



**ECONOMIC RESEARCH PAPERS**

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**Linkages between SMEs and Large  
Industries for Increased Markets and  
Trade: An African Perspective**

by

M. Nureldin Hussain  
Strategic Planning and Research Department

The views and interpretations in this paper are those of the author  
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## **ABSTRACT**

This paper considers modalities and mechanisms through which SMEs could forge horizontal links between themselves and vertical linkages with larger manufacturing and service industries for increased market access, enhanced investment flows, skills development and technological advancements. Such linkages would help overcome the constraints that currently plague industry in African countries. As the global economy becomes more integrated and economic reforms and liberalization take root in Africa, indigenous SMEs will have to network and build alliances to be able to survive and compete effectively. There is strong evidence that forming alliances, clustering and networking help small firms to compete, grow and cooperate with large firms. By working together, firms can gain the benefits of collective efficiency, enabling them to link with larger producers and break into national and global markets. The key to success seems to be a customer-oriented focus, a mutually supportive approach, and a cumulative effort to ensure continuous, rather than discrete improvements. While SMEs in Africa remain largely underdeveloped and isolated, SMEs in Mauritius illustrate the various forms of linkages that can be forged specially clustering in the Export Processing Zone (EPZ). Vertical integration in the textile industry in Mauritius also stands out as an interesting and successful example.

## RÉSUMÉ

Ce document examine les modalités et les mécanismes par lesquels les PME peuvent nouer des relations horizontales entre elles et verticales avec les grandes entreprises industrielles et de services pour élargir leur accès aux marchés, accroître les flux d'investissements, développer les compétences et réaliser des progrès technologiques. Ces relations permettraient de surmonter les obstacles actuels au développement industriel en Afrique. À mesure que l'économie mondiale s'intègre et que les réformes et la libéralisation économiques s'enracinent en Afrique, les PME locales devront se mettre en réseau et bâtir des alliances pour pouvoir survivre et soutenir efficacement la concurrence. Tout indique que c'est en formant des alliances, des groupements et des réseaux que les petites entreprises pourront être compétitives, croître et coopérer avec les grandes entreprises. En travaillant ensemble, elles pourront tirer parti de l'efficacité collective, et donc établir des liens avec les gros producteurs et percer sur les marchés national et mondial. La clé du succès semble être l'adoption d'une orientation centrée sur la clientèle, d'une approche axée sur l'assistance mutuelle et le déploiement d'efforts cumulatifs pour assurer des améliorations continues, plutôt qu'intermittentes. Si les PME en Afrique restent en grande partie sous-développées et isolées, celles de l'île Maurice illustrent les diverses formes de relations qu'elles peuvent nouer, en particulier le groupement dans la zone franche industrielle. L'intégration verticale de l'industrie textile à Maurice apparaît également comme un exemple intéressant et réussi.

# **Linkages between SMEs and Large Industries for Increased Markets and Trade for SMEs: An African Perspective**

By

**M. Nureldin Hussain\***

## **I. Introduction**

During the first half of this decade, most African countries have implemented far-reaching macroeconomic reforms in a bid to achieve higher levels of sustained economic growth. The last few years have witnessed a progressive reduction in budget deficits and inflation rates, the achievement of more realistic exchange rates and higher rates of GDP growth. These macroeconomic gains and the sustainability of the economic growth trajectory could be strengthened by actively promoting the development of small- and medium- scale enterprises, (SMEs), which have the potential to become a major force for growth, product diversification, employment creation and income generation. This paper considers modalities and mechanisms through which SMEs could forge horizontal links between themselves and vertical linkages with larger manufacturing and service industries for increased market access, enhanced investment flows, skills development and technological advancements. Such linkages would help overcome the constraints that currently plague industry in African countries.

The first section of the paper considers the definitional aspects of SMEs, which is important to an appreciation of enabling policy frameworks for SME development. This is followed by analysis of various modalities of enterprise linkages applicable to Africa, as well as the potential benefits that may accrue to SMEs, larger industries and overall economic activity. Typologies and examples of productive linkages in both manufacturing and financial industries are then discussed to demonstrate the applicability of the concepts to the African situation. The paper also addresses linkages in the banking industry. The inclusion of the financial industry is particularly important because the fortunes of SMEs are inextricably linked to the development of relevant and adequate financial services. There is also a need to forge productive linkages in this sector as the fragmentation of Africa's financial system have led to the emergence of a chasm between formal and informal financial institutions. The paper examines industry clustering and vertical integration in Mauritius as examples of successful linkages in African industries. The ensuing section identifies and examines the role of government in supporting these linkages through the provision of requisite institutional, regulatory and policy arrangements. The paper concludes by outlining the work of the African Development Bank in promoting a more vibrant private sector development.

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## 2. Profile of Small and Medium Enterprises in Africa

SMEs have been defined according to size, turnover, activity, ownership and legal status. There is, however, an emerging consensus that size (i.e., number of employees) may be the most appropriate defining characteristic, given the heterogeneity of enterprises operating in this sector. SMEs may, therefore, be defined as firms employing less than 100 employees while entities with less than ten employees are categorized as micro-enterprises (MEs). Although this sector is largely unenumerated, available estimates suggest that SMEs account for roughly 60 percent of the workforce and 25 percent of industrial output in value terms in Africa.

Compared to larger firms, they tend to use less capital per worker and have the capacity to use capital productively. For example, it has been found that in countries such as Colombia, Ghana, and Malaysia small firms have significantly higher value-added to fixed assets ratios. Their choice of techniques is thus consistent with factor availability in African countries, which are labor-abundant economies.

SMEs also play an important role in entrepreneurial development. SMEs employ workers with limited formal training, and use local raw materials that would otherwise be neglected. They also mobilize the small savings of proprietors which tend to exist outside the formal banking system. Studies have shown that owners of SMEs have a surprisingly high propensity to save and invest, even at quite low income levels. In addition, SMEs have important linkages with large firms through subcontracting arrangement and provision of spare parts.

Many African economies are characterized by the prevalence of a large number of informal MEs which utilize lower levels of investment and skills, and handle relatively simple products. The informal micro-enterprise sector revolves around secondary activities such as food processing, cosmetics, building, footwear and garments, and tertiary activities such as transport and mechanics repair, retail, food preparation and distribution. In terms of work-force, small enterprises may employ as many as ten employees or working family members. In urban areas, they range from street vendors to small manufacturing entities. In rural areas, small enterprises engage in the production and sale of farm products, handicrafts and services. The sector is characterized by ease of entry, reliance on indigenous resources, family ownership of enterprises, small-scale operation, labor-intensive and adapted technology, skills acquired outside the formal school system, and unregulated and competitive markets. In most cases, enterprises are created from personal savings or financed through informal savings schemes. Bank finance plays a very minor role in their operation. Not all MEs, though, fall in the informal sector. An OECD study indicates that the majority of micro-enterprises comply to some extent with registration and licensing regulations. Nevertheless, informal or not, MEs remain a highly “invisible” sector, poorly documented by statistical agencies and hence not adequately account for in policy-making.

The activities of the majority of MEs in the informal sector are trade-related, while only a small percentage belong to the services and manufacturing sectors. There are two forms of trade in the informal sector: domestic and international trade. Petty trading activity is the most typical form of domestic informal trade found in both urban and rural markets. The bulk of informal international trade consists of the flow of unrecorded and unregulated goods and services among African countries. While much of the activities are not well documented, it is generally believed that informal cross-border trade is substantially higher than the often quoted five per cent of official trade flows among African countries.

Women’s participation in informal MEs, particularly trading, is widespread and varied. They engage in such areas as food and beverages, textiles, retail trade, pottery, basket weaving, cross-border trade, etc. Women are highly involved in the area of trade, averaging as much as 90 per cent of MEs involved in trade in countries like Congo, the Gambia and Zambia. The informal sector also plays a considerable role in output, employment and income generation in both urban and rural areas.

The micro-enterprise sector is not only important because it create jobs; it can also be an instrument of “participatory development” since it enables a wider section of the population, particularly the poor, to participate in the process and benefits of development. In addition, MEs not only help to integrate marginalized elements of society— making better use of human energy and initiative— but they can also act as a breeding ground for entrepreneurs.

There is much evidence that MEs can be transformed into modern small and medium-scale enterprises. An IFC study on African entrepreneurs reported that several APDF-assisted entrepreneurs began their businesses on an informal basis. For example, an egg producer in Ghana started with less than US\$200, three chicken pens and 900 day-old chicks. The study indicates that the business grew to employ over 300 workers and has a turnover of US\$1.5 million. A garment maker in Botswana began with US\$100 personal savings, a rented shed and sewing machines, and two apprentices but now operates a business that employs 65 workers. A Malawian left school at 18 to work as a self-employed tobacco grader, and became owner and managing director of four companies engaged in tobacco growing and curing, commodity processing and exporting, property investment and importation of machinery with a turnover exceeding US\$1 million. A family-owned conglomerate in Ghana, which manufactures clothing, spirits, furniture, text books and other educational materials, and imports vehicles and equipment, grew from only a small dry-cleaning shop.

The progression from MEs to SME, and from SME to large companies is heavily dependent upon the strength of the linkages forged during this dynamic process. These linkages compensate for the shortcomings and constraints facing SME operators in an ever-growing, competitive and globalized economic arena.

### **3. Constraints on SMEs Development and the Need For Linkages**

SME development in many African countries has been hindered by many economy-wide and sector— specific problems including:

- ❑ Excessive state involvement in the economy which prevented indigenous entrepreneurs from gains managerial experience in dynamic medium and large-scale enterprises.
- ❑ Monopolies and subsidies given to public enterprises, and rules and regulations which stifled entrepreneurship.
- ❑ SMEs have been starved of capital and other inputs with credit directed to larger enterprises, even when practical experience has shown that it is possible to lend profitably and effectively to MEs.
- ❑ SMEs have scant access to foreign funds and foreign direct investment, reducing their ability to upgrade their technology and managerial know-how.

These problems have now been compounded by the process of increasing liberalization and globalization which is putting African large industries as well as SMEs under increasing pressure. Large industries and SMEs are required to compete with the industrially advanced countries at a time when markets are more competitive, volatile, and fluid than ever before. A more open trading environment requires SMEs to compete with imports and increase their exports of industrial goods; but foreign producers are becoming more competitive and export markets are ever-more demanding in terms of quality, delivery and product features. How can African SMEs overcome these challenges?

On their own, large as well as small firms will find it extremely hard to overcome these challenges. Whereas in the past it was conceivable for a single firm to meet all the input and technology requirements for its output, the degree of sophistication and expertise required to produce goods at internationally acceptable standards have made it necessary for firms to cooperate in their operations. As successful experiences have shown, for industries to succeed in the current economic environment, forming horizontal and vertical linkages is important. The factors that prompt industries to form networks and alliances to compete effectively in the current and rapidly changing global environment include:

***The Emergence of New Exporting Opportunities.*** Existing and new markets are opening up as countries liberalize their trade under the auspices of the World Trade Organization (WTO) and business becomes more globalized. While offering better exporting opportunities, these developments also pose considerable challenges. In order to access these markets or defend themselves against foreign competition in their own markets, it is imperative that African large industries and SMEs adopt a global outlook and form strategic partnerships, both domestically and in foreign markets. For example, they could form strategic alliances with strong foreign distributors as a way of accessing new markets, while at the same time improving the quality of their products.

***Non-price Competition is Becoming Increasingly Important.*** The process of liberalization and globalization has made non-price competition increasingly important. These encompass all those factors, other than price, that affect market performance. African SMEs have traditionally tended to focus attention on production, sometimes at the expense of quality. SMEs will have to pay more attention to non-price elements such as packaging, quality, international standardization and timely delivery of products. Successful SMEs are going to be the ones that respond rapidly to changing customer needs. Strategic partnerships through industry linkages provide flexibility to allow SMEs meet such requirements.

***The Emergence of Knowledge-Based Production Structures.*** Developments in information technology, transport, agriculture, manufacturing and finance are likely to erode further the competitiveness of African SMEs even in areas where Africa traditionally held a comparative advantage. If African firms are to respond effectively to changing customer needs and take advantage of changing production incentives, it will be imperative that they improve their technological capabilities. To keep up with these changes, African SMEs will have to form strategic alliances with the providers of technology, giving them access to state-of-the art production techniques. African SMEs could also forge joint ventures with foreign firms. Forming joint ventures has a number of advantages to local firms. Involvement with a foreign company not only gives the domestic firm access to its partner's technology, but through learning-by-doing it may be able to adapt that technology to local conditions. Foreign firms can also supply technically skilled and managerial personnel.

#### **4. Production Linkages for Increasing Marketing and Trade**

In more general terms, a distinction can be made between three main modalities of linkages in industry, namely: *alliances*, *clustering* and *networking*. This distinction is not exhaustive and should not imply that the existence of one type of linkages will preclude other types. In practice they can coexist and interrelate across industries, production sectors and countries. As will be shown in the case of Mauritius, for instance, the textile industry is experiencing both clustering and vertical integration through networking or alliances with foreign firms.

## Alliances

An alliance is formed by firms coming together in some contractual arrangement. The well known types of contractual arrangements include the following:

- ❑ **Subcontracting**: involves buying supplies from another firm and working closely on detailed specifications for a complex product.
- ❑ **Licensing**: includes permission to manufacture a product under license, to distribute a product and to include product in another design.
- ❑ **Joint-venture**: involves the creation of a third firm to manufacture or market a product which had been developed by the entrepreneurial firm. Equity was usually shared by the partners.
- ❑ **Strategic alliance**: which is essentially a joint-venture without the creation of a third firm and no equity is involved
- ❑ **Consortium**: which is usually a group of firms joining together in a buying group to purchase components or equipment which they mutually share.

Alliances between large companies and SMEs usually take the form of vertical linkages where inter-firm relationships are forged along the lines of the production and marketing chain within a specific industry. It essentially represents the contractual relationships between a parent firm and its ancillaries. The parent firm depends on its specialized ancillaries for the timely delivery of high quality components and services, while the ancillaries owe their livelihood to regular sub-contracting from the parent firm. In order to ensure the quality of the goods and services it receives, it is sometimes necessary for the parent firm to extend financial, operational and managerial assistance to the ancillaries. For their part, the ancillary firms strive to achieve quality-assurance and maintain a technological edge in order to remain within the sub-contracting chain. It is not uncommon for contractors to become fully independent, specialist entities in this process. This form of networking is most prevalent in manufacturing concerns requiring a wide range of processed, and standardized, inputs.

This symbiotic relationship between the parent and ancillary firms is eventually efficiency enhancing which makes them instrumental in increasing marketing and trade in a number of ways:

- ❑ Avoiding uncertainty in the timing and quality of inputs (both goods and services).
- ❑ Allowing for expeditious adaptation to technological advances.
- ❑ Removing the burden of rigorous post-delivery quality checks of all inputs.
- ❑ Ensuring greater flexibility to respond to change and stimulate innovation through interaction.
- ❑ Enhancing division of labor and specialization in marketing with the parent company catering for the requirements of price and non-price competition in international markets, while the ancillaries concentrate on meeting the quality and price requirements of the parent company.

Hence, linkages of this sort involve risk and cost sharing and considerations for market access and power. They also imply mutuality, in the sense that beneficial contributions emanate from both partners.

## Clustering

A cluster is a group of firms concentrated in one geographic location and working in the same sector. Firms may or may not be actively collaborating. Clusters of firms may or may not involve formal partnerships between spatially proximate firms. They are thought to facilitate access to externalities/public goods such as water, electricity, and the right kind of labor force. Clusters can be defined as industrial districts which are locally coordinated and articulated economic systems, normally specializing in limited lines of products and supported by local government authorities through policy dialogues and support structures. Thus, firms in such clusters benefit from both the division of labor and the externalities of spatial agglomeration. A cluster can enhance production, marketing and trade through:

- ❑ ***Allowing more efficient division of labor.*** Having a cluster of enterprises within close proximity facilitates the production process, especially in cases where the firms are producing the same goods, by allowing for a strategy of labor division.
- ❑ ***Facilitating the provision of infrastructure.*** Industrialization requires large investments in infrastructure and other production-servicing facilities that a developing country may not be able to provide country-wide. The available meager resources can be devoted to the provision of these facilities within a small confined cluster area.
- ❑ ***Facilitating more effective application of export incentives.*** The provision of country-wide export incentives, such as exemption or rebate systems, requires a high level of technical and administrative capacity. There is also the risk of abuse of these systems, with duty-free inputs not being used for export production and with exemptions and rebates provided to unqualified firms. A cluster area can help to avoid these costs and risks, since the use of duty-free imports and the provision of other incentives are more easily monitored in a confined area.
- ❑ ***Enhancing the integration of SMEs with large industries.*** A possible end result of clustering is that firms producing the same goods and clustered together may be able to integrate with larger enterprises, for example, in a consortium or an alliance.
- ❑ ***Promoting Production Efficiency.*** Clustering can also improve technological and managerial know-how through emulation, tacit knowledge transfer and lower transaction costs as trust builds up and/or through the ease of transaction that comes from 'geographical proximity'.

## Networking

A network is a collection of firms working in cooperation, though not necessarily in the same place. It described arms-length interactions between firms, such as international production or distribution networks. It includes interaction across a supply chain without the necessity of having either formal links or equity participation. The main characteristic of a network is that it does not require geographical proximity to be efficient: it can link firms whose activities are distributed around the world. Networks of small firms and international production as well as cooperation organized through subcontracting and/ or foreign direct investment by multinational corporations are included in this category.

One peculiar form of networking is what is called horizontal networking. Firms producing similar product lines benefit the most from horizontal networking. A small group of firms cooperate in the production of a final product by specializing in specific steps of the production process. A distinguishing characteristics in these arrangements is that unlike vertical linkages no firm performs a dominant role. The division of labor is determined by each entities comparative advantage in the production process

(comparative advantage is determined by asset endowment—be it equipment, skill or resource). In this complex set of arrangements, the assembly and marketing of the final product is handled by a separate entity. Examples of cross-sectoral networking may be found in family businesses or dominant finance houses. The shoe industry, where different entities produce the various parts and a separate company buys, assembles and markets the products provides a good illustration of horizontal networking. Networking can enhance marketing and trade through the following channels:

- ❑ **Enables firms to share risks and costs and access markets.** It improves price competitiveness through reductions of production and transaction costs, as well as enhancing market penetration and market power.
- ❑ **Increases knowledge about markets, suppliers, customers and competitors.** Networking links small, medium and large enterprises by an exchange of information (for example of a technological or marketing nature), commercial relationships (between suppliers and customers) and competition relationships in order to develop a responsive organization or production system.

However, the various forms of industry linkages have also risks and hidden costs. These include dependency on partners, disclosure of competitiveness ‘secrets’ reduce management control, and reduce individual company flexibility. While increasing size may be an indication of a network’s growing success, growth in size often comes at some costs. It increases difficulties of coordinating operations as more partners have to be consulted. An expanded bureaucracy can cause a loss of efficiency and slow down decision-making. In clustering, the same way the multiplier works forward it also works backward. For instance negative impulses (such as a drastic change in consumers’ taste) will have multiple negative effects which will tend to reduce the demand for all clustered industries. Hidden agendas of the members and competition instead of cooperation can also incur risks and costs. For instance some joint-ventures between firms that have hidden agenda may turn to be learning races in which each partner tries to accumulate more knowledge about how the other conduct business in the shortest period of time. Alliances that contain more competitiveness than cooperation would not be successful. A partner may enter the alliance under the pretext of creating a commercial technology, when in reality the alliance was formed to fund self-serving research interests.

However, most of these drawbacks emanate from mistakes in selecting partners and creating alliances and in management competence with regard to market research and forecasts. Informed and careful selection of partners and setting-up proper management systems would make it possible to reduce these risks dramatically, while maximizing the benefits of linkages.

## 5. Successful Industry Linkages in Africa: The Case of Mauritius

While industries in Mauritius have various forms of linkages, clustering in the Export Processing Zone (EPZ) and vertical integration in the textile industry stand out as interesting and successful examples. Mauritius established the EPZ to attain the following objectives:

- ❑ to promote processing and manufacturing, aiming to advance certain manufacturers into a renowned market niche;
- ❑ to encourage and host foreign investment;
- ❑ to act as a window through which the country can acquire technological knowledge and managerial know-how;
- ❑ to be the vehicle which pulls the economy to higher employment and growth rates.

As expected in the case of clustering, the geographical proximity of industries in the EPZ facilitated more effective provision of infrastructure services and application of export incentives. These included:

- ❑ Input-related incentives comprising subsidies on public utilities; tariff and tax exemptions and rebates for exporters and their suppliers of imported inputs; allowances on wastage; the provision of special depreciation rules on physical capital; and access to cheap credit.
- ❑ Output-related incentives comprising special tax exemptions; direct export subsidies; preferential export credit; and the provision of government export-servicing facilities in external marketing.
- ❑ Externality-related incentives include such policies such as the provision of technical training and export quality interventions.

For instance, the incentives offered to encourage foreign companies to set up their production facilities in the EPZ include a tax holiday of 10 to 20 years with dividends being exempt from taxation for 5 years, and duty-free imports of raw materials and capital goods. Rental rates for plants and equipment in the EPZ are low and electricity and water services are offered in the EPZ at cost.

Clustering in the EPZ has enhanced the linkages of industries, particularly in textiles. It has also led to the promotion of production efficiency through improved technological and managerial know-how. The textile industry within the EPZ is also linked to a vertical networking between Floreal Knitwear, the leading Mauritian firm, and the global textile multinational, Woolmark plc. Floreal Knitwear, the world's second largest manufacturer of Woolmark sweaters, has progressed from producing sweaters from imported colored woolen yarn, to utilizing colored yarn produced within the EPZ. Clearly, the benefits of vertical networking between Floreal Knitwear and Woolmark has led to product specialization, and the genesis of horizontal integration of the textile industry in Mauritius. The benefits of clustering and vertical integration have been evidenced in the large productivity gains and the remarkable growth in the production of manufactured goods. This resulted in a marked shift in the composition of the country's export basket towards manufactured goods that command higher international demand.

Against a background of prudent macroeconomic and industrial policies, the EPZ has managed to attain most of its objectives. The main achievements can be grouped into:

- ❑ **Export Diversification.** Over the period 1988/89 - 1996/97 manufacturing output grew annually by about 9 percent. The EPZ which is the core sector within manufacturing accounted for over 60 percent of total exports. The textile industry constitutes roughly 80 percent of EPZ output. The share of manufacturing in the country's total exports has increased from about 2 per cent in 1970 to over 63 per cent in 1996.
- ❑ **Fast and Steady Growth.** With EPZ as an the main engine of growth, the economy of Mauritius grew at an average annual growth rate of 8.5 per cent between 1984 and 1989 and by 5.5 percent during the period 1990-1996 - a record comparable to that of the Asian tigers before the latest financial crisis.
- ❑ **Employment generation.** The EPZ is now the largest employer in Mauritius accounting for over 30 per cent of employment and the labor market is in virtual full-employment.

The EPZ has also proved to be responding positively to challenges emanating from the domestic and international competitive environments. On the external front, competition in the international market for textiles and garments, in which the bulk of EPZ activities in Mauritius is concentrated, has increased.

On the domestic front, the country is experiencing severe constraints in the labor market. The attainment of virtual full-employment has intensified competition for particularly skilled workers and, consequently, labor costs in general have soared. These forces have inevitably led to a restructuring among smaller firms that are no longer able to compete in the labor market; and some were too weak to survive the competition.

The EPZ responded to these challenges by engineering a shift from labor-intensive, low technology to a relatively more capital-intensive, high technology production base. The package of policy initiatives is being refined and fine-tuned to upgrade the EPZ. The centerpiece of the evolving industrial development strategy is three-pronged: greater specialization in the textile industry, with emphasis on technological innovation; diversification into new industries; and the development of export services. Thus, the development of new industries (including printing, publishing, jewellery, watches and clocks, sporting goods, etc.) should complement existing industries, thereby creating “advantages of conglomeration”. Measures have been introduced to allow for backward and forward linkages between EPZ activities and the rest of the economy.

Governments in some other African countries have also taken conscious decisions to promote export-oriented SMEs through the creation of export processing zones (EPZs) which provide industry linkages through clustering. EPZs established in Egypt, Kenya, Nigeria and South Africa have attracted significant investment. As in the case of Mauritius, these zones provide the requisite administrative, legislative, regulatory and infrastructural support for the establishment and operation of thriving SMEs. The resultant concentration of commercial enterprises in these industrial hubs facilitate and promote productive inter-firm linkages.

## **6. Linkages in the Banking Industry**

To a large extent, the efficiency of SME linkages is directly related to developments in the financial sector. Unfortunately, the fragmentation of most financial systems in Africa has resulted in a significant disintermediation that has stifled investment flows. Over time, a wide chasm has emerged between the providers of financial services and the private sector. This gap is being bridged, to some extent, by the emergence of micro-finance institutions (MFI), which are providing the much-needed linkage between formal financial institutions (the commercial banks) and less formal business entities (MEs and SMEs). The relationship between the MFIs, banks and SMEs may be described as a form of vertical enterprise networking. Furthermore, the benefits of this relationship generate clustering among informal finance operators, as they discover the importance of scale economies in their financial transactions with the MFIs.

The modalities of MFI operations facilitate risk pooling, information sharing and collective responsibility; this makes their portfolios more stable and deposits more secure. Quite apart from functioning as intermediaries between the SMEs and formal banking institutions, MFIs also play a catalytic role for individuals, communities and institutions involved in the provision of informal finance. By pooling risk and credit demand, the MFIs are in a position to channel credit from formal institutions to SMEs at reasonable cost, while mobilising deposits from the informal sector at minimal unit cost. The opportunities for pooling create a more conducive environment for enterprise networking among SMEs.

### ***Forging Links in Deposit Mobilization***

The emergence of MFIs has enhanced the capacity to mobilise financial assets from hitherto unserved sections of the population. Deposit mobilisation is crucial to the sustainability of financial intermediation as it supplies re-cyclable resources, which, in effect, reduce dependence on more costly finance from outside the community. Additionally, the accumulation of such deposits could provide significant leverage opportunities for the MFIs. Regulatory authorities in African countries should, therefore, endeavour to introduce policies and procedures that favour the establishment and development of MFIs. Relevant legislations, supportive institutions and supervisory arrangements must also be introduced to provide the requisite institutional framework

While direct contact between banks and informal deposit mobilizers is very useful, the use of semi-formal institutions (such as savings and loan companies, well-functioning finance houses, and credit unions) also hold considerable potential. It is often suggested that when markets are fragmented, it is best to develop new institutions that will integrate markets before attempting to regulate them. In an efficiently operating market-based economy, the development of such institutions is likely to take place if the demand for additional financial services exists. The supportive role of Governments in this regard is crucial.

### ***Forging Links in Credit Allocation***

One way to link up banks and informal lenders for purposes of credit allocation is to develop an agency relationship in which loanable funds are channelled through MFIs for on-lending to small borrowers (be they SMEs, informal retail lenders or individuals). The operations of informal operators in various parts of the continent provide valuable insights into the means by which such arrangements might be pursued effectively, cost-efficiently and sustainably. The importance of vertical linkages and horizontal clustering cannot be overemphasised.

While the principle of channelling credit through informal sources is accepted, caution must be exercised in the choice of informal agents that might act as conduits for such lending. It is important to rely on well-established agents that operate from within recognizable bodies—such as associations, cooperatives, companies, unions, etc. These have greater credibility than individuals do. In a number of countries, individual moneylenders who maintain long-standing relationships with banks could be useful for this purpose. The policy of channelling formal credit to informal lenders may be defended on the grounds of efficiency and increased financial integration, especially among small farmers. Informal lenders can build a personal relationship with borrowers that can ensure an extremely low loan default rate. Encouragement of more subcontracting in the real sector would also generate more parallel financial linkages. For example, if leasing companies could pass on tax benefits to banks in order to obtain better credit terms, they could in turn pass on more finance to their clients.

## **7. Government Policies Supporting SMEs and Industry Linkages**

Creating an enabling environment is crucial for the successful development of SMEs and promoting efficiency-enhancing linkages between industries. SMEs have flourished in environments where governments have allowed the markets to operate freely and firms have been allowed to compete with each other. Many of the most impressive linkages between industries — e.g. in Italy, Brazil, Pakistan — have emerged largely spontaneously. But other successful experiences — e.g. in Mauritius, Korea,

Taiwan — suggest that governments can assist a great deal in the process. Hence, the introduction of market reforms does not necessarily rule out the role of government. Government policies to support SMEs development and industry linkages fall into the following main groups:

- ❑ **Finance and credit.** There is a need to extend financial services specifically tailored to the needs of SMEs. Although informal arrangements have served as sources of finance, they have proved insufficient in meeting the needs of MEs and SMEs. For example, because of the size of the sector and the environment in which they operate, informal arrangements do not provide long-term finance. Thus, there is greater urgency to find innovative ways of providing micro-finance to meet the financial requirements of MEs and SMEs. Efforts should concentrate on upgrading informal financial arrangements, strengthening their links with formal institutions, and improving the legal framework. Informal financial arrangements such as savings clubs and credit associations can be upgraded into cooperative banks. Linkages between formal and informal institutions can be promoted by providing fiscal incentives, such as tax relief on the profits of formal financial institutions with informal linkages. There is also a need to improve the legal environment through better definition and enforcement of property rights of MEs and SMEs.
- ❑ **Supporting technical services.** In addition to financial services SMEs require a variety of other services such as contract services, general advice, information, and basic managerial and vocational training for their development. They also need assistance in areas such as management and skill development, technology transfer, counselling, marketing, and collecting and assessing market information. While many SMEs-supporting services could be commercialized, the government has a prominent role to play in the provision of business support programmes. These services are needed during the stage of starting-up as well as during later phases of expansions and linkages with other industries.
- ❑ **Initiatives to promote subcontracting.** Government would need to adopt the policies and legislations that promote subcontracting between domestic as well as foreign industries. Subcontracting is an increasingly important factor in promoting linkages and improving the competitiveness of businesses. Intensive competition in the international market is inducing more and more large companies to contract out some activities in an effort to reduce the size of their operations and concentrate on their core business. This process offers considerable opportunities for specialised subcontractors and could help to stimulate growth and employment of SMEs.

## 8. The Role of the African Development Bank

The strategy of the African Development Bank for supporting the private sector has evolved over time in line with the greater attention being accorded to private enterprise and markets in regional member countries. Since the 1970s, the Bank has provided mainly indirect support to the African private sector in four major areas. First, the Bank has provided lines of credit and resources to national development banks and, in some cases, commercial banks for on-lending to small- and medium- scale enterprises. Second, through policy-based lending, the Bank Group has encouraged its regional member countries to adopt favourable macroeconomic policies that create enabling environments for private sector operations. This includes support for institutional reforms, the strengthening of fiscal discipline, measures to liberalize economies, and the reduction of excessive public sector involvement in economic activities. Third, by financing public sector infrastructure projects, the Bank has looked beyond the immediate impact of the projects to the long-term effect of providing basic services required for private sector development. Fourth, the Bank has provided institutional support for private sector development.

The Bank, co-sponsored with UNDP, IFC and other donor, the creation of the African Project Development Facility (APDF) and the African Management Services Company (AMSCO). APDF's main objective is to provide project advisory assistance to African entrepreneurs in establishing small to medium sized businesses. This assistance includes the preparation of feasibility studies and the identification of markets. AMSCO provides management services to African companies with the potential for long term economic viability but without experienced management. In line with its continuing efforts to promote the African private sector, the Bank sponsored the establishment of the African Business Roundtable (ABR), an autonomous body comprising some of Africa's leading businessmen. The objectives of the ABR are to strengthen the African private sector, promote intra-African trade and investment, and attract foreign investments to Africa. ABR's investment promotion activities within and outside Africa have resulted in a number of joint ventures. The Bank also spearheaded the establishment of African Export-Import Bank (AFREXIMBANK). Inaugurated in 1993, the AFREXIMBANK provides short-term financing, including syndication, in support of intra and extra African trade; finances imports linked to export development; provides pre- and post- export credit guarantees and insurance facilities; issues and confirms letters of credit and other documentary credit; and promotes non-traditional African exports. AFREXIMBANK has lead-managed meaningful syndications involving intra and extra African trade, and has provided trade facilities to entities in member countries. It has also entered into trade financing cooperation agreements with other banks.

In 1990, the Bank established a private sector window to provide equity and credit directly to private enterprise as a catalyst for attracting private sector financing partners. Loans, with maturities of 5-12 years, were the principal instrument of assistance to the private sector. By the end of 1997, commitments from the private sector window amounted to US\$126 million, for 33 projects, with a total investment cost of about US\$566 million. Though the operations of the window have been modest, systematic measures are being taken to enhance engagements in this important area. In 1996, the Bank adopted a new private sector strategy, which aims to enhance the scope and strengthen the effectiveness of our private sector operations. Under the strategy, the Bank intends to leverage its financing by catalysing and mobilizing private domestic and foreign capital. Towards this end, the scope of activities include: support to countries to develop enabling environments for private sector development; expanding existing financial instruments to cover co-financing, guarantees, quasi-equity and underwriting; support for privatization programs through the provision of advisory services and technical assistance; and, support for medium- and small-scale enterprises through lines of credit to commercial banks and financial institutions. To reach out to micro-entrepreneurs, the Bank has introduced a micro-finance facility under which assistance will be provided to micro-finance institutions using NGOs as intermediaries to reach micro-entrepreneurs, especially women.

## **9. Conclusions**

As the global economy becomes more integrated and economic reforms and liberalization take root in Africa, indigenous SMEs will have to network and build alliances to be able to survive and compete effectively. There is strong evidence that forming alliances, clustering and networking help small firms to compete, grow and cooperate with large firms. By working together, firms can gain the benefits of collective efficiency, enabling them to link with larger producers and break into national and global markets. The key to success seems to be a customer-oriented focus, a mutually supportive approach, and a cumulative effort to ensure continuous, rather than discrete improvements.

In most African countries, a central problem in the financing of private sector undertakings is related to filling the 'credit gap' facing SMEs. One option to fill this gap is to forge links between formal and informal financial sectors in deposit mobilization and credit allocation; and promoting government policies that enhance such linkages as well as measures to reduce lender risk in micro-finance. Banks should be encouraged to enter into closer relationships with such informal agents as savings collectors and savings and credit associations, as well as with non-governmental organizations. They have the potential of becoming effective mechanisms to mobilize deposits from and deliver credit to the household and micro business sectors. These agents can bolster small savings at relatively low cost and could retail more credit to the informal sector if backed up by access to bank credit.

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