Patrick Honohan: Does credit matter for the SME?

Opening address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Central Bank Conference on the SME Lending Market, Dublin, 2 March 2012.

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Access of SMEs to credit and other financial services is a perennial topic for policymakers, besieged – as they often are – by frustrated entrepreneurs who, whether wishing to expand or dodging closure, are unable to access the credit necessary to do so. The pat answer traditionally offered by market fundamentalists to the effect that, if creditworthy, the business would have secured financing from eager and shrewd financiers, wears thinner these days after we have seen the consequences of massive credit misallocation.

Indeed there are fundamental reasons why – even in the non-crisis environment – even well-run small and medium enterprises whose likelihood of creating loan losses are low nevertheless don' t get credit. Information is the key. A key societal function of banks and other financiers is the gathering and processing of the information necessary to make good loan decisions and to continue monitoring the performance of borrowers, intervening promptly where necessary to protect the sums advanced. But gathering and processing that information is not cheap or easy, especially when the economy is changing gears and the external environment is uncertain, as it is now.

Does credit matter for the SME? A large body of empirical evidence internationally says "yes", noting that access to finance can promote new firm entry, firm growth, innovation, the achievement of optimal firm size and risk reduction.

Furthermore, well-financed small firms contribute significantly to broader economic growth. Admittedly, the much vaunted capacity of small firms to create employment is also matched by an above-average incidence of job destruction: much of the churn in any economy happens in small firms. It' s not a question, though, of whether big or small is best for growth; both are key. But the effectiveness of a financial system in catering for firm needs is best evidenced by its capacity to serve small firms; big firms can find their needs catered for even in poorly developed financial systems.

It is, of course, possible to over-emphasize the importance of credit in the economy. Not only have we seen how too much credit can have devastating effects when it is proved to have financed wasteful or pointless projects. And, on the other hand, a number of countries have experienced (in recent decades) post-crisis recoveries that were virtually credit-less.

What about Ireland? As I have noted in the past, Ireland' s fast growth period in 1990s does not seem to have been finance-rich: before the property bubble Ireland' s growth performance had other drivers than the Irish financial sector both in good and in bad times. Partly this was a function of the degree to which many of Ireland' s leading firms, both in manufacturing and services, have been foreign-owned and brought their finance with them. But I would be cautious about assuming that Ireland does not therefore need much credit in the years ahead of recovery. The recovery will need to maintain and strengthen the resumed relative importance of the export sector, including new subsectors, and likely an increased share of Irish-owned firms, alongside the MNCs. Those trends may well call on locally provided credit to a greater extent than in the past.

It is against this background that we need to consider the recent trends in credit for SMEs, the topic of today' s conference in which a wide range of new statistics and analysis are being presented. The picture cannot be said to be favourable. Indeed, as you will hear, credit conditions for SMEs are tougher in Ireland than anywhere elsewhere in the euro area both in terms of cost and availability. To be sure, the banking system is emerging from a major credit collapse and the economy is operating at only about 85% of its previous level of productive activity: in such circumstances there have of course been a large number of small firms who cannot get credit because on any assessment they are not creditworthy. But the research reported in this Conference strongly suggests that credit constraints go beyond that.

Given how depleted personal wealth of many families who would have, in more normal times, been able to fund start-ups and small expansions with their own risk capital resources, the lack of bank credit is likely to be a more serious drag on the recovery than it might otherwise be.

What are the authorities doing about this? The answer is: a whole lot. Government has arranged to recapitalise the main banks with fiscal injections almost unmatched – as a percentage of national GDP – in World history. The Central Bank, supported by the Eurosystem, has provided open-ended liquidity to ensure that shortage of liquid assets cannot have been a constraint on lending. True, the EU-IMF agreement requires deleveraging by the banks, but the authorities are closely monitoring this deleveraging to try to ensure that, as intended and agreed with the Troika, it falls mainly on non-core business (mostly abroad) and run-offs. The intention is the deleveraging would not affect credit availability for the recovery at home.

Other measures (such as the work of the Credit Review Office – which has been effective in pinpointing some of the procedural and skill shortfalls in the banks' procedures for underwriting SME loans – and the proposed new partial credit guarantee scheme) could also be mentioned. In any market economy, though, we rely on banks and other financiers to make the underwriting decisions, and this is what needs to be right as the recovery expands.

Many SMEs also got caught up in the property bubble so that their balance sheets are weighed down with under-water property investments that threaten their viability and discourage outside financiers from sending good money after bad. Working out such problem lending relationships is challenging at the best of times. This reminds us that SME lending is not just a question of supply and demand, but has also had significant prudential and indeed financial stability dimensions.

All of these dimensions, I am happy to say, receive attention in what seems to me to be a very promising agenda for today' s timely conference.