

## Michael C Bonello: Financing the small business sector – constraints and opportunities

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the European Federation of Ethical and Alternative Banks and Financiers Seminar, St.Julian's, 15 April 2010.

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The holding of a seminar on credit for small businesses is both appropriate and timely given the important role played by these enterprises in modern, free-market economies and the contribution they are likely to make in the recovery phase as economies emerge from recession. It is perhaps not widely known that of the almost 20 million enterprises active within the European Union (EU) in 2005, 99.8% were small and medium-sized enterprises (SMEs), defined as businesses that employ fewer than 250 persons.<sup>1</sup> In turn, more than nine-tenths of these were micro enterprises, with a workforce of fewer than 10. In 2005 SMEs accounted for 58% of the value added generated in the EU and 67% of all employment, compared to 55% in the US.<sup>2</sup>

Small businesses are a major source of dynamism in the Maltese economy too. SMEs constitute the overwhelming majority of businesses, accounting for over 99% of the total and two-thirds of total employment. The vast majority are micro enterprises. These small operations act as customers of, and suppliers to, larger companies and are an essential source of entrepreneurship and innovation. It is thus no exaggeration to say that small IMF Update of World Economic Outlook, January 2010. businesses form the backbone of European economies, including Malta's.

A better understanding by policymakers of this sector and of the constraints it faces, which are often different from those encountered by larger firms, is therefore crucial for the purpose of further expanding the economy's growth potential. In the current environment characterised by a reduced availability of credit and tighter lending standards, the financing needs of small businesses deserve particular attention. In this regard it is important to recall that SMEs in general, and micro enterprises in particular, are more dependent on the banking sector than larger firms, which have the expertise and the resources to tap the capital market. This is very much the case in the euro area: between 2004 and 2008, banks accounted for roughly 70% of the total external financing requirements compared to just 20% in the US.

This critical role of bank credit partly explains the unprecedented liquidity-providing operations undertaken by the European Central Bank since August 2007 designed to sustain the flow of credit to the real economy during the crisis, and the repeated calls by the Governing Council for banks to reinforce their balance sheets so as to be better able to fulfil their responsibility in this regard.

### The economic environment in the near term

The world economy is finally emerging from the most severe recession in recent history. Global output declined by 0.8% in 2009, while trade volumes shrank by more than 12%.<sup>3</sup> Economic activity in both the euro area and the United Kingdom, Malta's largest trading

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<sup>1</sup> Eurostat *Statistics in Focus* 31/2008.

<sup>2</sup> Financial Times "*The cogs are clogged*", 16 February 2010.

<sup>3</sup> IMF *Update of World Economic Outlook*, January 2010.

partners, declined by 4.1% and 4.9%, respectively. This contraction had inevitable consequences for labour markets, with unemployment increasing to levels not seen in decades. The combination of lower tax revenues and higher outlays arising from the operation of automatic stabilizers and fiscal stimulus programmes took their toll on public finances, with deficits in a number of countries rising close to, or even exceeding, double digit levels. The growth rate of these economies over the coming years will be constrained by the inevitable fiscal consolidation required to bring deficit and debt ratios back to sustainable levels.

These recessionary headwinds inevitably took their toll on Malta's open economy. The impact, however, proved less severe than might have been expected. The economy came out of the recession in the fourth quarter of 2009, after contracting for three consecutive quarters. On a seasonally adjusted basis, the peak-to-trough drop in GDP was around 3.0%, compared to 4.7% in the euro area.

The relative resilience of the Maltese economy is attributable to four factors. First, membership of the euro area has enhanced its capacity to withstand external shocks. Second, the impact of the financial crisis was mitigated by the strength of the domestic banking system, underscored by the absence of toxic assets in bank balance sheets, prudent lending policies and a funding structure based primarily on retail deposits. The third factor was the strategy of temporary government assistance targeted to those non-financial corporations (NFCs) that were in difficulty, mostly in the manufacturing and tourism sectors, along with the implementation of some infrastructure projects. Besides limiting the number of potential job losses, this approach proved to be more appropriate in the domestic context than an across-the-board increase in spending whose impact would have been severely weakened through import leakages. The fourth factor was the continuing diversification of the economy towards high value-added services, which have proved less vulnerable to the downturn. Small businesses have featured prominently in this process. Indeed, most of the enterprises in the emerging sectors of the economy, such as those in pharmaceuticals, remote gaming, ICT and business and financial advisory services are SMEs.

Going forward, the prospects are for only slow growth in Malta's external demand. While IMF projections suggest that global activity and trade volumes will expand by around 4% and 6% this year, respectively, the recovery in the euro area promises to be less robust and more gradual than in other advanced economies, and is expected to be conditioned, *inter alia*, by the ongoing process of balance sheet adjustment in both the private and the public sectors. Economic activity is therefore expected to remain sluggish and uneven in 2010, with GDP expanding by less than 1.0% in both the euro area and the United Kingdom.<sup>4</sup>

Mirroring these expected trends abroad, the Central Bank of Malta's projections point to a modest GDP growth rate of around 1.0% in 2010. Net exports are likely to contribute negatively to growth, so that the main growth impulse is expected to come from domestic demand, driven by higher investment outlays on infrastructure projects and, to a lesser extent, by a moderate expansion in private consumption. Labour market conditions are unlikely to improve this year, with the unemployment rate remaining above 7%. This subdued growth outlook, together with the expectation that inflation will remain more elevated than in the euro area, will exert downward pressure on disposable income.

Overall, therefore, the economic environment facing small businesses in the foreseeable future, both domestically and in our main trading partners, will be less favourable than that which prevailed before the onset of the financial crisis in 2007.

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<sup>4</sup> European Commission Interim Forecasts, February 2010.

## Small businesses access to finance

Since SMEs and micro enterprises are typically more dependent on bank financing than larger firms, the ongoing deleveraging of bank balance sheets in many EU countries represents a potential threat. The prospect of a prolonged period of restricted access to both working and investment capital at a time of subdued demand could result in the closure of many enterprises.

In the euro area, credit growth has indeed slowed progressively during the past year. The latest figures, for February, suggest that loans to the private sector contracted by 0.4% from a year earlier. The annual growth rate of loans to all NFCs – large, medium and small – fell from a peak of almost 15% in April 2008 to –2.5% in February.

With regard to credit flows to SMEs, a recently published ECB survey, which however does not include the five smallest countries in the euro area, including Malta, shows that SMEs were generally less successful than large companies in obtaining bank loans in 2009, even if the majority received part or all of what they had applied for. In the second half of 2009, 75% of all SMEs reported successful approaches, slightly less than in the first half of the year. The main reasons given by the banks were the general economic and the firm-specific outlook, together with a reduced willingness to extend credit.

It would appear, therefore, that both demand and supply factors explain recent credit developments in the euro area. This conclusion is corroborated by the evidence from the Bank Lending Survey, which points to factors associated with the weak macroeconomic conditions, such as a lower demand for credit due to less fixed investment, combined with supply side factors such as the tightening of credit standards.

The restricted flow of credit in the euro area does not, however, appear to have been replicated in Malta, whose banking sector emerged from the financial turmoil with high capital and liquidity ratios. Domestic credit to the private sector continued to expand at steady, though slower, rates in 2009. The annual rate of increase in bank loans to the private sector declined from around 10% in 2008 to 8.3% last year, and the latest figures for February suggest that total credit is still expanding by over 6%. Lending to NFCs, meanwhile, is growing at an annual rate of 3.9%.

With regard to the recent experience of domestic small enterprises, our estimates suggest that bank lending to them expanded by around 6.6% per annum between 2005 and 2009. This impression of a sustained credit flow is confirmed by a joint survey carried out by the European Commission (EC) and the ECB during 2009.<sup>5</sup> The results for Malta are based on a sample of 100 enterprises, of which 94% were categorized as micro enterprises in the services sector with an average annual turnover of less than EUR 2 million in 2008.

One of the most significant results was that small enterprises in Malta did not consider access to finance a main concern. Only 8% of respondents cited it as their most pressing problem, compared to 16% in the EU. In addition, only 12% thought that the willingness of banks to provide a loan had deteriorated, while the number of those replying that banks were actually more willing to extend credit was among the highest in the EU.

At the same time, however, the demand for bank loans by domestic small enterprises last year was weak. Only 10% of respondents applied for bank loans compared to 22% in the EU. The indication of a subdued demand for loans is confirmed by information derived from the Bank Lending Survey and from other intelligence collected by the Central Bank of Malta.

One possible explanation could be the fact that small businesses in Malta rely on a mix of internal and external finance to a greater extent than their European counterparts. Another is

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<sup>5</sup> Flash Euro Barometer No. 271.

the reported postponement of investment plans in the light of the slowdown in both domestic and external demand.

Albeit to a lesser extent, supply side factors also seem to have been present. For example, according to the joint EC/ECB survey more than half of the small businesses in Malta considered the interest rate as the most limiting factor for obtaining a bank loan, a higher proportion than in any other country surveyed. And about one fifth reported that they had actually refused the loan offered because they considered the interest rate as too high. Again, this was by far a higher percentage than anywhere else in the EU, where on average only around 6% cited high costs as a reason for turning down a loan. In the same vein, the proportion of Maltese businesses replying that interest rates charged on loans had decreased was among the lowest.

These results support the information obtained from an analysis of bank interest rates. In general, while domestic banks have reduced interest rates charged on loans to households by more than the average in the euro area following the cumulative cut of 325 basis points in official rates by the ECB since 2008, the opposite is true for loans to NFCs. This suggests that domestic NFCs, most of which are small enterprises, are finding it more expensive to obtain or service a loan than their counterparts in the euro area. This apparent relative rigidity of domestic interest rates charged to NFCs merits further analysis as it could harm the recovery process, particularly if businesses continue to postpone their investment plans.

### **Other constraints faced by small enterprises in Malta**

The same survey also provides an insight into the broader range of concerns faced by domestic micro and small enterprises. These include the limited purchasing power of customers, obstacles faced in trying to expand market share and competitive pressures. In addition, a disproportionately high percentage of these businesses reported higher costs in 2009.

In this regard, the automatic adjustment of wages to inflation through the COLA mechanism, irrespective of the level of productivity, is one of the factors that has been contributing adversely to the cost structure of these enterprises, and consequently to their competitive position. Here I must reiterate that a currency union member country like Malta, whose only sustainable source of long-term growth are its exports, cannot afford to allow nominal wages to grow faster than productivity, which is what has happened during the past decade.

The competitive position of these enterprises is also constrained by their ability to introduce more efficient production processes. The proportion of enterprises that did not undertake some form of restructuring last year was one of the highest in Europe. This is probably one reason why Malta has lagged behind its European peers in pursuing the targets set by the Lisbon Innovation Scoreboard, in particular in the areas of entrepreneurship and human resources.<sup>6</sup>

Another frequently mentioned cost factor are administrative burdens. This is an endemic problem in Malta, confirmed by a recent survey in which a reduction in such burdens featured as the priority recommendation by executives of foreign-owned companies operating in Malta as a means of enhancing the attractiveness of the island to foreign investors.<sup>7</sup>

Finally, with regard to the constraint represented by the small size of the domestic market, Maltese entrepreneurs have no option other than to attempt to break into foreign markets. This is not an easy task. During the past decade, Malta has registered one of the slowest

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<sup>6</sup> European Innovation Scoreboard 2009. Link available at:  
<><http://www.proinno-europe.eu/sites/default/files/page/10/03/1981-DG%20ENTR-Report%20EIS.pdf>

<sup>7</sup> Ernst & Young's 2009 *Malta Attractiveness Survey*.

average annual export growth rates in volume terms in the EU. Survey information from micro and small enterprises reveals that the most frequently cited obstacles to exporting relate to taxation issues in foreign markets, inadequate market intelligence and insufficient capital.<sup>8</sup>

### **Recent initiatives and the way forward**

This suggests the need for a comprehensive strategy to help these small enterprises exploit the opportunities offered by the EU Single Market, building on the existing public and private initiatives. The Budget for 2010, for example, included measures aimed specifically at easing some of the constraints I have just referred to. Chief among these is a 40% tax credit scheme, which is directed at micro enterprises that invest in productive processes or create more jobs.

Meanwhile Malta Enterprise is playing an active role in assisting small businesses to tap EU regional funds. It has been recently reported that applications for grants from the European Regional Development Fund (ERDF), from which EUR 20 million for industry and EUR 10 million for investment in renewable energy are available, have led to the selection of almost 400 projects with a proposed outlay of EUR 25 million. An additional EUR 7 million, announced in the Budget for 2010, is also being made available. Maltese entrepreneurs have submitted more than 600 proposals for funding under the third call of the ERDF scheme, with the total value of assistance requested expected to exceed EUR 40 million.

At the same time, an agreement between the Government and the European Investment Fund will provide another EUR 10 million by the end of this year from a specialized EU fund aimed at small enterprises that would otherwise find it difficult to raise up to EUR 25,000 to improve their operations. These initiatives should also help to increase awareness about EU funding schemes.

Malta Enterprise is also involved in the management of the Kordin Business Incubation Centre. Between 2003 and 2008, this facility produced over 50 start-ups, with a success rate of 86%. Some of the most successful ventures have gone on to employ more than 100 workers. Within the next few months small enterprises will also benefit from more than 300 industrial spaces that will be made available in three locations, while other parks for micro enterprises in both Malta and Gozo are in the pipeline. Such initiatives facilitate networking among SMEs and can lead to the development of business clusters and consequent positive spillover effects.

Initiatives to assist small businesses have also been taken by the private sector. For instance, a major domestic bank has recently teamed up with a leading international software house in a programme designed to increase the success rate of ICT start-up companies. A number of banks have established dedicated funds or have tailored business packages that are specifically designed to meet the demands of small enterprises. In contrast, however, the concept of investing private money in small enterprises has yet to gain currency in Malta, and the commitment of government funds for the establishment of the first official venture capital fund has so far not been followed up by private investors.

### **Conclusion**

Small businesses have undoubtedly contributed to the resilience shown by the Maltese economy during the recession. Indeed, the majority of emerging niche industries in both the manufacturing and the services sector belong to this category. Going forward, they could also play an important role in sustaining the recovery. This calls for the creation of a more

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<sup>8</sup> Flash Euro Barometer No. 196 – Observatory of European SMEs.

congenial environment, which not only allows entrepreneurship to flourish but also focuses on the ingredients that will become increasingly important in the post-crisis economic environment. These include a greater emphasis on innovation, research and development and marketing, drawing on EU and public and private financial assistance schemes. Without such a proactive orientation, small businesses cannot hope to overcome the limitations inherent in a small domestic market.