 50 indicates increase relative to previous quarter). Apart from a slight dip corresponding to Q1 of 2020, demand has remained strong among MSMEs for multiple reasons, including, the need for working capital and fixed investment needs, seasonal effects, and overall economic conditions. In total, the narrow channels available for MSME financing have not been due to dampened demand; rather, factors emerging on the side of lenders and policymakers account for the shortfall.

Figure 58: Pakistan: MSME Demand for Loans, Diffusion Index (quarter over quarter)

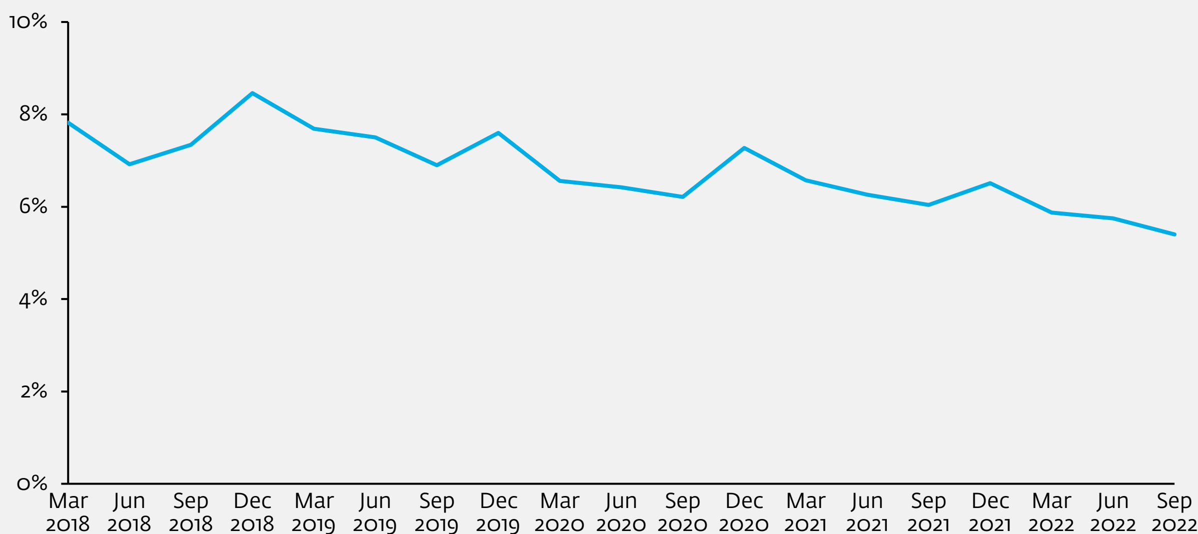


Source: State Bank of Pakistan

Supply Side

Affordable credit is essential to MSMEs to start, expand, acquire new technologies, and support a larger operating cycle. However, MSME access to affordable finance has been historically weak. Private credit flows to MSMEs have always been relatively muted, reaching an apex at the end of 2016 at 9.2 percent of all private sector credit. Since then, the pipeline has tightened, particularly over the course of the pandemic, shrinking from 7.6 percent in December 2019 to 6.5 percent in December 2021 (State Bank of Pakistan 2022a). As Pakistan's economic difficulties worsened in 2022, financing for MSMEs continued to be an adversely impacted segment (figure 59).

Figure 59: Pakistan: MSME Finance as a Percentage of Private Sector Credit



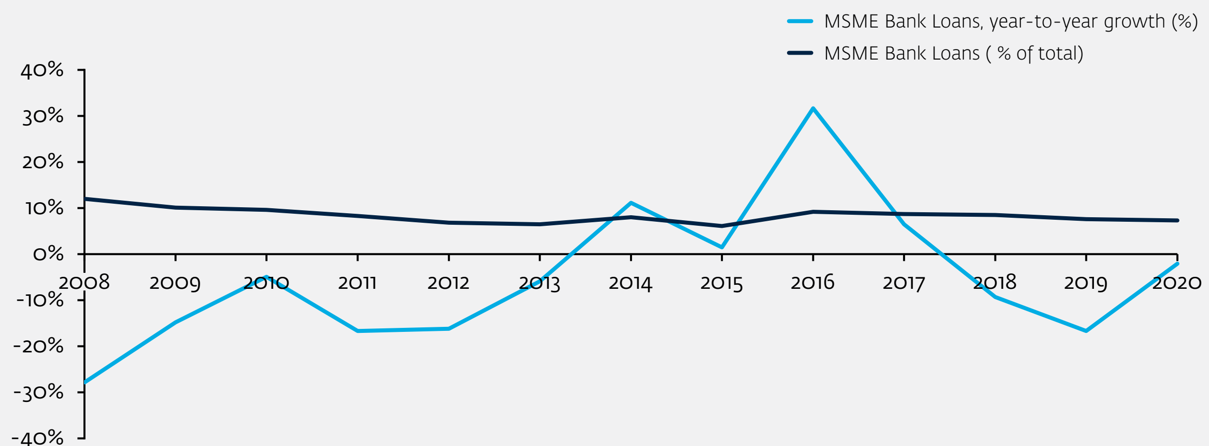
Source: Karandaaz

The pre-COVID stagnation and subsequent COVID decline indicate that there has been little or declining progress in facilitating greater credit access for MSMEs. Pakistan's potential audience for MSME financing stands at approximately US$61 billion, with formal finance meeting only 5 percent of firms' needs. This leaves the remainder to be funded through indirect channels.[1] The traditional sources of formal financing including commercial loans and leasing products seem to have reached a ceiling in tapping into MSMEs' financing potential. As a result, this unfilled vacuum has pushed firms to rely primarily on informal sources of lending, self-financing, and/or retained earnings to finance their operations. Consequently, this hampers firms' ability to finance their day-to-day operations and expand their businesses, thus limiting potential growth in the greater economy.

Beyond unaddressed financing needs, and the narrow total share of MSME lending, there has been a lack of convergence in growth rates for MSME loans. Apart from 2016, State Bank of Pakistan (SBP) data indicates that MSME lending has grown at lower overall rates on a year-to-year basis (figure 60). This is in contrast to overall lending since the Global Financial Crisis of 2007-2008. In the immediate years succeeding the crisis, growth rates contracted for five consecutive years (State Bank of Pakistan 2022a).

1 Based on IFC MSME Finance Gap estimates.

Figure 60: Pakistani MSME Access to Finance



Source: Asian Development Bank and the State Bank of Pakistan

Persistent negative growth rates arising from the previous financial crisis (2007-2008) should be on the top of the minds of policymakers in supporting MSMEs resiliency and recovery, especially coming out of this current pandemic-induced crisis. From the perspective of banks, lenders have been reluctant to finance smaller firms due to a lack of MSME credit histories, higher default ratios, and opacity concerning the ability of MSMEs to repay their loans.

Pakistan experiences high levels of informality (exceeding over 80 percent, according to the latest estimates) (World Bank 2021b). This may be due to the fact that smaller firms face disproportionately higher regulatory and tax compliance costs, which can incentivize small firms to remain informal and unregistered (thus, tax revenue to GDP stands at only 12.5 percent in Pakistan) (IMF 2020c). NPL rates are consistently two or three times greater for MSMEs; however, this may be due to the fact that MSMEs face higher interest rates than their larger counterparts (Asian Development Bank 2021).

For their part, MSMEs are hesitant to access loan facilities due to insufficient repayment ability and unaffordable collateral requirements that are a condition for loan approval. Altogether, the MSMEs lack of credit histories and successful repayment histories hamper their credit worthiness in the eyes of lenders, thus making formal loans unaffordable and inaccessible. MSMEs incapable of tapping into formal sources then resort to borrowing from relatives, friends, and local moneylenders. Alternatively, they may draw from their earnings and savings to finance their operations as the opportunity cost of equity financing from formal sources is too high. This sequence of events can be cyclical, compounded, and it can magnify the constraints faced by MSMEs in accessing affordable formal finance sources.

Unique to EMDEs, and Pakistan in particular, is the role of microfinance institutions (MFIs) in supporting MSME lending. Although these institutions only comprise 1.8 percent of total deposits in the country, their share of domestic borrowers exceeds 50 percent, highlighting their central role in loan origination in Pakistan (State Bank of Pakistan 2022b). The World Development Report (WDR) (World Bank 2022g) highlighted how Pakistani MFIs managed pandemic-related shocks to their operations, specifically by increasing digitization of financial services and accessing support programs from regulators. In total, MFIs saw a net increase in their loan portfolios from US$1.97 billion to US$2.02 billion in 2020 (World Bank 2022g). However, the WDR does note that by the end of the first year of the pandemic, many MFIs in Pakistan had temporarily suspended their lending operations as credit demand slowed.

Macroeconomic Policy and Regulatory Environment

Amid the challenges that Pakistan MSMEs face in accessing finance, the government and SBP have introduced several initiatives to promote and ensure easier access to formal finance. At the height of the pandemic, the SBP introduced a financing scheme for SMEs to enable them to obtain loans without collateral Small and Medium Enterprise Authority 2021). The scheme was particularly crafted to target informal firms, as a "majority of SMEs in the informal sector that do not have collateral are currently borrowing in cash or kind at rates of at least 25 percent" according to the SBP (Small and Medium Enterprise Authority 2021). Moreover, the SBP introduced some temporary regulatory measures to maintain banking stability and support MSMEs by increasing the regulatory limit on the extension of credit to MSMEs by 44 percent to PKR 180 million (IMF 2021d).

Looking at the long term, the Small and Medium Enterprise Development Authority (SMEDA), established by the Government of Pakistan in 1998, has put forward the National SME Policy (2021). It sets the following Key Performance Indicators to be achieved by 2025: (i) increasing the economic contribution of SMEs; (ii) making SMEs more competitive and productive; (iii) enhancing formalization and increasing the number of SMEs; (iv) improving the networking of SMEs; and (v) increasing start-up enterprises (Small and Medium Enterprise Authority 2021). Furthermore, according to the Enhanced National Financial Inclusion Strategy of 2023, the SBP strives to increase the number of SME borrowers to 700,000, with a financing volume of PKR 800 billion by the end of 2023 ((Small and Medium Enterprise Authority 2021). With these figures standing at PKR 164,756 and PKR 524 billion, respectively, these initiatives will need to greatly scale up borrowers and volumes beyond what growth rates have exhibited over the past 15 years to accomplish its objectives.

Conclusion

MSMEs have historically faced many challenges in Pakistan. The COVID-19 pandemic has been an accelerant of these pre-existing issues. Pakistan headed into 2023 at risk of default after a depletion in its foreign exchange reserves, hitting a nine-year low. At the present time, amid rising inflation, debt levels, fiscal imbalances, the weakening of the Pakistani Rupee, and dwindling foreign direct investments, the MSME cost of doing business and access to finance is under severe pressure.

In April 2022, the SBP raised its benchmark interest rate by 250 basis points to 12.25 percent, as the Central Bank tried to grapple with these issues (Trading Economics 2022b). The six-month Karachi Interbank Offered Rate (KIBOR), a benchmark for lending to both firms and consumers, hit a 13-year high, thus raising risks for credit accessibility and overall economic growth (Zaida 2022). Subsequently, over the course of the rest of 2022, the SBP has continued to raise its benchmark rate to deal with persistently high inflation. Indeed, the SBP raised the policy rate up to 16 percent by the end of the year, the highest level since 1999 (Business Recorder 2022).

Private sector credit growth to MSMEs, which has been at persistently low levels, can potentially see greater slowdowns, thereby creating greater hurdles for firms to cover their day-to-day operating costs, as well as expand their current businesses and make new investments. The domestic and global macroeconomic uncertainty will adversely impact the viability of MSMEs to remain profitable. It will also hamper their recovery from the pandemic.

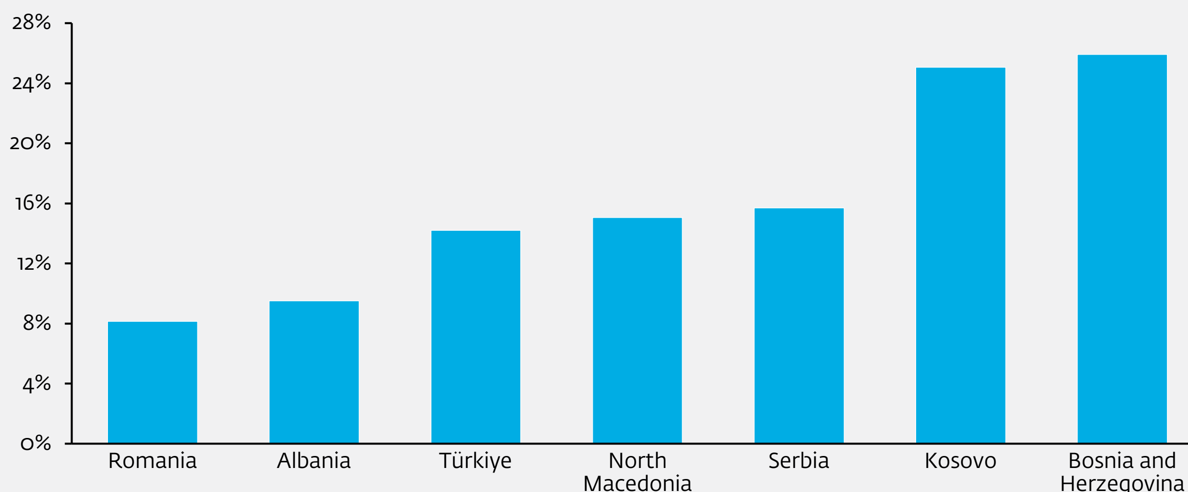
8.5 Romania

Introduction

Much like other EU member states, Romanian MSMEs comprise virtually all national enterprises, including the majority of employment and GDP. As was the challenge with every enterprise across the globe, Romanian MSMEs were forced to deal with the exogenous shock and economic downturn of the COVID-19 pandemic. However, the initial impact in 2020 was rather muted compared to other countries of its income level. The impact was not as severe due to the support of both national- and regional-level policy measures to support MSMEs. As a result, value-added declined by a mere half of a percentage point, and employment increased by 1.1 percent (European Commission 2022). In total, the Romanian economy declined 3.9 percent in 2020, which is on the lower end for EU members. However, the less severe impact on Romanian enterprises has not been felt across all sectors. MSMEs in manufacturing and services — two sectors particularly affected by mobility restrictions and lockdowns — experienced value-added declines of 10.5 percent and 36 percent, respectively, in 2020 (European Commission 2022).

The pre-COVID situation presented challenges to smaller firms in the country. Among the Europe and Central Asia region, Romania is on the higher end in terms of its MSME financing gap relative to GDP, that is, 26 percent as compared to the regional average of 18 percent (figure 61) (IFC 2022b). Within their immediate neighborhood of the Balkan Peninsula, for countries reporting data, Romania ranks the lowest in terms of MSME lending relative to GDP from 2016 to 2019.

Figure 61: Romanian Commercial Bank Lending to MSMEs (relative to GDP)

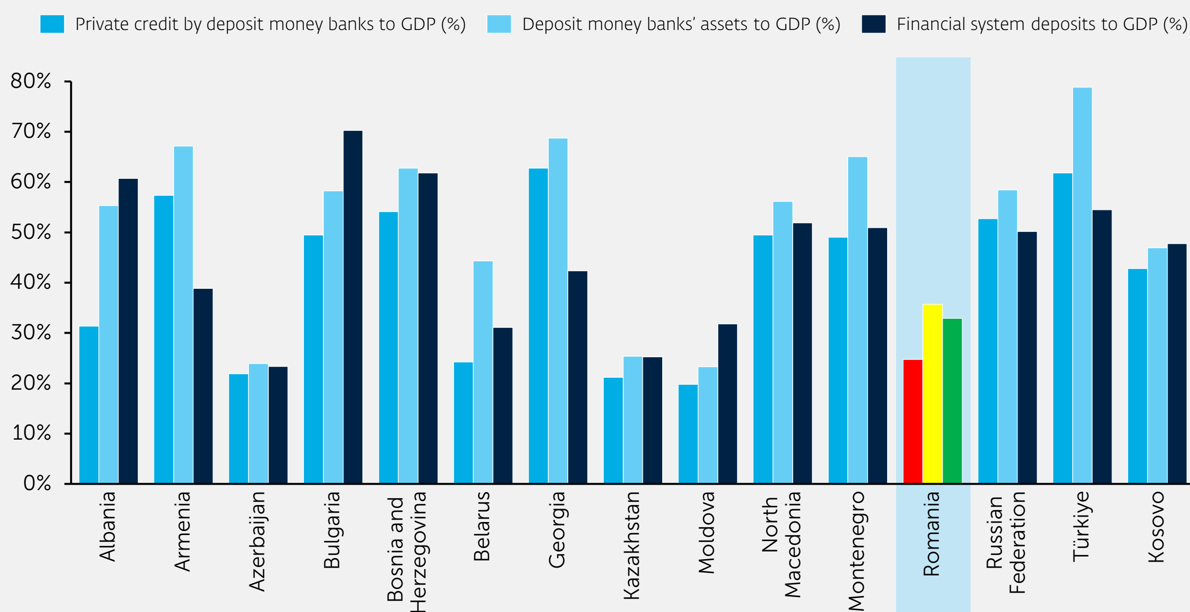


Source: International Monetary Fund, Financial Access Survey

The low rate of MSME lending relative to GDP is due to a confluence of factors. First, Romanian MSMEs are significantly less productive than those of the rest of the continent, with the value added per person employed at approximately €15,100 in Romania compared to the EU average €44,600 (European Commission 2022).

Second, this may be due to the fact that, relative to the economy, the banking sector has shrunk over the span of the 2010s. Private credit growth has been stagnant in Romania over the past decade, reaching its apex at 39 percent of GDP in 2011, and declining to 25 percent in 2019 (World Bank 2022b). Amongst the ECA economies of the same income level, the depth of Romania's banking sector is much shallower relative to its economy. In fact, it is near the bottom of the group with regard to private credit, assets, and deposits relative to GDP (figure 62).

Figure 62: Romanian Financial Sector Depth Relative to GDP, 2019



Source: World Bank, Global Finance Development Database

Whether it be the lower productivity of shallow financial markets, Romanian MSMEs use of financial services reflect similar trends in other middle-income economies. Firms with checking or savings accounts and/or bank loans have a positive relationship with firm size. Conversely, investment financed internally is greater for smaller firms, as small firms struggle in accessing external bank finance. Internal financing declines as firm size increases.

When smaller firms do access loans, they pay higher costs in the form of the value of collateral needed, averaging 276 percent for Romanian micro and small firms (as compared to 167 percent and 203 percent for small firms across ECA and globally, respectively) (World Bank 2019c). The challenge is two-fold in expanding overall credit growth in the greater economy, and within that, making credit more accessible and affordable for smaller firms.

Demand Side

In late February 2020, initial mobility restrictions in Romania emerged earlier than in most places, generally occurring after the initial spread of COVID-19 in Italy (Radio Romania International 2020). However, like many places, Romania's first national lockdown came in late March following a surge in new confirmed cases domestically. Restrictions to limit the spread of COVID-19 had adverse impacts on MSMEs, and, as previously noted, for firms in the manufacturing and services sectors. A majority of small and medium-sized firms, including manufacturing and service sector firms of all sizes, reported an initial downturn in cash flow availability in the early stages of the crisis.

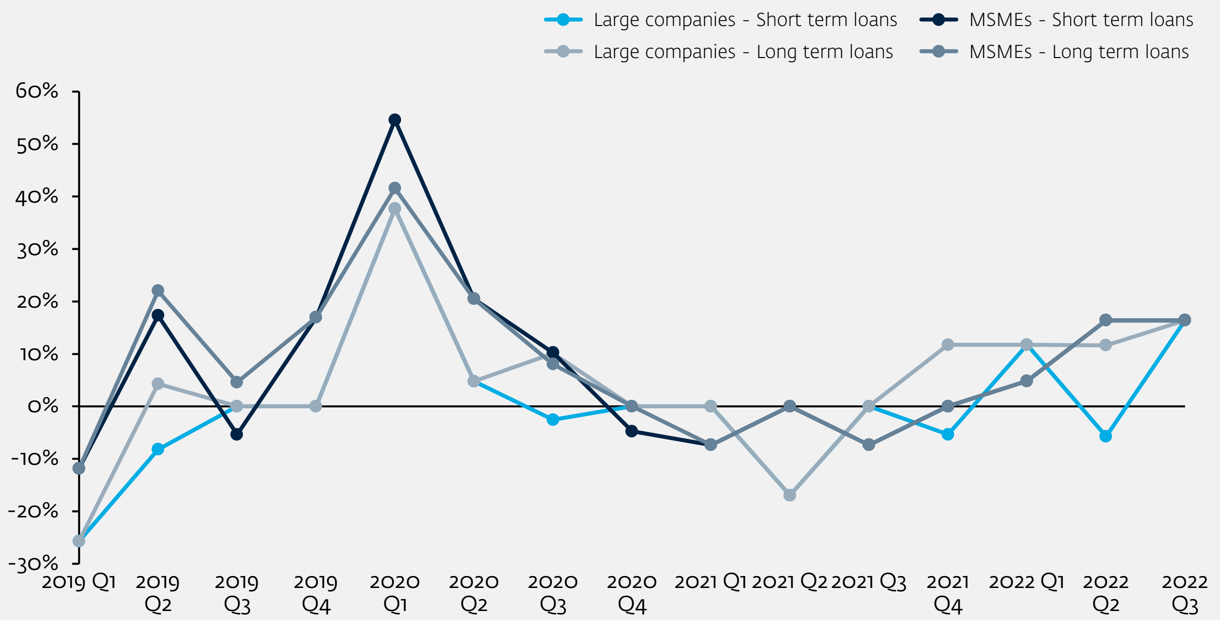
With decreased demand for products and services, firms also scaled back work hours, furloughed or laid off workers, and, in some cases, closed temporarily or even permanently.

Smaller firms disproportionately had higher frequencies of being temporarily or permanently closed, or closed for longer durations. They also experienced greater declines in full-time workers from December 2019 into 2020 and beyond (World Bank 2022a). Additionally, smaller firms were much more limited in terms of their space and ability to mitigate the operational challenges of COVID. By contrast, large firms increased or started remote work more than their smaller counterparts. They also exhibited higher proportions of employees working remotely, and higher levels of online business activity than smaller firms (World Bank 2022a). Thus, the following factors contributed to an immediate liquidity crisis and credit crunch for Romanian MSMEs: (i) the sudden drop in consumer demand; (ii) the inability to shift workers and business activity online; and (iii) pre-existing lower usage of financial services.

Data concerning the evolution of credit demand collected by the National Bank of Romania (NBR) highlights the quarterly change in demand across both short-term and long-term loans, as well as by firm size (figure 63). Q1 of 2020 highlights the dire situation MSMEs initially found themselves in at the onset of the pandemic. Loan demand from small and large firms alike reflects the heightened financial and economic uncertainty, as well as the role of government intervention to support credit markets. Although loan demand is up across both duration and firm size, the greatest surge in demand is seen in the need for short-term loans among the MSMEs, thus highlighting the need for quick liquidity injections and working capital to sustain business operations.

The initial downturn in March 2020 led to the largest quarter-to-quarter change during the pandemic, which was particularly severe for smaller firms. Although the intensity of demand eased in the succeeding quarters, the sentiments of reporting credit institutions reflect a trend of still moderate demand through 2021 and 2022.

Figure 63: Romanian MSMEs: Credit Demand, (relative to previous quarter)

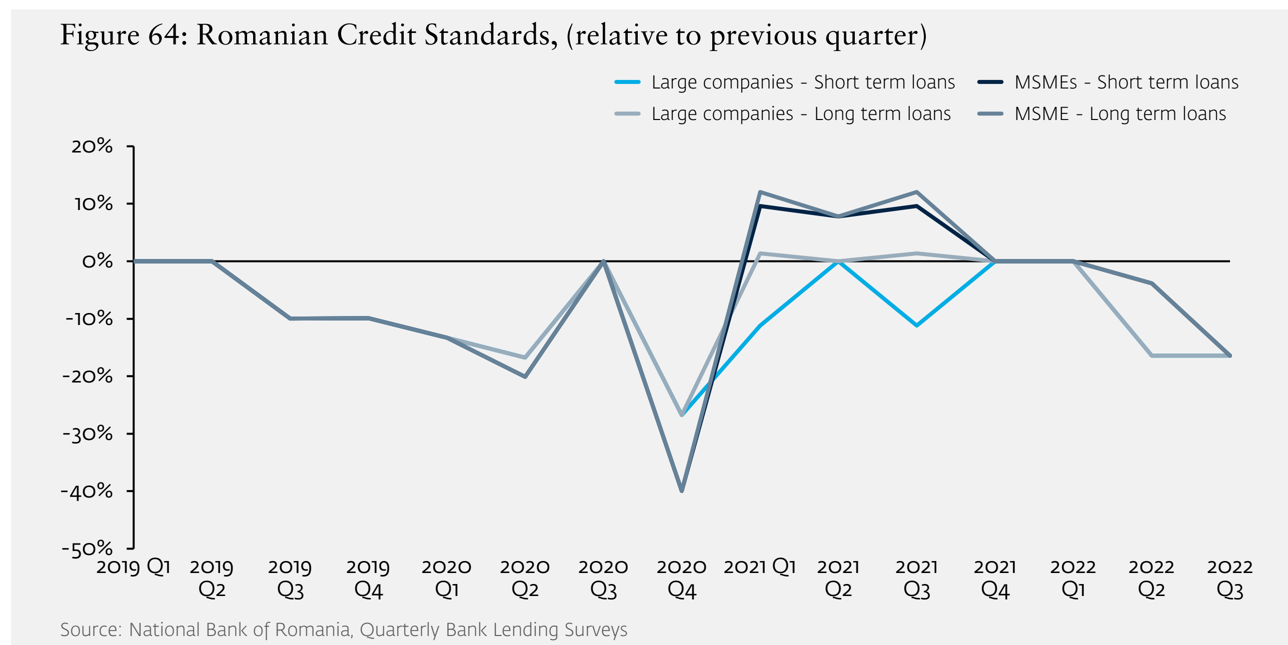


Source: National Bank of Romania, Quarterly Bank Lending Surveys

Supply Side

Given the existence of heightened liquidity needs stemming from the COVID-19 pandemic, it is important to examine how lenders responded to elevated demand. First, in the cloud of uncertainty, lenders initially tightened credit standards across all segments. However, MSMEs faced the most acute tightening in the first half of 2020, with standards softening more than for smaller enterprises and corporates over the course of 2021 and 2022 (figure 64).

Figure 64: Romanian Credit Standards, (relative to previous quarter)



Source: National Bank of Romania, Quarterly Bank Lending Surveys

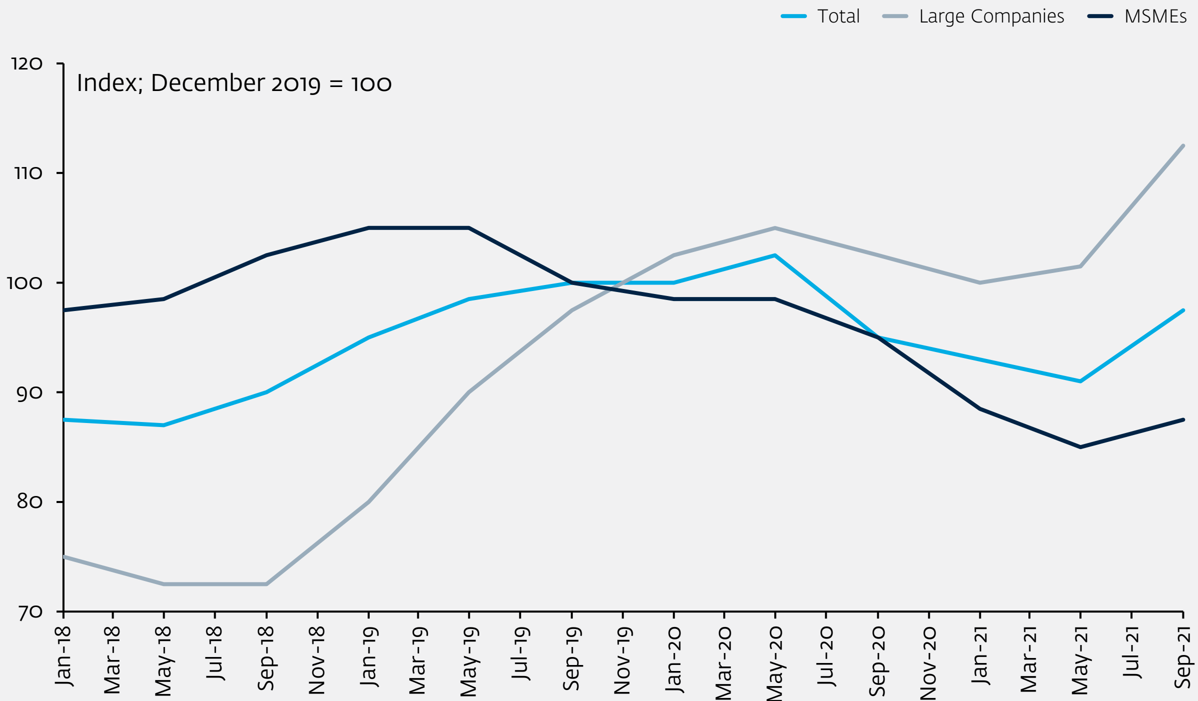
It should be noted that even pre-2020/pandemic, lenders applied more stringent standards for MSMEs relative to larger firms. The greater scrutiny of MSME lending through the tightening of credit standards is evidenced when looking at the actual trend of bank lending to the private sector. MSME lending saw a decline in the immediate months following the initial lockdowns in March 2020.

However, lending increased somewhat in the latter months of 2021, although overall lending to smaller firms remains below the pre-pandemic level. Since then, the flow of new loans granted by banks to large corporates is up 16 percent year-on-year between April 2021 and March 2022, with the extension of the loan guarantee scheme for MSMEs facilitating this uptick (figure 65) (National Bank of Romania 2022).

Throughout the course of the pandemic, credit institutions have considered smaller firms to be the riskiest segments, particularly micro and small enterprises. This may be due to existing pre-pandemic issues that may have been exacerbated during the crisis (figure 66). With higher NPL levels and smaller cash reserves to mitigate an exogenous shock such as a global pandemic, the uncertainties in the early days of the crisis furthered exacerbated credit risks vis-a-vis the MSMEs.

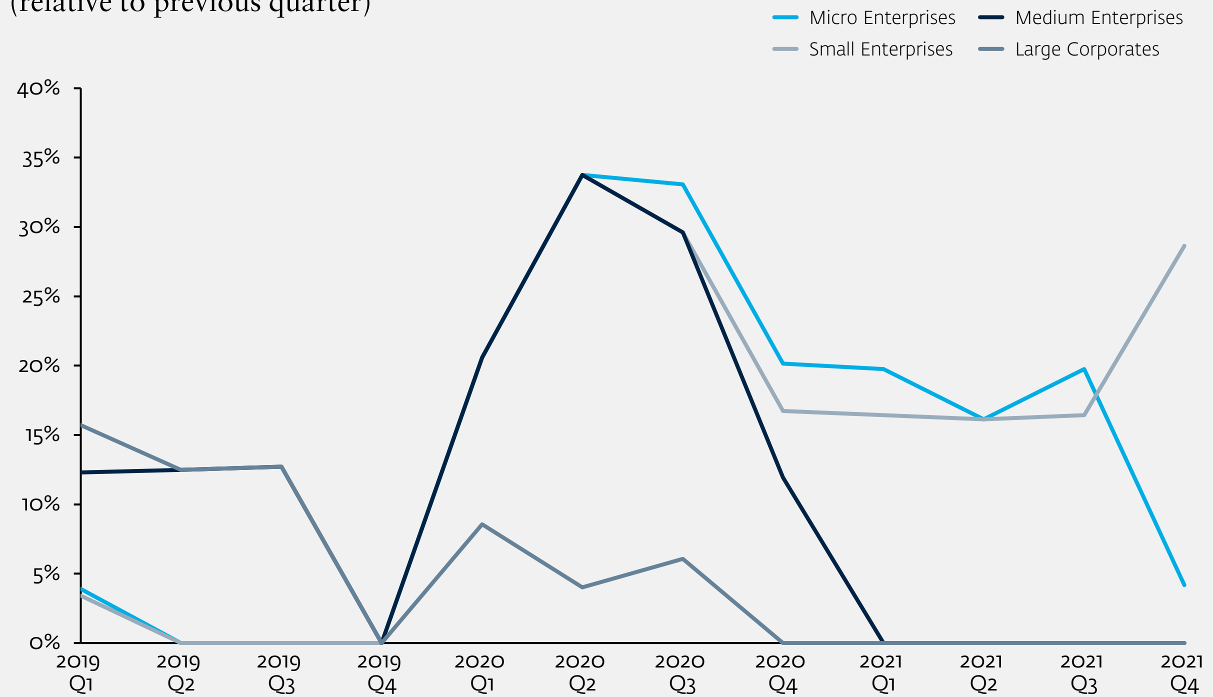
With improving macroeconomic conditions, the banks' perception of lending risks was tempered as MSME NPL rates declined and their standing below pre-pandemic levels recovered (6.6 percent in September 2021 compared to 8.8 percent in December 2019) (National Bank of Romania 2021). Nonetheless, as of the end of 2021, credit risks remained particularly elevated for micro and small enterprises. These higher associated risks with MSMEs played out in attendant interest rates for firms.

Figure 65: Romania: Annual Flow of New Bank Loans to Non-Financial Corporations



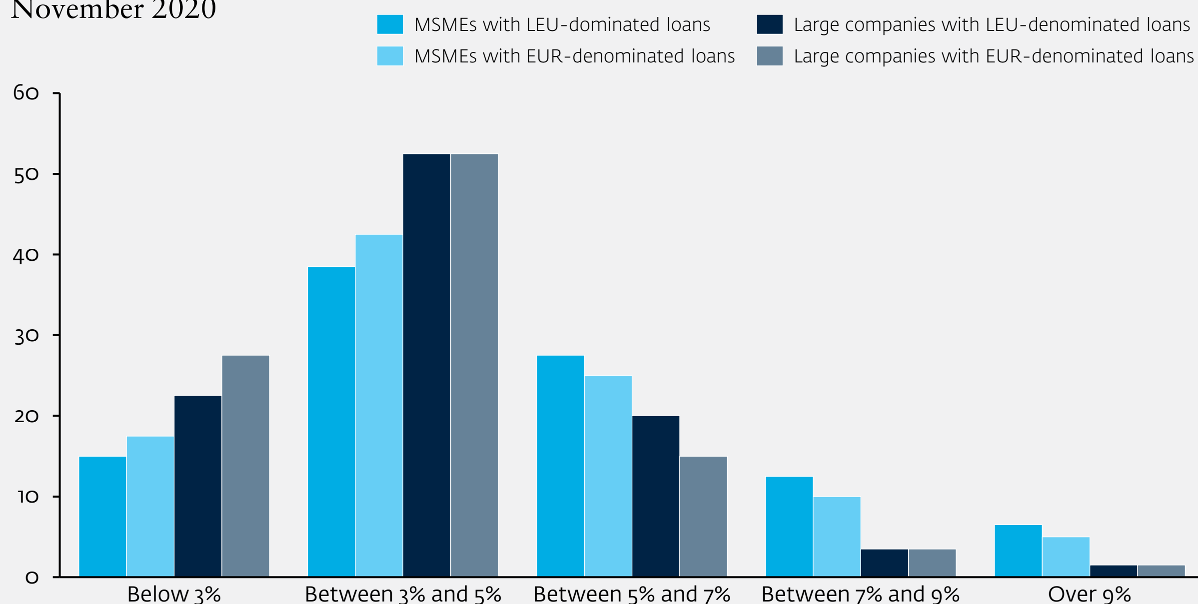
Source: National Bank of Romania, Financial Stability Report (December 2021)

Figure 66: Romanian Banks: Assessment of Evolution of Credit Risk (relative to previous quarter)



Source: National Bank of Romania, Quarterly Bank Lending Surveys

Figure 67: Romania: Average Interest Rates held by Non-Financial Companies, November 2020



Source: National Bank of Romania, Survey on the Access to Finance

Whether accessing loans denominated in Romanian Lei or Euros, the distribution of firms with higher lending rates skewed predominately to MSMEs (figure 67). The government and central bank implemented fiscal measures to ease and support lending to MSMEs. However, large firms' greater bargaining power, more stable financial standing, and lower associated credit risk led banks to provide easier lending conditions to larger enterprises.

While nominal lending declined overall in 2020, domestic credit to the private sector grew from 24.9 percent to 26.1 percent of GDP from 2019 to 2020 (World Bank 2022b). However, relative to GDP, loans to MSMEs remained pretty much flat, that is, from 7.48 percent to 7.46 percent from 2019 to 2020 (IMF 2022b). This reflects the fact that MSME lending seems more procyclical to economic downturns than lending to larger firms.

Macroeconomic Policy and Regulatory Environment

While overall lending fell below pre-pandemic levels in 2020, Romania's decline in GDP was relatively modest at 3.9 percent. In fact, it was well below the EU average (6.1 percent) (World Bank 2022d). This can be potentially attributed to the measures undertaken by the government and central bank to deal with the sudden drop in productivity stemming from the COVD-19 pandemic. The government acted swiftly and liberally in the early days of the crisis, implementing fiscal measures accounting for 4.4 percent of GDP in 2020. Credit markets were buoyed up by the government and liquidity constraints eased. Romania's only modest decline was stemmed by a private sector that was resilient amid the calamity. Putting forward a MSME support scheme amounting to €3.3 billion (European Commission 2020b), the Romanian government helped businesses cover the increased demand for working capital, thus aiding businesses in keeping up their levels of activity. Additionally, Romanian policymakers raised the ceiling for credit guarantees for MSMEs by approximately €1 billion, with the potential to increase further to €6 billion.

By comparison, the MSME credit guarantee ceiling was about €142 million in 2019. Further, the guarantees covered 90 percent of loans of up to €200,000, as well as 50 percent for credits over that value (European Commission 2020b).

Despite the financial burden of the pandemic, the NPL ratio in 2020 did not increase because of the role of expanded credit guarantees and debt service moratoria. However, as noted, although the contraction in 2020 was rather muted, the severity of the impact was not equal across the array of firms. The overall financial health of the MSMEs has improved amid the economic recovery. Still, by the end of 2021, the MSMEs had not recovered to the levels of lending they experienced pre-pandemic, which were already relatively low compared to its neighbors.

Conclusion

Reflecting pre-pandemic trends, large firms did not appear to suffer from a credit crunch associated with the downturn in real economic activity during the crisis. However, the narrow channel for formal finance for MSMEs tightened as banks turned to perceived safer borrowers in the form of large corporates. Even with the robust policy response to support MSME lending, there appears to be legacy issues still at play that dampen lending to smaller firms.

On the supply side, accessible and affordable formal credit channels continue to remain constricted for 99 percent of firms that comprise Romanian businesses. Alongside the challenges that have emerged over the past two years, Romania must now affront the risks emerging from the war in Ukraine. With inflation at its highest in 18 years — and surging regionally and globally — Romania's central bank raised its benchmark interest rate to 3.75 percent in May 2022, thus further tightening and squeezing liquidity to households and firms alike (Trading Economics 2022c). Since then, Romania's key rates stand at an 11-year high, including a total increase of 500 basis points in 2022, and interest rates at 6.25 percent as of October 2022 (Reuters 2022a).

External vulnerabilities stemming from the war in Ukraine have compounded inflationary pressures, as reflected in higher energy and food prices for households, thus putting a potential dampener on consumer demand. With businesses still trying to climb back to pre-pandemic levels of business activity, these interconnected and compounding challenges pose a threat to firms, particularly those affected by the pandemic downturn. Thus, whether it be shallower financial depth, lower levels of financial intermediation, the poor health and inefficiency of smaller enterprises in the eyes of lenders, or the regional and global uncertainties of the current moment, understanding and reforming the determinants of low levels of MSME financing is important. It can also serve as an impetus to support a sustainable recovery and generate robust growth in Romania in the future.

8.6 Zambia

Pre-COVID-19 Pandemic Situation

MSMEs are central to both employment and output in the Zambian economy, accounting for 97 percent of all businesses, 88 percent of employment, and 70 percent of GDP (Financial Sector Deepening Zambia 2017). Although MSMEs play an outsized role in business activity and daily life, Zambian MSMEs have faced obstacles in growing their operations. This was the case even prior to the COVID-19 pandemic, particularly with regard to their access to credit. MSMEs face a US$788 million financing gap, comprising 3 percent of GDP.

The main financing challenge Zambian MSMEs have faced is accessibility; small firms have lower levels access to bank loans, lines of credit, and checking and savings accounts than larger firms (World Bank 2019a). Lower levels of access may be due to the fact that smaller firms are frequently informal. Estimates find that about 70 percent of Zambian workers are employed by businesses that are not formally registered (World Bank 2021b). Thus, high levels of informality constrain lending levels due to the lack of credit histories. Nonetheless, even those that are formally registered still suffer from a lack of accessibility. This has spillover effects in the greater economy. Indeed, without sufficient working capital, firms are unable to invest and grow their operations, thus dampening economic growth.

The COVID-19 pandemic has compounded these challenges and widened the MSME finance gap. Zambia's macroeconomic challenges have constrained the credit channel, with Zambia's total public debt to both foreign and local lenders equal to about 120 percent of gross national income pre-COVID. By comparison, this is almost five times greater than the EMDE average (World Bank 2022e). Slowing overall growth prior to the crisis has also dampened credit access.

As real activity expands, finance grows in response to increasing demands for services from the nonfinancial sector. In this context, GDP growth in Zambia has averaged 3 percent in the three years prior to the pandemic, below the approximate 4.5 percent growth experienced by other lower-middle income markets during the same time frame (World Bank 2022i). Thus, Zambia's financial and economic difficulties in recent years have crowded out lending to the private sector from its peak of 19.5 percent of GDP in 2015 to 15.6 percent in 2019. With the exogenous shock of the COVID-19 pandemic, these challenges have been exacerbated for MSMEs. Indeed, MSMEs have seen a massive reduction in consumer demand, which has dried up their liquidity and decimated their cash flows.

Demand Side

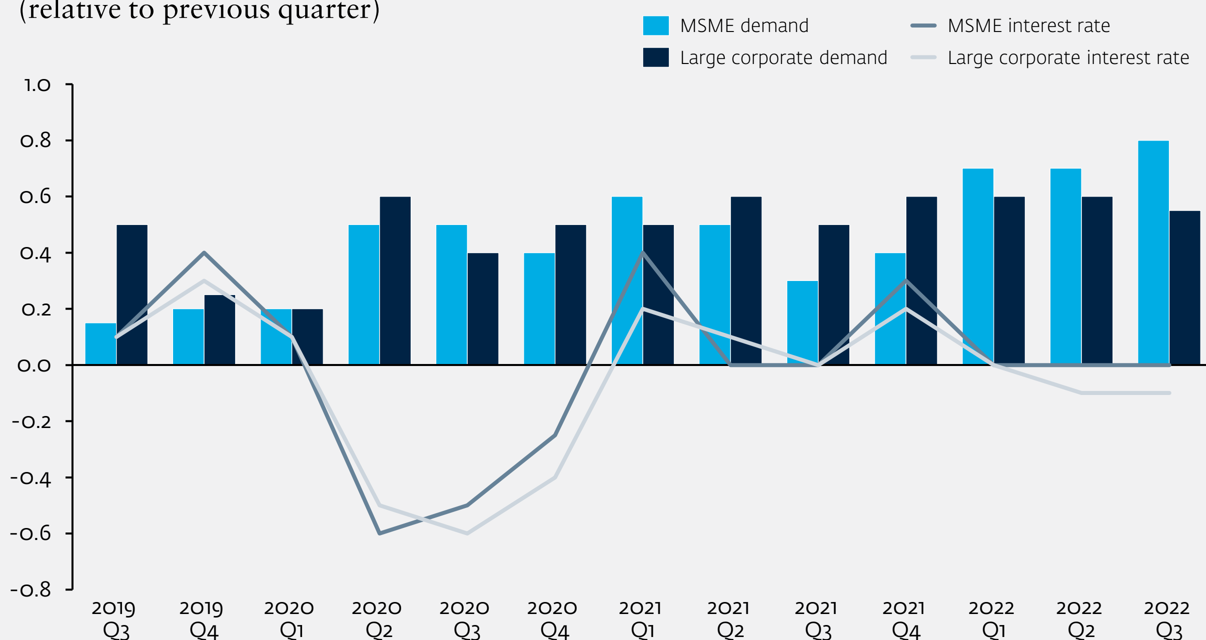
Zambia recorded its first official COVID-19 case in March 2020. The cumulative impact on MSMEs over the past two years of the crisis has been significant. The downturn in economic activity has been particularly felt in sectors dominated by MSMEs, with sharp manufacturing declines as global supply chains were disrupted. In the service and retail sectors, lockdown measures to stem the spread of the virus limited mobility, leading to a drastic downturn in private consumption and reducing customer demand and revenues for firms.

Two rounds of Enterprise Survey data, conducted in June 2020 and February 2021, capture the deleterious effects of the COVID-19 pandemic on firm operations and finances in the initial stages of the crisis. Across both waves, smaller firms saw greater decreases in demand, monthly sales, liquidity, and cash flow than their larger counterparts (World Bank 2022a). In addition, a significant number of firms, regardless of size, have been closed temporarily at some point of the crisis. However, smaller firms stayed closed for longer durations of times in contrast to medium- and large-sized firms. Extended business closures and crashing consumer demand have also wiped-out cash reserves and created a liquidity crisis.

To address an acute liquidity shortage and support business operations, firms turned to external sources of financing. Quarterly surveys of commercial bank loan officers conducted by the Central Bank of Zambia found elevated levels for demand for working capital for both MSMEs and large firms. The follow-up round of COVID-19 Enterprise Surveys finds firms of all sizes using loans from commercial banks as their primary source of funding in higher proportions, which is in contrast to the initial survey round (World Bank 2022a).

With a surge in demand for firm financing, commercial banks cut interest rates in the quarters immediately following global lockdowns. This was done to ease the financial distress that firms were facing in the early days of the pandemic. The interest rate cut in Q2 of 2020 was facilitated by the intervention of the Bank of Zambia (BoZ) to ease lending constraints by lowering the policy rate 225 basis points to 9.25 percent in May 2020, and by an additional 125 basis points in August of that year (World Bank 2022a).
The persistently high level of demand for working capital throughout 2020, 2021, and into 2022 reflects an increase in short-term credit demand from crisis-hit enterprises struggling to meet operating costs (figure 68).

Figure 68: Zambia: Evolution of Working Capital Demand and Interest Rates (relative to previous quarter)



Source: Bank of Zambia

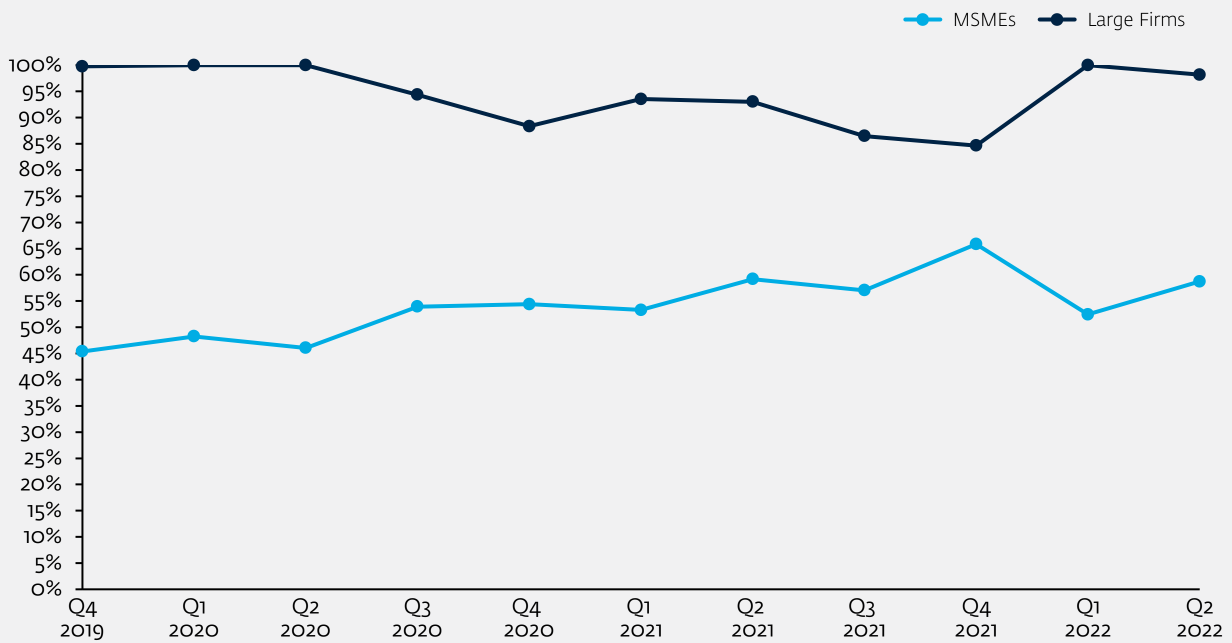
Regulatory Side

Beyond cutting the benchmark rate, the BoZ worked to support lending through a package of Kwacha10 billion (2.9 percent of GDP). Specifically, the BoZ provided: (i) medium- and short-term liquidity support to eligible financial service providers; (ii) ratcheted up its open-market operations to support commercial banks; and (iii) initiated a Kwacha 8 billion bond purchase program to provide liquidity to the financial sector. The BoZ also revised provisions to allow financial service providers to renegotiate the terms of credit facilities with borrowers affected by the downturn (IMF 2021d). Governmental and central bank intervention has propped up credit markets to a degree. However, this expansionary fiscal policy, in concurrence with declining economic activity, has widened fiscal deficits (African Development Bank 2021a). Increasing deficits and rising debt levels have brought more potential challenges to Zambian MSMEs, especially if the economy experiences a slow and prolonged recovery from the crisis.

Supply Side

Although demand for working capital remained elevated for firms of all sizes, loan approval rates for MSMEs and large firms were divergent. Whereas 3 percent of the surveyed large firms claimed their loan application was rejected, 26 percent of medium-sized and 31 percent of small firms experienced rejections (World Bank 2022a). However, BoZ data shows that the ratio between loan applications, a proxy for credit demand, and loan disbursements, a proxy for credit supply, converged somewhat over the course of the crisis between MSMEs and large firms by the end of 2021. Nonetheless, the gap has somewhat widened into 2022, and the ratio of application to disbursement remains about 40 percent higher for large firms than for MSMEs by Q2 of 2022 (figure 69) (Bank of Zambia 2022).

Figure 69: Zambia: Loan Disbursements to Loan Applications Ratio



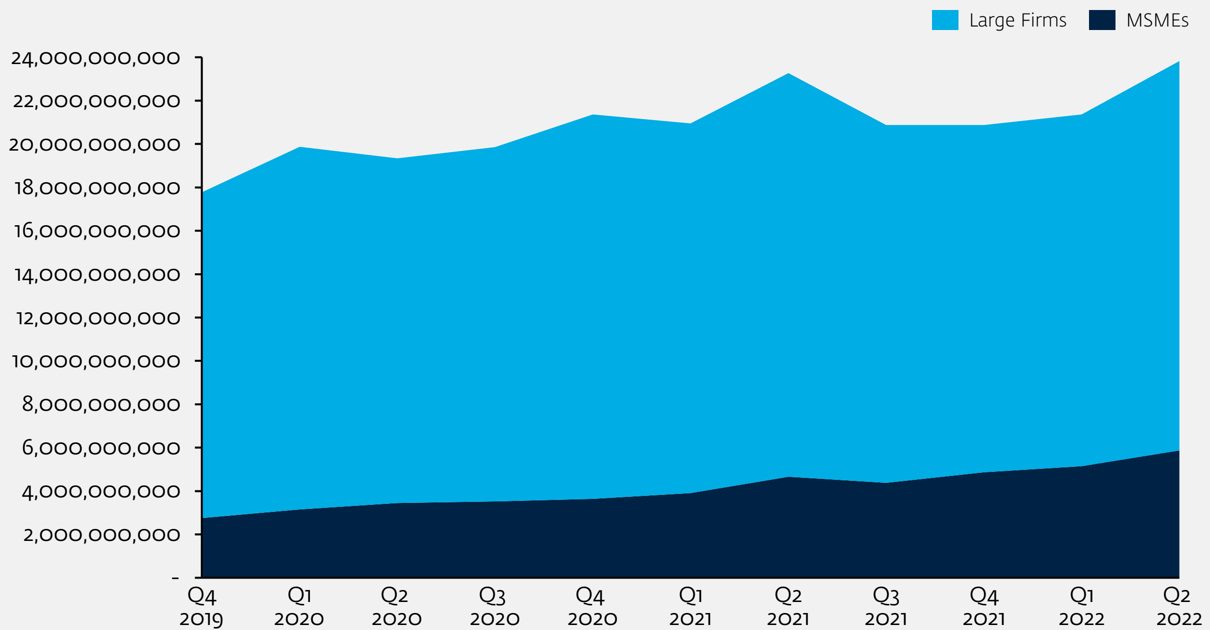
Source: Bank of Zambia

This slight convergence can possibly be attributed to the deterioration of bank asset quality. Banks identified the crisis, subsequent economic downturn, and rise in unemployment as the particular drivers of their increasing NPLs (Financial Sector Deepening Zambia 2021). Indeed, NPL rates for large corporates rose from 9.74 percent by the end of 2019 to 14.1 percent in Q3 of 2020. The MSME NPLs were already at precipitously high levels, specifically, at 20.6 percent pre-COVID, and then rising a couple percentage points to 22.7 percent in Q3 of 2020.

NPL rates have now dropped to or below pre-COVID levels for both large firms and MSMEs by Q2 of 2022 (Bank of Zambia 2021). Declining NPL rates may be attributable to BoZ interventions, such as the aforementioned relaxing of BoZ provisioning guidelines, as well as the issuance of the Targeted Medium-Term Refinancing Facility (Bank of Zambia 202). However, the pickup in credit supply facilitated by BoZ policy seems to still favor larger firms over MSMEs. Loan disbursements for MSMEs by Q2 of 2022 have grown by approximately 36 percent since the pre-COVID levels. However, disbursements to large firms have grown by over 62 percent since Q4 of 2019.

Regarding total disbursements in nominal terms, Zambia diverges from the trend of other emerging markets, including others explored in the COVID-19 pandemic cases. MSMEs have outpaced larger firms in their growth compared to pre-COVID levels. Not accounting for the real effective exchange rate, MSMEs have seen their loan portfolios double over the past 30 months following Q4 of2019 (figure 70). This is in contrast to larger firms, which experienced 20 percent growth. This can possibly be attributed to the loose credit conditions facilitated by the BoZ's interventions, which fostered an improved liquidity environment for both lenders and firms seeking capital.

Figure 70: Zambia: Total Outstanding Loans (in Kwacha)



Source: Bank of Zambia

Conclusion

Government intervention seems to have propped up certain lending segments throughout the initial stages of the pandemic; however, it has come at a cost. The Zambian economy experienced a deep recession in 2020, contracting by almost 5 percent (African Development Bank 2021c). In November 2020, Zambia became Africa's first pandemic-era sovereign default (Smith 2020). As noted, Zambia already suffered from exorbitant levels of debt predating the pandemic. With unprecedented levels of government support and a sharp contraction in GDP, the pandemic-induced downturn pushed Zambia's external debt to 170 percent of gross national income (World Bank 2022e). This high level of debt distress and pandemic-induced recession have also been attributed to the sharp depreciation of the Kwacha, as well as rising inflation levels.

Although the Bank of Zambia kept its benchmark rate constant throughout 2022, the Kwacha's slump has placed an upward pressure on inflation, prompting policymakers to consider tightening liquidity conditions in what is already a precarious macroeconomic situation. Zambia's economy looks to stabilize and improve in and beyond 2023. However, Zambia's fiscal and external imbalances worsened during the pandemic and recovery. This does not bode well for the MSMEs that were decimated by the crisis, and which had faced severe constraints to credit access even before the pandemic.

Annex 2: Summary *of* Other MSME Finance Gap Estimation Methodologies

Paper	Countries Covered	Data Used	Methodology	Findings
fi-compass (2019): Gap analysis for small- and medium-sized enterprises receiving financing from the European Union	EU countries	Eurostat 2017, ECB SAFE 2018 wave 19, 2019	They employ both quantitative and qualitative approaches. The quantitative data analysis involved using available data on SME financing produced by various sources to calculate financing gaps at the Member State level for (i) debt financing and (ii) equity financing. The qualitative analysis consists of reviewing the literature on European SMEs' access to finance and conducting interviews with experts from the EIB (European Investment Bank) Group on SME financing. The quantitative approach is to estimate the unmet demand of financially viable but unsuccessful SMEs, i.e., firms that should have access to finance but do not. The gap is calculated (for both financial instruments) as the product between the number of SMEs, the average loan size to SMEs, and the share of financially viable but unsuccessful SMEs.	Applying this approach to the 2018 data on European countries, the report highlights that the debt gap is 176.7 billion euros, which allows estimating that 4.3% of SMEs in the EU are considered viable but unable to access debt financing. Finally, the analyses show that equity financing gaps, which provide an indication of the maturity of equity markets in the EU, are higher than debt financing.
Lopez-de-Silanes and others (2019): Estimating the financing gap of small and medium-sized enterprises	France, Germany, the Netherlands, Poland, and Romania	This EIB study is based on data from country statistical offices and surveys (SAFE European Central Bank Survey)	The approach quantifies the financing gap as the difference between the demand for and supply of loans to SMEs and the available equity capital. The supply of loans or equity is the product between the percentage of outstanding SME loans or equity issued relative to total loans or equity and total outstanding loans or equity issued. The demand estimation is like the supply approach and is estimated as the product of the number of firms by size, the average size of loans or equity requested by firm size, and the percentage of firms needing loans/equity by firm size.	In addition to computing the finance gap of the selected European countries, the one of the United States has also been added for comparison purposes. In line with expectations, the results show that finance gaps in European countries are three to five times larger than those in the USA. These figures are considerable when one considers that the total estimated financing gap for SMEs in the USA is between 2.30% and 3.78% of GDP.

Paper	Countries Covered	Data Used	Methodology	Findings
Abraham and Schmukler (2017): Addressing the SME finance problem	Developed and developing countries	Stein and others (2011)		Larger financing gap in developing countries. In all developing regions, the financing gap for formal SMEs ranged from $900 billion to $1,100 billion in 2011, representing between 26% and 32% of total credit extended to formal SMEs.
Beck and Kessler (2023): The SME finance gap in the European Union. RSC Working Paper No. 2023/07.	EU countries	Orbis, Survey on the Access to Finance of Enterprises (SAFE), EIB Investment Survey (EIBIS)	The finance gap is defined as the difference between demand and supply of external finance for SMEs in different sectors	The results show that the real estate sector exhibits high finance gaps across countries and over time, which may be explained by Sweden's particularly high value in this sector in 2013. Another sector with high funding gaps between countries and over time is arts, entertainment and recreation. In manufacturing, Bulgaria is the country with the highest median finance gap over the years, although German manufacturing companies also show a surprisingly high finance gap, as in the Czech Republic, Estonia and Austria. Bulgarian companies generally show the highest finance across all sectors, followed by the other Central European countries. Finally, the authors find that the box plot shows that the dispersion of the financing gap has been relatively stable over the years, i.e. over the study period (2013-2020).
Koriakin and others (2021): SME finance in Moldova: estimation of financing gap and priorities for improving access. Policy Briefing No. 05 | 2021	Moldova	National Bureau of Statistics of the Republic of Moldova	The gap is defined as the difference between the demand and supply of financing.	The total finance gap is estimated at 1.3 billion euros, or 50% of SME demand. The debt financing gap represents the largest share, at 56%, compared with the equity financing gap (40%).

Paper	Countries Covered	Data Used	Methodology	Findings
Lin and others (2022): Development strategy and the MSME finance gap	Panel data from 115 countries	IFC (2018): MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets	The difference between a country's potential demand and its existing supply, divided by the amount of financing provided, or the total supply of financing.	The aim of the study is to analyze the profound causes of the large financing gap for MSMEs. Results based on 115 countries highlight that the adoption of a strategy of defiance towards comparative advantages accelerates the development of SOEs in capital-intensive industries, leading to a concentrated banking sector and oversized SOEs that obtain high proportions of loans and benefit from low interest rates on borrowings. Finally, using cross-sectional data in 2017, the paper shows that the adoption of a strategy of defiance of comparative advantage is associated with a large financing gap for MSMEs. The article thus concludes that the fundamental cause of the MSME financing gap is the government's inappropriate development strategy.
Yoshino and others (2018): The role of SMEs in Asia and their difficulties in accessing finance	Asian economies	Damu (2017); Vandenberg, Chantapacdepong, and Yoshino (2016); and the State Committee of the Republic of Uzbekistan on Statistics, Bank of Japan (BOJ) (2016), Yoshino and Taghizadeh-Hesary (2018), Japan Federation of Credit Guarantee Corporations (JFG) (2014), Credit Risk Database website, Yoshino and Taghizadeh-Hesary (2014),	Description of SME access to financing in Asia.	The paper outlines the state of access to finance in Asia. The authors point out that lack of information is the major problem in companies' access to credit, and that the development of infrastructures such as credit information for SMEs and the use of credit scoring techniques to solve the problem of information asymmetry, as well as the development of a sustainable credit guarantee system to solve the problem of SME collateral, can alleviate the problem.

Paper	Countries Covered	Data Used	Methodology	Findings
OECD (2022): Financing SMEs and Entrepreneurs 2022: An OECD Scoreboard	48 countries	Country websites and the OEDC Economic Outlook	Descriptive review of access to financing for SMEs in the 48 selected countries.	The report provides a picture on the evolution of indicators such as debt, equity, asset-based financing and framework conditions for SME and business financing, complemented by information on demand and recent developments in public and private initiatives to support SME financing for monitoring the needs of SME financing
Runde and others (2021): Supporting small and medium enterprises in sub-Saharan Africa through blended finance. Center for Strategic and International Studies.	African countries	World Bank's International Finance Corporation, the U.S. International Development Finance Corporation (DFC), Runde and others (2021)	Mapping the financing challenge of SMEs in Sub-Saharan Africa with descriptive statistics.	Fifty-one percent of SMEs need more financing than they currently receive. 28.3 percent of firms in the region are fully credit constrained.
Guo and others (2023): FinTech and financing constraints of enterprises: Evidence from China. Journal of International Financial Markets, Institutions and Money, 82, p.101713.	China	Shanghai and Shenzhen A-share listed companies from 2011 to 2018 data	KZ-Index (main measure of financial constraint) and WW index (alternative measure of financial constraints).	The aim of the study is to analyze the effect of FinTech on financial constraint. The results show that the development of FinTechs can significantly reduce corporate financial constraints, and that this effect is partially mediated by the facilitation of direct and indirect corporate financing, and by the promotion of interbank competition.

Annex 3: World Bank Enterprise Survey Coverage

Economy	Year	New to MSME Finance Gap Report[46]
Afghanistan	2014	
Albania	2019	
Angola	2010	
Argentina	2017	
Armenia	2020	
Azerbaijan	2019	
Bangladesh	2022	
Belarus	2018	
Belize	2010	
Benin	2016	
Bhutan	2015	
Bolivia	2017	
Bosnia and Herzegovina	2023	
Botswana	2023	
Brazil	2009	
Bulgaria	2023	
Burkina Faso	2009	
Burundi	2014	
Cabo Verde	2009	
Cambodia	2023	
Cameroon	2016	
Central African Republic	2023	
Chad	2023	
China	2012	
Colombia	2023	
Congo, Dem. Rep.	2013	
Congo, Rep.	2009	
Costa Rica	2023	
Cote d'Ivoire	2023	
Djibouti	2013	
Dominica	2010	
Dominican Republic	2016	
Ecuador	2017	

46 For those WBES's that are not new, they either comprise of the same surveys as used in the previous MSME Finance Gap report or have a newer survey for the same country.

Economy	Year	New to MSME Finance Gap Report[46]
Egypt, Arab Rep.	2020	
El Salvador	2023	Yes
Eritrea	2009	
Eswatini	2016	
Ethiopia	2015	
Fiji	2009	
Gabon	2009	Yes
Gambia, The	2023	
Georgia	2023	
Ghana	2023	
Grenada	2010	
Guatemala	2017	
Guinea	2016	
Guinea-Bissau	2006	
Honduras	2016	
India	2022	
Indonesia	2023	
Iraq	2022	
Jamaica	2010	
Jordan	2019	
Kazakhstan	2019	
Kenya	2018	
Kosovo	2019	
Kyrgyz Republic	2023	
Lao PDR	2018	
Lebanon	2019	
Lesotho	2023	
Liberia	2017	Yes
Madagascar	2022	
Malawi	2014	
Malaysia	2019	
Mali	2016	
Mauritania	2014	
Mauritius	2023	

Economy	Year	New to MSME Finance Gap Report[46]
Mexico	2023	
Micronesia, Fed. Sts.	2009	
Moldova	2019	
Mongolia	2019	
Montenegro	2023	
Morocco	2023	
Mozambique	2018	
Myanmar	2016	
Namibia	2014	
Nepal	2023	
Nicaragua	2016	
Niger	2017	
Nigeria	2014	
North Macedonia	2023	
Pakistan	2022	
Papua New Guinea	2015	
Paraguay	2023	
Peru	2023	
Philippines	2023	
Russian Federation	2019	
Rwanda	2023	
Samoa	2023	
Senegal	2014	
Serbia	2019	
Sierra Leone	2023	Yes
Solomon Islands	2015	
South Africa	2020	
South Sudan	2014	
Sri Lanka	2011	
St. Lucia	2010	
St. Vincent and the Grenadines	2010	
Sudan	2014	
Suriname	2018	
Tajikistan	2019	
Tanzania	2023	
Thailand	2016	
Timor-Leste	2021	
Togo	2023	

Economy	Year	New to MSME Finance Gap Report[46]
Tonga	2009	
Tunisia	2020	
Türkiye	2019	
Uganda	2013	
Ukraine	2019	
Uzbekistan	2019	
Vanuatu	2023	
Venezuela, R.B.	2010	
Viet Nam	2023	
West Bank and Gaza	2023	Yes
Yemen, Rep.	2013	
Zambia	2019	
Zimbabwe	2016	

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