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## INSTITUTE OF DEVELOPING ECONOMIES

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IDE DISCUSSION PAPER No. 148

### **Financing Small and Medium Enterprises in Myanmar**

Aung Kyaw\*

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#### **Abstract**

Small and medium enterprises (SMEs) share the biggest part in Myanmar economy in terms of number, contribution to employment, output, and investment. Myanmar economic growth is thus totally dependent on the development of SMEs in the private sector. Today, the role of SMEs has become more vital in strengthening national competitive advantage and the speedy economic integration into the ASEAN region. However, studies show that SMEs have to deal with a number of constraints that hinder their development potential, such as the shortage in power supply, unavailability of long-term credit from external sources and many others. Among them, the financing problem of SMEs is one of the biggest constraints. Such is deeply rooted in demand and supply issues, macroeconomic fundamentals, and

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lending infrastructure of the country. The government's policy towards SMEs could also lead to insufficient support for the SMEs. Thus, focusing on SMEs and private sector development as a viable strategy for industrialization and economic development of the country is a fundamental requirement for SME development. This paper recommends policies for stabilizing macro economic fundamentals, improving lending infrastructures of the country and improving demand- and supply-side conditions from the SMEs financing perspective in order to provide a more accessible financing for SMEs and to contribute in the overall development of SMEs in Myanmar thereby to sharpen national competitive advantage in the age of speedy economic integration.

**Keywords:** small and medium enterprise (SME), financing, competitiveness

**JEL classification:** G20, G30, L60, M10

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## I . INTRODUCTION

The availability of financing for small and medium enterprises (SMEs) has become a subject of academic interest in recent years. This issue is a major element in SME development strategy in developing and developed countries.

Although the term “small and medium enterprise” has various definitions, such definitions are basically based on the size of the economy and the level of economic development of the country. Representing the biggest share in business establishments in practically all countries, SMEs play an important role in a country’s economy and make substantial contribution to employment and outputs regardless of the level of economic development of a country<sup>1</sup>. They play a key role in the industrialization of a developing country. They have unique characteristics on their own—they are naturally more labor intensive, easy to start up, focus on small markets, require lower investment, and promote customer intimacy. In SMEs, separation of ownership and management is nonexistent and there is better response to market needs, so SMEs are extremely flexible and can readily adapt to today’s rapidly changing environment.

During the Asian financial crisis in 1997, though both small and large enterprises reeled from the effects of the financial crisis, small companies enjoyed higher survival rate and took on the responsibility to revitalize and develop the country’s economy after the crisis. The governments of Asian countries, having acknowledged the important role that SMEs play in their economy, have initiated various policies to foster SME development by reducing the various problems that SMEs have to contend with, including those on marketing, human resources, management, technology, infrastructure and regulations, and financing<sup>2</sup>. Recognizing SMEs as the new engine of economic growth and development, various ASEAN governments have formulated in recent years national agenda addressing all aspects to promote their SME sector.

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<sup>1</sup> Small businesses with less than 100 workers in the United States represent one-third of domestic employment and sales value (Velasco and Cruz 2001, p.19). SMEs represent 99.8 percent of all European enterprises (European Small Business Alliance-The independent voice for small business, 2006). SMEs in the EU (those with fewer than 250 workers) account for about one-half of the total value added and two-thirds of labor force (European Union 2002, p.118). SMEs contributed between 40 percent and 50 percent of manufacturing output in Chinese Taipei, Japan, and the Republic of Korea in the 1990s (UNCTAD 1998, p. 17-19). SMEs in ASEAN contribute up to 90 percent of business establishments and 70 percent to 90 percent of the domestic workforce (Thitapha Wattanapruttipaisan 2003 p.2).

<sup>2</sup> Chaipat Poonpatpibul and Watsaya Limthammahisorn, *Financial access of SMEs in Thailand: What are the roles of the Central Bank?* 2005

In this age of economic integration and trade liberalization and deregulation, both opportunities and threats for local SMEs have gone more intense. Liberalization, accompanied with improved communications and transportation facilities throughout the globe, brings vast opportunities as well as fierce competition. Many SMEs in Southeast Asia and Asia countries including Japan are already feeling the intense pressure from competing with China over a wide array of manufactured goods<sup>3</sup>. This has created a challenge for local SMEs to upgrade the quality of their products and services and boost their level of competitiveness up to international level in order to survive in the new paradigm. Making SMEs more competitive has also become one of the most important considerations in policy-making efforts of governments.

Despite various efforts, however, SME growth in ASEAN countries is hindered by a number of problems that come from external sources as well as from internal inefficiencies. SMEs face problems from all fronts of their operations, and this prevents them from developing their full potential.

There may be a long list of problems or challenges for SMEs in ASEAN countries: poor infrastructure, higher cost of materials and inputs, outdated technology, insufficient R&D, stiff competition, limited knowledge, poor management skills of owners or managers, and inadequate financing support. Access to formal sector financing tops the list.

SMEs in ASEAN countries heavily rely on internal funds and funds from informal sector for startup and development. But the legal and regulatory frameworks of many ASEAN countries are inadequate to provide the right infrastructure to facilitate SME lending from the formal sector. The lending infrastructures, including protection for creditors, enforcement of contract and collateral rights, rules dissolving commercial disputes and arbitration, and commercial laws, are not comprehensive. This is compounded by strict prudential regulations by monetary authorities, inflexibility and unfriendly lending rules of commercial banks, and unduly complex administrative procedures.

Lack of consistent definition, laws, and special programs to finance SMEs are some of the impediment to SME financing<sup>4</sup>. Indeed, the SME financing problem arises from both supply- and demand-side factors. Information asymmetry, which has been created by limited knowledge of finance and accounting, poor track record, and

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<sup>3</sup> Thitapha Wattanapruttipaisan, *Four proposals for improved financing of SME development in ASEAN*, Asian Development Review, Vol.20, No.2, December 2003

<sup>4</sup> RAM Consultancy services Sdn Bhd, *SME access to financing: Addressing the supply side of SME financing*, REPSF project No. 04/003, July 2005

inadequate skill to prepare comprehensive and viable business plans are demand-side problems coming from SMEs. These can be regarded as demand-side problems. Unfriendly and time-consuming procedures to process loan applications that are strictly controlled by monetary authorities and failure to adopt flexible and modern credit assessment methods and techniques come from the supply side. Other systemic and institutional issues, such as macroeconomic management and well-defined lending infrastructures, also affect the ability to finance SMEs in these countries.

Having recognized the problems and constraints in financing SMEs, ASEAN countries, especially Malaysia, Thailand, and Vietnam have implemented various policy measures to enhance credit availability for their SMEs. They attempt to reform their present system of financing in all aspects. Singapore is significantly leading all other nations in the region in financing SMEs.

The previously mentioned problems and constraints are more or less common in all ASEAN countries. However, CLMV lag behind their counterparts in all aspects of lending infrastructures and institutional frameworks that pose significant barriers for effective financing. Financing frameworks are extremely in short supply in CLMV economies. As a result, SMEs face inadequacy of funding sources even though their contribution to national economies is very impressive.

Almost every research on SMEs indicates financing as one of the top problems this sector is facing. Such financing problem retards SMEs competitiveness and further development.

SMEs in Myanmar are not exempted from this situation. Myanmar has its own special financing problems, such as tight collateral requirement (only real estate), limitation of loan amount based on appraised value of collateral property (up to 40 percent), unavailability of long-term loans from the banks, and lack of international funding agencies that provide financial assistance to SMEs. If Myanmar wants to set up a nationwide SME development program to sharpen the competitiveness of its indigenous SMEs and consequently narrow the development gap between Myanmar and leading countries within the ASEAN family, it has to address this serious financing issue first.

This research is conducted with the following objectives: (1) to discuss the role of SMEs in industrialization and economic development; (2) to present various problems and constraints that SMEs in Myanmar have to contend with; (3) to address the financing SMEs problems and their related causes; and (4) to propose ways to cope with these problems by offering suggestions that are relevant to Myanmar context.



## II. IMPORTANCE OF SMES IN ECONOMIC DEVELOPMENT

In any nation, SMEs play very important role in its economic activities. They represent over 90 percent of enterprises and account for 50 percent to 60 percent of employment in the world. In least-developed countries (LDCs), their role is considered even more important, since they offer the only realistic prospects to increase employment and value added.<sup>5</sup> Many LDCs provide employment opportunities for the majority of population who live under the poverty line, so SMEs contribute not only economic but also social benefits by reducing crime rate and alleviating poverty.

Industrial development was earlier believed to have occurred because of large enterprises. However, starting in the late 1970s and early 1980s, SMEs have become perceived as the key agent for industrialization. SMEs, which usually operate in the formal sector of the economy, are a very heterogeneous group of businesses usually operating in the agribusiness, service, trading and manufacturing sectors. They may include a wide variety of companies from traditional, small, and family-owned enterprises to dynamic, innovative and growth-oriented enterprises<sup>6</sup>. If they are given proper opportunity, they have a great potential to become large businesses. Most large business corporations in today's world economy, such as Microsoft, Vodafone, HP, internet search engine Google, and online bookstore Amazon.com, started as small businesses from the exciting ideas of young entrepreneurs.

When the large but inefficient state-owned enterprises failed, small and more efficient private entities started to emerge as shown in the cases of East Europe countries. A rapidly growing number of SMEs offered solution to the unemployment problem in these transitional economies.

The growth of SMEs is synonymous with the growth of private sector, since SMEs represent larger number of businesses in the private sector. The development of entrepreneurship spirit is highly associated with the development of SMEs, as these are formed and run by entrepreneurs. Due to their private-ownership nature, entrepreneurial spirit, and the ability to adapt to the ever-changing environment, they contribute to sustainable growth and employment generation in a significant manner.

The strategic importance of SMEs is acknowledged around the world for the

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<sup>5</sup> N. Suzuki, *SME development (Excerpt from the UNIDO paper for GOIC conference)*, May 2001

<sup>6</sup> Edit Lukacs, *The economic role of SMEs in world economy, especially in Europe*, Institute of Business Sciences, University of Miskolc, Hungary

following reasons<sup>7</sup>:

- SMEs contribute to employment growth at a higher rate than larger firms (around 50 percent to 70 percent in developing countries, 72 percent in Japan, and 66 percent in EU);
- The private sector, particularly SMEs, form the backbone of a market economy and, in the long-term, may provide most of the employment in the transition economies;
- Support for SMEs will help restructure large enterprises by streamlining manufacturing complexes. Units with no direct relation to the primary activity are sold off separately as in the cases of privatization of state economic enterprises (SEEs) in East European countries;
- SMEs curb the monopoly of the large enterprises and offer services complementary that those offered by big businesses, and absorb fluctuations in a modern economy;
- Through inter-company cooperation, SMEs raise the level of skills with their flexible and innovative nature. Thus, SMEs can generate important benefits in terms of creating a skilled industrial base and industries, and developing a well-prepared services sector capable of contributing to GDP through higher value-added services;
- Small industrial enterprises produce predominantly for the domestic market, generally relying on national resources;
- The structural shift from the former large state-owned enterprises to small and private SMEs will increase the number of owners, a group that represents greater responsibility and commitment than in the former centrally planned economies;
- An increased number of SMEs will bring more flexibility to society and the economy and might facilitate technological innovation, as well as provide significant opportunities for the development of new ideas and skills; and,
- SMEs use and develop predominantly domestic technologies and skills.

Moreover, by utilizing slack labor, SMEs in rural areas contribute significantly to rural development in the form of poverty alleviation. They can easily recruit poor laborers in rural areas during lean season. Rural SMEs promote a closer working relationship between employer and employees and provide social benefits to poor families.

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<sup>7</sup> Antal Azabo, *The role of governments in the promoting small and medium sized enterprises countries in transition*, 1996

Putting emphasis to the promotion of SMEs in the rural areas is a move that helps to reduce income gap between urban and rural areas. Also, the competitiveness of local SMEs is one of the push factors for foreign investors to invest in a particular country. The potential to be reliable suppliers is credited by foreign investors who want to outsource their noncore activities to local suppliers.

Nabil Y. Barakat (2001) <sup>8</sup>cited the role of SMEs in the economy of a nation as follows:

*All over the world, there is ample evidence that SMEs play an important role in the national economic development of any country. The achievement of Taiwan is a good example of the role that SMEs play in a nation's economy with limited resources. Over the last decade, Taiwan has established itself as a world-class supplier for a wide range of electronic hardware products. SMEs in Taiwan have been at the heart of this impressive success. In 1993, SMEs accounted for 96 percent of the total number of companies, 69 percent of total employment and 55 percent of Taiwan's manufacturing exports. Most of Taiwan's current 400 electronic companies started as small businesses. They also provide the majority of entrepreneurship in any economy.*

Ayyagari and Beck (2003), who reviewed the contribution made by SMEs to economies in 76 countries, observed a relationship between the contribution that SMEs give to GDP and national income. They revealed that 51 percent of GDP was produced by SMEs in high-income countries, 39 percent in medium-income countries, and only 16 percent in low-income countries. Beck, et al. (2005) also explored the strong correlation between the presence of SMEs and growth in GDP per capita. Derek Newberry (2006) showed a positive relationship between a country's overall level of income and the number of SMEs per 1,000 individuals. He presented that low-income countries are associated with the low number of SMEs per 1,000 individuals and that the rise in the income level of a country is proportional to the increase in the number of SMEs per 1,000 individuals. UNIDO also observed that the presence of SMEs was correlated with lower-income distribution inequality.

SMEs are also necessary for the structural change of a country, from agriculture-dependent economy to an industrial and service-oriented economy<sup>9</sup>.

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<sup>8</sup> *Jordan Times*, The role of small and medium enterprises in the economy, October 4, 2001

<sup>9</sup> In a 2002 survey of developing member countries, APEC found that nearly 99 percent of SME employees were working in the manufacturing and services sectors, up from 55 percent in 1990

### III. BACKGROUND OF SMES IN MYANMAR

It is difficult to trace the background of the development of SMEs in Myanmar because of the scarcity of literatures on such development. Throughout their history, Myanmar SMEs did not have a chance to develop their full potential relatively except during the period when Myanmar gained independence (from 1948 to 1962). However, traditional/local enterprises involved in handicrafts, textile manufacturing, weaving, jewel polishing, and lacquerware, as well as goldsmiths and blacksmiths, have long existed in Myanmar villages since the period of the Myanmar Kingdoms. They were deeply rooted in the Inwa (Ava) Dynasty, about the 14th century<sup>10</sup>.

Blacksmiths who made military arms (like shields and swords) and farming tools for agriculture are believed to be the precursors of private businesses in Myanmar. Due to the subsistence level of economy at that time, their scope of operation was very limited even in local scale.

During the pre-colonial period, the country's indigenous industries were confined to cotton spinning and weaving, salt exploitation, pottery, brick making, cart making, boat making, carpentry, iron smelting, blacksmithing, and the like<sup>11</sup>. When the country was fully colonized by the British, the British government brought foreign capital and technology into Myanmar. Consumer goods manufacturing and food processing (sugar, oil, textile, flour, coffee, soft drinks, rubber, and match) were introduced<sup>12</sup>. Mostly foreigners, such as British, Indian, and Chinese, owned and managed businesses and the indigenous inhabitants were employed as laborers.

Throughout the colonial period, the British did not favor the establishment of industries for manufacturing consumer goods. Under the laissez-fair policy, domestic industries did not get any protection from the government<sup>13</sup>. Consequently, domestic industries were concentrated in agriculture, and resource-based industries, like rice mills and sewing mills, where the country has comparative advantage. Traditional local enterprises such as handicrafts, textiles, and goldsmith businesses started to expand and became commercially oriented during the colonial period. Some local entrepreneurs

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<sup>10</sup> Extracted from presentation made by Sein Thaug Oo, seminar on "Current situation and future prospects of SMEs in Myanmar, August 6, 2005

<sup>11</sup> Ministry of Industry 1, Burma's Industrial History: Vol. I: Industrial History during the Rule of Burmese Kings (Rangoon: 1988), pp. 11-46

<sup>12</sup> Chit So, *Industrial development and reforms in Myanmar*, Paper in A report of a symposium by The Sasakawa Southeast Asia Cooperation Fund, 1999 p.125

<sup>13</sup> I bid p. 127

like U Nar Aungth (a Mon ethnic who competed with Irrawaddy Flotilla Company, a giant company that monopolized inland water transport business) came into the scene although the economy was largely dominated by foreigners at that time. In 1940, there were 1,027 factories, of which 998 were private enterprises composed of rice mills (67 percent), sawmills (11 percent), cotton gins and presses (5 percent), and vegetable oil mills (3 percent). Locally owned rice mills and sawmills comprised 46.5 percent and 31 percent, respectively, of the total of said industries.<sup>14</sup>

The colonial government did very little to promote indigenous industries. The exception was the establishment of the Cottage Industries Department in 1923, which was mainly concerned with assisting in and overseeing the development of small-scale industries in weaving, pottery, and lacquerware<sup>15</sup>.

When Myanmar gained independence in 1948, the Anti-Fascist People's Freedom League (AFPFL) government welcomed private sectors, including foreign investments for the remaining sectors. Private industries flourished from 1948 to 1962. Even as the government set up state-owned industries under the long-term industrial plan, private industries were allowed to run in parallel with the factories operated by public entities<sup>16</sup>. From 1959 to 1960, there were 2,468 factories, made up of 1,294 foodstuff factories, 529 clothing and apparel factories, and consumer goods factories. Of these, 87.44 percent were owned by nationals, 4.54 percent were fully foreign-owned, and 8.02 percent were joint ventures with foreign and local involvement operating as small- and medium-scale industries<sup>17</sup>.

Most large-scale industries were run by the state. Consequently, small and medium-size industries in the private sector had achieved considerable progress by the early 1960s. The government provided incentives in the form of industrial loans and supply of raw materials to attract investments in the private sector. The private sector mainly operated food, garment, and consumer goods (noodle, vermicelli, biscuits, ice, weaving, blankets, towels, nylon, plastic, soap, slippers, and cosmetics) businesses<sup>18</sup>. As the factories in the private sector annually increased, by the 1960s, the government had

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<sup>14</sup> Tin Maung Maung Than, *State Dominance in Myanmar: The Political Economy of Industrialization*, 2007 p. 12

<sup>15</sup> I bid p.13

<sup>16</sup> Chit So, *Industrial development and reforms in Myanmar*, Paper in A report of a symposium by The Sasakawa Southeast Asia Cooperation Fund, 1999, p. 128

<sup>17</sup> Burma's Industrial History, Vol. III: pp. 164-65

<sup>18</sup> Chit So, *Industrial development and reforms in Myanmar*, Paper in A report of a symposium by The Sasakawa Southeast Asia Cooperation Fund 1999 p.129

to limit the issuance of licenses to construct new factories, because the state-owned factories were already at the losing end.<sup>19</sup>The ownership pattern for 1961-1962 reveals that nearly 91 percent of the registered establishments were owned by Myanmar nationals (up from 86 percent in 1953-1954), while those under joint ownership increased 4.5 percent to 5.5 percent, thereby reinforcing the indigenization trend set after independence<sup>20</sup>.

The boom in private businesses came to an end when the military took over in 1962. The Revolutionary Council declared the adoption of the socialist economic system and nationalized all sizable private businesses. According to socialist economic system, all means of production and distributions were undertaken by the state and cooperatives. However, small private businesses, most of them employing less than 10 workers, were retained. They were operating under various constraints posed by the socialist economic system while providing basic consumer goods that could not be effectively fulfilled by state-owned enterprises. Nonetheless, the number of establishments was far greater than the combined number of state-owned enterprises and cooperatives. In 1970, the total number of registered industrial establishments reached 15,453, made up of 1,048 state-owned enterprises, 159 cooperatives, and 14,246 private enterprises. However, the private sector's production remained stagnant, keeping the 1961-1962 level. The state's control and restrictions dampened the spirit of the private processing industries, which was compounded by the shortage in spare parts and machinery. This resulted in a vicious cycle of technical obsolescence, decline in quantity and quality of products, low return of investment, and little or no investment activities<sup>21</sup>.

Due to the deteriorating economic condition of the country under the socialist economic system, an institutional restructuring with limited reforms were made during the mid-1970s. Since then, the role of private enterprises was implicitly recognized by the state. To enhance economic development through private sector investment and employment, the Right of Private Enterprises Law was promulgated in September 1977, which recognizes the legal status of private enterprises and allows them to perform specified economic activities. However, private investments throughout the socialist period were confined to small-scale activities, concentrating on processing natural resources. The role of SMEs in the private sector was subordinated to state-owned

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<sup>19</sup> Burma's Industrial History, Vol. III: pp. 350-53

<sup>20</sup> Tin Maung Maung Than, *State Dominance in Myanmar*, The Political Economy of Industrialization 2007 p.90

<sup>21</sup> I bid p. 127

enterprises and the cooperatives.

After taking over national power in 1988, the State Law and Order Restoration Council (SLORC) <sup>22</sup>officially declared the adoption of market-oriented economic system. In line with the market economy, the government encouraged private-sector participation in the economy and permitted foreign investment in the country. The Private Industrial Enterprises Law of 1990 and the Promotion of Cottage Industrial Law of 1991 were promulgated in order to boost private business enterprises.

The Myanmar Citizen Investment Law was enacted in March 1994 to promote indigenous businesses. In an effort to establish the national industrial sector through the three pillars systems—the state sector, the local private sector, and foreign investment—the national entrepreneurs were regarded as the new economic forces<sup>23</sup>. Industrial zones have been established since 1991, in accordance with the state policies of industrialization. Also, the private sector was encouraged to set up import-substitution industries. As a result, the number of private business establishments was drastically increased.

In order to encourage coordination among businesses in the private sector, the Union of Myanmar Chamber of Commerce and Industry was formed in January 1989. It was restructured and upgraded as the Union of Myanmar Federation of Chambers of Commerce and Industry (UMFCCI) in 1999. The UMFCCI become a focal point of private business interests and by 2007, its memberships reached a total of 16,363, consisting of 10,854 Myanmar companies, 1,656 enterprises, 770 foreign companies, 185 cooperatives, and 2,898 individual members.<sup>24</sup> The institutional members included 16 state/division chambers of commerce and industries, nine border trade associations, and 19 other associations<sup>25</sup>.

Today, SMEs represent the majority portion of businesses in the private sector of Myanmar. They dominate most of the country's economic activities. They account for 90 percent of the industrial sector and 99 percent of the manufacturing sector<sup>26</sup>.

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<sup>22</sup> It was renamed and reestablished as the State Peace and Development Council (SPDC) on 15 November 1997)

<sup>23</sup> Theimm Htut, *To exert all-out efforts for industrial development*, NLM, Sunday Supplement, 5 September, 1999

<sup>24</sup> [http://en.wikipedia.org/wiki/Union\\_of\\_Myanmar\\_Fedreation\\_of\\_Commerce\\_and\\_Industry](http://en.wikipedia.org/wiki/Union_of_Myanmar_Fedreation_of_Commerce_and_Industry)

<sup>25</sup> Tin Maung Maung Than, *State Dominance in Myanmar*, The Political Economy of Industrialization, 2007 p. 390

<sup>26</sup> Said by U Zaw Min Win, vice president of the Myanmar Industries Association, The Myanmar Times news, April 25-May 1, 2005

Notwithstanding their sheer number, SMEs in Myanmar face a number of difficulties, as in the case of SMEs in other developing countries. Lack of capital, expertise, and the right connection discourage would-be entrepreneurs from the private sector. Poor infrastructure and unfavorable business environment seriously hinder the growth of SMEs in Myanmar. Power shortages, rising fuel prices, escalating rentals and property prices, high cost of inputs, as well as the increasing expenses brought about by inflation severely limit their growth potential. They are being squeezed by the rising costs of doing business and competitive pressure brought by products imported from neighboring countries mainly via border trade.



#### **IV. ROLE OF SMES IN MYANMAR'S INDUSTRIAL DEVELOPMENT**

The importance of industrialization in a country's economy does not need much introduction. Classifying developing countries and developed countries is mainly based on the extent of industrialization of a country.

The industrial development of a country starts from production and export of primary products like agricultural products, timber, and marine products. It would then move on to the production and export of processed, value-added products by using simple technology. In such case, exports may be garments, furniture, processed sea foods and vegetables, cans, and household appliances. The next phase would be the production and exportation of technology-based capital and intermediate goods such as automobiles, computers and electronic parts, and hi-tech products. The extent of industrialization of a country can be assessed by the percentage share of the manufacturing sector in the country's GDP and the percentage of labor force employed in the manufacturing sector.

Historically, it was apparent that every Myanmar government tried to promote industrialization without apparent success since Myanmar gained independence in 1948. The industrialization strategy adopted in Myanmar was based on so-called state-led industrialization, which mainly focused on import substitution. Accordingly, governments heavily relied on state-owned industries to implement their strategy. As a result, private enterprises (majority of those are SMEs) rarely got favorable treatment from government in terms of subsidies, tax relaxation, development loans, and assistance in training and technology transfer.

When the SLORC government took over national power in September 1988, it officially declared the adoption of market-oriented system. The SLORC laid down four economic objectives that would serve as guidelines in the country's effort to move toward the developed-country status. The first economic objective, "Development of agriculture as the base and all round development of the economy as a whole" clearly states the government's emphasis on agricultural sector as the main engine for economic growth. The fourth objective, "The initiative to shape the economy must be kept in the hands of the state and national people" explicitly declares the government's commitment to maintain national economy within the reach of its control.

At present, the government attempts to achieve industrialization via the public sector and private sectors. To boost industrialization process through private-sector investment, The Private Industrial Enterprises Law and The Promotion of Cottage Industrial Law were enacted on 1990 and 1991, respectively. The Private Industrial

Enterprise Law provides for the official definition of small, medium, and large enterprises in the private sector. The law also requires SMEs to register with the Ministry of Industry (1).

Industrial zones were established in 1991, starting from adjacent areas of Yangon and Mandalay. The Myanmar Industrial Development Council (MICD) was formed on July 18, 1995, which included government ministers and deputy ministers from various ministries. MICD, composed of eight subcommittees, laid down plans for the successful establishment of industrial zones and industrial parks. The number of registered private industrial enterprises has been increasing yearly, from 28,848 in FY 1991 to 41,475 in FY 2005<sup>27</sup>. According to statistics released by the Ministry of Information, the number of registered private industrial enterprises reached 43,374 by end of 2006<sup>28</sup>. Cottage industries that employed less than 10 workers and used less than three horse powers are exempted from registration, and that means the actual number of businesses in the private sector may be much higher than what is entered in the official records<sup>29</sup>.

Due to the reform measures, private sector's share of ownership in factories and industrial establishments was increased from 93.8 percent in 1988-1989 to 98.41 percent in 2002-2003, while state's share decreased from 4.4 percent to 1.3 percent in the same period. In terms of labor, private industrial enterprises take up 96.9 percent of total establishments that employed fewer than 50 workers, while state enterprises accounted for 63.8 percent of total establishments that employed more than 50 workers<sup>30</sup>. More than 90 percent of the manufacturing sector in the country employed fewer than 10 workers<sup>31</sup>. Most of the private industrial establishments involved in manufacturing and processing food and beverage accounted for 60 percent of the total<sup>32</sup>. They are mainly served the local market. The majority of private industrial companies

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<sup>27</sup> Toshihiro Kudo, *Stunted and Distorted Industrialization in Myanmar*, 2005

<sup>28</sup> See *Chronicle of National Development Comparison Between Period Preceding 1988 and after up to 31.12.2006*, p.341

<sup>29</sup> According to an estimate made by the Ministry of National Planning and Economic Development in early 2004, there were altogether some 101,000 private industries (including unregistered establishments) in the entire country, employing around two million workers (Work Coordination Meeting No 1/2004): see more details on Tin Maung Maung Than, *State Dominance In Myanmar*, 2007 p. 410, footnote no.126

<sup>30</sup> Tin Maung Maung Than, *State Dominance In Myanmar*, 2007, p. 380-81

<sup>31</sup> Johzen Takeuchi, *Formation and Features of Entrepreneurship in Myanmar and Japan*, A paper on Industrial Development and Reform in Myanmar, 1999, p. 311

<sup>32</sup> I bid p.315

may be categorized as small and medium enterprises (SMEs) and were essentially geared towards import substitution<sup>33</sup>.

The imposition of new restrictions on the exchange rate and trade system after the 1997 Asian economic crisis deprived private companies of access to imported goods, causing a slowdown in their economic activities. Most of the private industries heavily used imported materials, equipment, and components in their production processes to produce import substitution finished products. The fluctuations in the exchange rates, severe shortage in electricity supply, rising costs of inputs due to high inflation, and spiraling prices caused by imported goods that mainly flowed from border trade prevented the growth of private industrial companies.

As for the public sector, privatization measure for SEEs was introduced as part of a reform package to transform the command economy to a market-oriented system. The Myanmar Privatization Commission (MPC), which was formed in January 1995, announced the list of candidates for privatization (mainly cinema halls, small processing plants, and nationalized business premises). By early 2003, the number of privatized assets reached 180 (out of some 600 enterprises identified by 18 ministries) with a total sales value of 2.87 billion kyat<sup>34</sup>.

However, starting from the second half of 1990s, with the state's focus on processing and manufacturing, SEEs became increasingly oriented towards an import substitution industrialization strategy aimed at gaining self-sufficiency and self-reliance<sup>35</sup>.

Toshihiro Kudo stressed the shift to a state-owned-factory strategy in his paper, "Stunted and Distorted Industry in Myanmar (2005)." He comments:

*The number of public industrial enterprises did not decrease throughout the transitional period toward a market economy; their number increased from 597 in FY 1985 to 1,132 in FY 2002. Moreover, the establishment of new public industrial enterprises is accelerating. The number of such enterprises increased by only 19 for five years between FY 1985 and FY 1990, by 92 for the next five years between FY 1990 and FY 1995, and by around 20 to 30 every year until 2000. Thereafter there was further impressive growth: 53 public industrial enterprises being set up in FY 2001 and 231 in FY 2002.*

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<sup>33</sup> Toshihiro Kudo (Ed.), *Industrial Development and Reform in Myanmar (2): Prospects and Challenges*, 2002, p. 266

<sup>34</sup> Tin Maung Maung Than, *State Dominance in Myanmar, The Political Economy of Industrialization*, 2007 pp360-61

<sup>35</sup> Ibid p.379

*The timing of this surge in construction suggests that the government launched a massive state-owned factories program in 2000 and 2001. The policy change may accord with the government's drive toward self-sufficiency.*

Data released by respective ministries support this fact. Ministry of Industry (1) reported that 53 new factory projects were implemented between 2001 and 2005 with an investment cost of 127,831.98 million kyat and 991.81 million US dollar<sup>36</sup>. The number of factories under the Ministry of Industry (1) in 2001 totaled 154 (textile, 33; foodstuff, 43; pharmaceutical, 18; ceramics, 23; general services and maintenance, 28; and paper, 9). It was projected that their number would reach 230 in 2005.

Since 1995, the Ministry of Industry (1) has also established and extended the number of distribution outlets (*Win Thu Zar* shops) to handle distribution of its products directly to domestic consumers. In 2002, 26 shops opened in the country. Of which eight were located in Yangon<sup>37</sup>. Similarly, the number of factories and industrial buildings under the Ministry of Industry (2) increased from 10 in 1988 to 22 in 2002. The cost of implementation for these factories and buildings dramatically increased from 17.37 million kyat in 1988 to 5,474.93 million kyat (provisional) in 2002.<sup>38</sup>

Despite these expansions, SEEs were being operated with budget deficits throughout the period. Current cash budget of SEE showed deficits (kyat in million) of 891.7 in 1990-1991, 4439.5 in 1995-1996, 29,718.5 in 1997-1998, 67,431.6 in 1998-1999, and 50553.5 in 1999/2000. In the industry sector, the combined total of Ministry of Industry (1) and (2) showed a surplus of 633.2 kyat million in 1990-1991, but a deficit of 216.8 kyat in million in 1995-1996, a small surplus of 137.4 in 1997-1998, deficit of 3037.4 in 1998-1999 and 881.9 in 1999/2000. The capital expenditures of the industry sector also significantly increased after the second half of 1990s: 340.3 million kyat in 1995-1996, 937.4 in 1997-1998, 1,061.2 in 1998-1999, and 2,969.6 in 1999-2000<sup>39</sup>. However, the level of industrialization of the country did not change significantly. Table 1 shows the structural changes in contribution of agriculture and manufacturing sectors to national GDP by CLMV countries during a 10-year period; this highlights the state of industrialization in a country.

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<sup>36</sup> 52 new factories in six industry branches will be extended within the period: textile-12, foodstuff-9, pharmaceutical-8, ceramics-7, general services and maintenance-10, and paper-7.

<sup>37</sup> *Magnificent Myanmar* (1988-2003), published by the Ministry of Information, pp. 112-117

<sup>38</sup> *Ibid* pp. 122-123

<sup>39</sup> *Statistical Year Book* (2005), Central Statistical Organization ( Note: The budget data obtained are only up to 1999-2000; such data for the 2001 onwards were not yet published as of press time.)

**Table 1 Change in Sectors' Contribution to GDP in CLMV**

	Cambodia		Lao PDR		Myanmar		Viet Nam	
	1994	2004	1994	2004	1993	2003	1995	2005
Agriculture sector	47.6%	32.9%	57.1%	47.0%	63%	50.6%	27.2%	20.9%
Manufacturing sector	9.3%	21.5%	12.8%	20.4%	6.8%	9.8%	15.0 %	20.7%

Source: ASEAN-JAPAN statistical Pocketbook, 2007-, ASEAN-JAPAN CENTRE

Table 1 shows that Myanmar economy is still heavily dependent on the agriculture sector, gaining no significant change throughout the period. As to the manufacturing sector's contribution to GDP as a proxy of industrialization, Myanmar's share showed a marginal increase, while other CLMV shares enjoyed a bigger increase during the same period. This suggests therefore that Myanmar is the only country in the ASEAN region whose agriculture sector's contribution to GDP is greater than 50 percent and industrial sector's contribution is less than 10 percent during the previous decades.

Though the inefficiencies of SEEs have long been proven and there were unsuccessful attempts of import-substitution industrialization strategy, the current strategy of state-led industrialization in Myanmar seems to follow the pattern adopted in previous eras. In terms of access to inputs, financing, and the processes in government bureaucracies, SEEs received a more favorable treatment than private SMEs<sup>40</sup>. Subsidizing deficits of SEEs using state budget would result in an increase in domestic borrowing, which, in turn, affects money supply and pushes inflation up due to misallocation of resources in the country. So, it is difficult to achieve the desired results in the long term.

SME development does not seem to be a priority area of the government, as there are limited programs and funding for SME development. Government funds are devoted to financing inefficient SEEs. Since SMEs occupy lion shares in manufacturing sector (99 percent of total), the effort towards industrialization will not be feasible without sufficient promoting SMEs sector. The objective to achieve industrialization could be met only when private sector (SMEs in particular) becomes major driver as in the cases of other Asian countries.

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<sup>40</sup> Toshihiro Kudo, *Industrial Policy in Myanmar, Lessons from the Past*, a Paper on the Industrial Development and Reform in Myanmar, 1999, p. 230

## V. CURRENT STATE OF SMES IN MYANMAR

SMEs represent over 92 percent of total business establishments and accounts for 99 percent of the total number of firms in the private manufacturing sector. Thus, a study on SMEs also means a study on businesses in the private sector. The study of SMEs in Myanmar can explore businesses and the operational and financial difficulties faced by the major part of the private sector businesses environment in Myanmar.

### 5.1 Official and working definitions of SMEs

According to the Private Industrial Enterprises Law 1990, classification of business enterprises in the private sector is based on four criteria, namely, power usage, number of workers employed, capital invested, and annual production. This classification system is rather complicated than those in other countries in the region, because the latter mainly use only one or two criteria to classify SMEs<sup>41</sup>. Such system also ignores the nature of business, whether they are wholesale, retail, or manufacturing. Table 2 shows the classification of SMEs in Myanmar.

**Table 2 Classification of SMEs in Myanmar**

<b>Categories</b>	<b>Small</b>	<b>Medium</b>	<b>Large</b>
Power used (horsepower)	3-25	26-50	Over 50
Number of workers	10-50	51-100	Over 100
Capital investment (million kyat)	Up to 1	1-5	Over 5
Annual production (million kyat)	UP to 2.5	2.5 to 10	Over 10

Source: Private Industrial Law (1990)

This complication generates problems. It is very rare that an establishment meets all four criteria at the same time to easily earn a business classification. It is difficult to classify a business whether it is large or small, if it employs 15 workers and uses less than three horsepower but invests more than five million kyat. The required amount of capital, 5 million kyat, for a business to be classified as large business was defined in 1990 when the Private Industrial Enterprises Law 1990 was enacted. No modification or amendment has been made since then. At present, however, the criterion is no longer

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<sup>41</sup> Detailed definitions of SMEs in some ASEAN countries are shown in appendix 1 for comparison.

adequate capital for a large firm and even for a small firm. If an individual owns a car and uses this car as a taxi, it means he is doing a large business as measured by capital investment, because the average cost of a taxi in Myanmar is about 15 million kyat. The definition based on monetary value should be periodically amended; otherwise, it can lead to confusion<sup>42</sup>.

For this reason, a working definition is used to define SME in this paper, as follows: “An SME is a business operating in private sector which employs up to 100 workers. It may be operating in any business setting where ownership and control are not separated. However, it shall not be a subsidiary of any holding company or institution.” In this definition, it is estimated that more than 99 percent of all business establishments in the private sector will fall in this category. Therefore, financing SMEs in this context is almost synonymous with financing the private sector.

## **5.2 SME Contributions to National Economy**

According to the official statistics released by the Ministry of Industrial (1) in 2004, there were 43,435 registered enterprise in Myanmar, of which small enterprises (between 10 and 50 workers) accounted for 78 percent; medium enterprises (between 51 and 100 workers), 14.6 percent; and large enterprises (above 100 workers), 7.4 percent. Thus, the combined SMEs represented 92.6 percent of total registered enterprises. This statistics also shows that SMEs contributed 80 percent of employment, 69 percent of output, and 68 percent of investment value in the country.

When SMEs are classified by category, data from Ministry of National Planning and Economic Development in 2005 show the foodstuff industry as the number-one industry with 62.91 percent, followed by construction articles with 7.43 percent, and clothing and wearing apparel industries with 4.84 percent of total.

Another source showed that private sector’s contribution to industrial enterprises in 2005-2006 was 92.36 percent<sup>43</sup>. SME contribution to private industries was 95.6

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<sup>42</sup> It was also suggested by Dr. Kyaw Htin, one of the prominent Myanmar SME experts, that the government should consider the industrial law draft which includes changes in the definition of SME. It is a big block to overcome. He said that many businesses do not have access to benefits as SMEs because they are using more electricity and have more money for investment than the definition of an SME allows (see more details, The Myanmar Time News, August 28, September 3, 2006)

<sup>43</sup> Said by former Prime Minister General Soe Win, Chairman of IDC, a news report in coordination with members of IDC, People’s Daily Online, November 26, 2007

<sup>44</sup> Khin Moe Aye, Local Business Promotion Seminar for Regional Development III, Malaysia (April 24-25, 2006)

percent in 1999, 94.6 percent in 2001, and 92.7 percent in 2004<sup>44</sup>. These figures show that SMEs play a significant role in Myanmar economy, specifically in the manufacturing sector.

### **5.3 SMEs in Industrial Zones**

Before 1988, SMEs in Myanmar were scattered all over Myanmar, both in urban and rural areas. However, majority of SMEs were located in residential areas of Yangon and Mandalay.

In 1990, the SLORC government planned to relocate the SMEs to newly established industrial zones. The Department of Human Settlement and Housing Development (DHSHD) supervised the development of industrial zones, which started from adjacent areas of Yangon. Industrial zones were further extended to other cities and major towns throughout the country. Mingarlardon Industrial park and Thanlyin-Kyauttan Industrial zones were developed through joint-venture agreements between foreign partners and governments; these industrial zones are reserved for foreign investments.

To effectively supervise the development of each industrial zone, industrial zone administration committees were established under the supervision of each minister assigned by the MIDC. Now, majority of SMEs in the industry sector are located in the industrial zones, while majority of cottage industries are still located in residential areas in cities.

In 2004, there were 18 industrial zones in Myanmar, with a total of 8,794 industries (nearly 22 percent of the total registered industries) and 142,601 employees. This number reached to 21 industrial zones throughout the country at the end of 2006, with a total of 9,915 industrial enterprises. As of 2006, about 150,000 employees worked in these zones.<sup>45</sup>

Industrial zones in Myanmar are made up of 57.48 percent small enterprises, 25.24 percent and medium enterprises, and 17.28 percent large enterprises<sup>46</sup>. Thus, the combined total of SMEs represents 82.72 percent of the total number of establishments in all of the industrial zones in Myanmar.

### **5.4 Business Environment of SMEs**

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<sup>44</sup> Chronicle of National Development Comparison Between Period Preceding 1988, up to December 31, 2006, Ministry of Information, Myanmar, March 2007

<sup>45</sup> Chronicle of National Development Comparison Between Period Preceding 1988, up to December 31, 2006, Ministry of Information, Myanmar, March 2007

<sup>46</sup> Xinhua news, People's daily Online- Industrial contribution to GDP of Myanmar, December 3, 2007



The business environment of SMEs is affected by the greater economic integration among countries in the region and increasing liberalization of trade among neighboring countries. Common preferential tariff scheme exercised in the ASEAN countries lead to the inflow to Myanmar of cheaper and better commodities from ASEAN countries. This certainly poses a future threat to SMEs in Myanmar. At present, the competition generated by imports from neighboring countries through border trade have pushed down prices of products from local SMEs. Domestic products, especially household appliances and consumer electronic products (watches, clocks, radio, television, motorcycle, garment, shoes, and umbrellas) are reeling from the price competition brought about by cheaper products imported from China. Other products, such as canned foods, snack foods, garments, plastic products, and toys, are competing with products from Thailand<sup>47</sup>.

Imported products greatly damage the market share of local industries, because local industries cannot compete with these products and consequently, most of them are confined in the resource-based and labor-intensive products. Over 60 percent of local manufacturing firms are in the food and beverage sector that heavily rely on agro resources.

As to infrastructure, the most challenging problem is power supply. Frequent breakdowns and low-voltage power supply are major disturbances in the production processes. This leads to increase in wastage, especially in power-sensitive industries like cold-storage factories. To avoid interruptions in production during power failures, almost all factories in the industrial zones have reserved generators. But the cost of generators and associated fuel costs lead to increased cost of production. Approximately, the cost of production when generators are being used is five times more than the normal cost of production.

In most cases, customer orders cannot be fulfilled on time due to unreliable power supply during peak periods in production. So they are forced to use generators because they want to fulfill customer orders. This prevents industries from becoming competitive because of high cost of production caused by using generator.

This problem gets more serious during summer season when water level in rivers is lower (majority of power supply is generated from hydropower in Myanmar) and power usage in urban areas become more intensive due to hot weather. To cope up with this situation, companies in industrial zones have to reduce production shifts, since

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<sup>47</sup> When visiting to Mingalar bazaar located in Yangon, the largest wholesale bazaar for household appliance products in Myanmar, one can easily notice the fact that most of the products in the bazaar are imported. Products from indigenous SMEs can be more available in Theingyi bazaar.

production is limited by power shortage. This further creates seasonally unemployment.

The rising costs of inputs and imported materials are another tough challenge for the SMEs in Myanmar. Cost of utilities, such as telephone charges, power, license fees, and taxes increased two to three times in recent years. Most manufacturing SMEs use imported raw materials, so the rising costs of these materials due to fluctuations in the exchange rate and frequent changes in office procedures on import and export matters severely affect their operations. The increasing cost in acquiring import license is another possible reason for the increasing costs of imported raw materials<sup>48</sup>.

Another problem that local SMEs in Myanmar have to hurdle is the shortage in skilled workers in every area of manufacturing. Though labor cost is relatively cheap and labor is abundant in Myanmar, majority of workers have limited skills. Formal training is almost lacking in the manufacturing sector. For skill development, businesses have to rely on apprenticeship. Also, existing skilled laborers are difficult to maintain due to strong demand from competing companies. This problem is more prevalent in businesses located near the Thailand border—most of the skilled workers cross the border to work in Thailand.

Inter-firm linkages either among SMEs or SMEs with large businesses in the form of supplier and customer relationship are not well developed. There is also a dearth in cooperation among SMEs in the areas of technology development and research. There is virtually no linkage between SMEs and research institutions of universities and government agencies.

On the bright side, some opportunities offer a rosy outlook for the local SMEs. Myanmar has a fairly large domestic market with a population of approximately 52 million (as of 2006). As a developing country, Myanmar has so many market niches with unfulfilled customer needs. This offers an opportunity for SMEs to diversify their products.

Strategically, Myanmar shares border with two largest populated countries, namely, China and India. It can openly access these markets via border trade. Laws and regulations that determine standards for environmental protection and consumer safety are still not well established in Myanmar, so the cost for meeting such standards remains low. Myanmar consumers have relatively high tolerance for faulty and unsafe

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<sup>48</sup> Import licenses are issued by the Ministry of Commerce in Naypyidaw, the new capital of Myanmar, which is about 250 miles away from Yangon. Almost all the government offices are located there. So, manufacturing firms in Yangon have to go to Naypyidaw in order to get licenses. The cost of traveling and living in Naypyidaw is very high, and it takes about 10 days on average to get import licenses. This is one of the reasons for increasing cost of imported materials and doing business.

products. Bringing a manufacturer to court for a faulty product is not common in Myanmar.

Another advantage of Myanmar is that it is abundant in natural resources, allowing domestic producers a ready access to an abundant supply of relatively cheap local raw materials.

Still, Myanmar boasts of cheap and educated labor force—another advantage for the local manufacturing.

The ability to understand the preferences of local consumers, coupled with the ability to quickly adopt with changing market needs, is an advantage of the SMEs in Myanmar. Also, employees and business owners in Myanmar can easily develop a social contract based on mutual understanding, because most business owners have genuine concern for their employees and usually take care of the social needs of their workers. Most workers either live in the workplace or in the house of their employers. This situation suggests that SME operators have the opportunity to fully maximize their workers' productivity and innovative ideas. This has become a very important factor for survival and generating competitiveness in a highly competitive marketplace.

Myanmar has a remarkable business culture in which most of the businessmen in the same line of business frequently meet in roadside tea shops where they exchange ideas, share information and knowledge, and discuss their business affairs and market potentials. This is an effective mechanism to reduce risk of uncertainty in the business environment and solve the problem of information asymmetry in the business. Moreover, businessmen in the same line of business know each other very well and can help each other during crunch time. They share a certain degree of mutual trust and cohesiveness. Most transactions among them are usually done on credit. Cash down payments are very rare. This enables them to finance short-term working capital requirements for their business operations.

### **5.5 Problems and Constraints of SMEs**

The discussion on the business environment already covered some problems and constraints of the SMEs. In this section, the discussion will highlight the problems and constraints of SMEs and business owners as explored by various studies on SMEs and related fields. This study itself mainly follows the findings of previous studies.

Professor Daw Nu Nu Yin from the Yangon Institute of Economics made a survey on 132 manufacturing firms in Yangon and Mandalay in October and November of 1997 and 1998. The survey covered six SEEs, 17 foreign joint ventures, two local joint ventures, one cooperative, and 106 private companies. It explored the notion that the shortage in electricity seems to be the greatest obstacle to productivity for almost all

companies. Problems in infrastructure (weak transportation and telecommunications systems, weak drainage and sewage systems, and limited space), shortage in spare parts and raw materials, low level of technology, insufficient machines and equipment, lack of capital, and shortage in foreign currency are also cited as financial barriers<sup>49</sup>.

In a study on young entrepreneurs in Myanmar in 2002, it was found that exposure and culture, access to finance, high inflation rate and competition are major problems that new entrepreneurs in Myanmar have to contend with. The author of the study underscores the fact that access to bank financing is one of the biggest barriers for entrepreneurs who want to start a new business<sup>50</sup>.

One survey conducted on 75 sample SMEs located in Yangon and Monywa in 2003 reveals that all of the respondent firms ranked first the shortage of capital among their overall problems; shortage of skilled labor was ranked as second<sup>51</sup>. The similar result was also found in the field study of SMEs in Yangon Industrial Zones conducted from May to July 2007. Majority of the respondents, a total of 164 businesses, said that shortage of financing was one of the biggest problems and that they wanted to get reliable sources for additional financing for their expansion efforts. Shortage of power is another common problem that placed at the top of the list<sup>52</sup>.

Myanmar SME expert Dr. Kyaw Htin, an advisor to the Union of Myanmar Federation of Chambers of Commerce and Industry (UMFCCI), pointed out that lack of access to bank financing forced SMEs to borrow from other sources that usually charged higher interest rates. He suggested that this problem should be considered seriously to develop local SMEs in Myanmar. An SME industrial law could help to solve financing problems and secure raw materials for these enterprises.<sup>53</sup>

In general, various surveys, seminars, and reports suggest that Myanmar SMEs face a number of difficulties and constraints in their operations as well as in their

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<sup>49</sup> Nu Nu Yin, *A Survey of Selected Manufacturing Firms in Myanmar, A paper in Industrial Development and Reforms in Myanmar*, A Report of a Symposium by The Sasakawa Southeast Asia Cooperation Fund, 1999

<sup>50</sup> Toshihiro Kudo (Ed.) *Creating and Reviewing Entrepreneurs in Myanmar*, Industrial Development and Reform in Myanmar (2): Prospects and Challenges, 2002 pp. 23-29

<sup>51</sup> Htein Lynn, *Linkage between small scale enterprises and other business segments in Myanmar*, December 2004.

<sup>52</sup> Aung Kyaw, *Survey of SMEs in Yangon Industrial Zones*, 2007(forthcoming)

<sup>53</sup> *The Myanmar Times news, A call for help as SMEs outgrow law*, Aug 28, Sept 3, 2006

environment<sup>54</sup>. They commonly identify weak infrastructure (particularly power shortage), lack of formal financing sources, lack of training and technology advancement, outdated machineries and other equipment, poor product knowledge and market development, lack of inter-firm linkages, and heavily reliance on imported materials. These are the major obstacles to SME development. In terms of ranking, shortage in power supply and inadequate financing from formal sector top the list.

A comprehensive policy framework on SME development is required to eradicate these barriers and to allow for the development of *an enabling business environment*<sup>55</sup> for SMEs in the private sector. Only in such kind of environment that competitive, strong and export-oriented SMEs can well defend their market share as well as gain the ability to penetrate international markets and take advantage of the greater economic integration in the region. Figure 1 shows a suggested framework of SMEs development program in Myanmar.

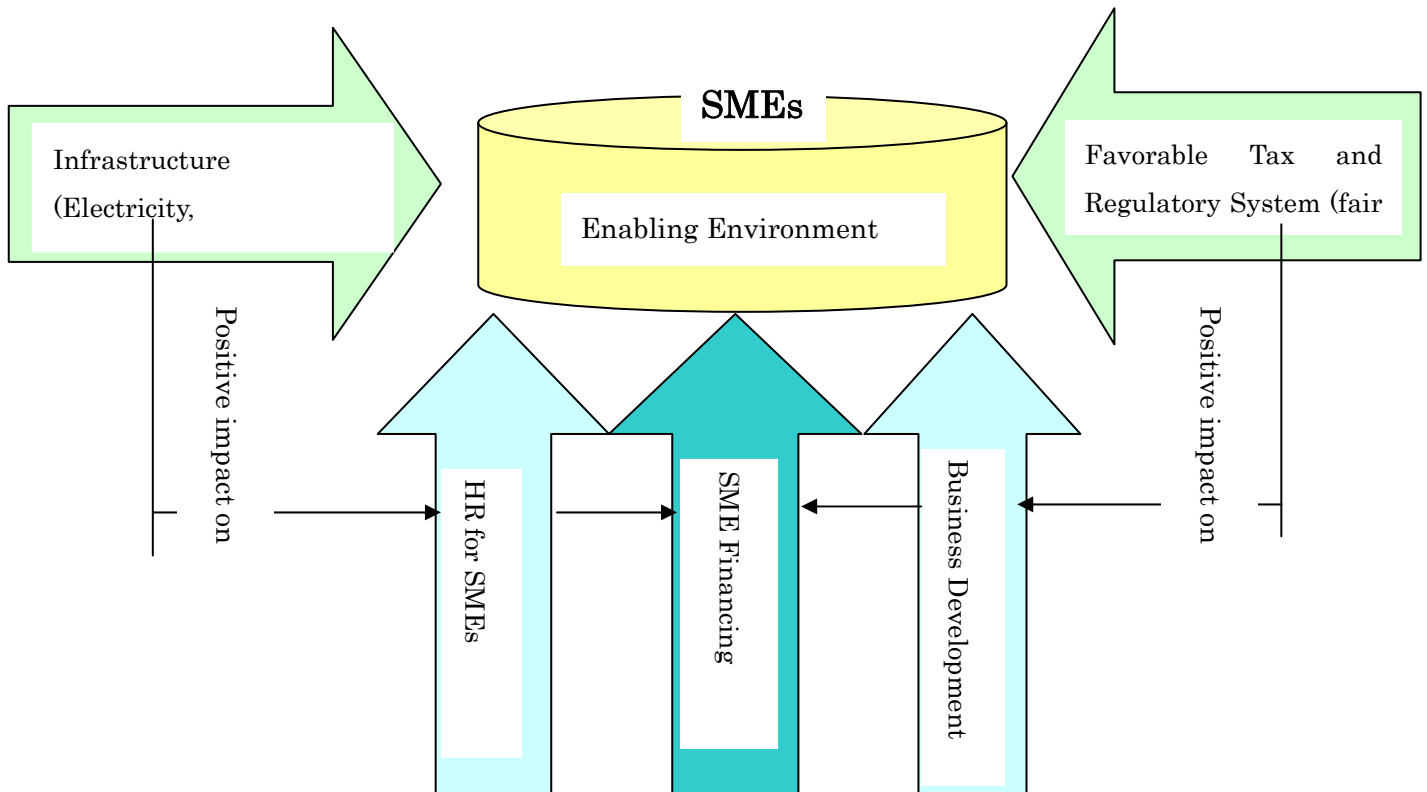
In order to create such favorable environment, at least two supportive measures are required: these are providing adequate infrastructures in the areas such as power, road and transformation and adopting policies that are conducive in the form of lower tax rates, clear administrative procedures such as ease of licensing and export/import procedures. To be more effective, the environment should be further supported by additional three pillars. These are (1) human resources development of SMEs; (2) easy access to formal financing sources for SMEs; and (3) business development (including cluster development, institutional development for SMEs such as vocational training school, R & D centre, entrepreneurship development centre and technology and IT development) for SMEs. This paper, however, focuses only on one of these three pillars, that is, improving SMEs access to formal sector financing. By improving their access to financing, this paper's author believes that most of the SMEs' problems in doing their business can be reduced in such areas as lack of capital, training, and technology

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<sup>54</sup> Various seminars concerning SME development reported the issues and challenges facing SMEs in Myanmar (for example, presentation by Khin Moe Aye, "Local Business Promotion Seminar for Regional Development III," Malaysia, April 24-25, 2006, Than Myint, Sub-national Innovation Systems and Technology Capacity Building Policies to Enhance Competitiveness of SMEs, Seoul, January 18-20, 2006)

<sup>55</sup> Hany A. Assaad(2004) defines "enabling environment" as the environment with (1) better financial development and low financing constraints; (2) good polices (low inflations, distortions, entry regulations, high level of education); (3) good institutions (control of corruption, rule of law, property rights); good information sharing to allow creditors to distinguish between good and bad borrowers; and (4) protection of creditor's rights and collateral enforcements.,

**Figure 1 A Suggested Comprehensive SME Development Program in Myanmar**  
*(Financing SMEs is a part of SME development program)*



Source: author

advancement, as well as outdated machineries and equipment and poor product knowledge and market development since these problems mainly rooted in shortage of financing. However, it should also be noted that even SMEs with access to better financial help cannot maximize productivity in an unfavorable environment and unless they get active support from other areas. Thus, financing SMEs is only a part of a more comprehensive SME development program.

## VI. WHY FINANCING SMES MATTERS IN MYANMAR

SMEs need finance in every stage of their development—from startup to developing stages, and ultimately, when they go public. By recognizing the role of SMEs in the economy, governments in both developed and developing nations can establish or facilitate different funding programs and institutions to give SMEs easy access to financing in each stage of their development.

During startup stage, the best sources of financing can be business owner's savings, loans obtained from friends/relatives, as well as venture capital and development financing schemes from government and SME promotion institutions. In their growth stage, there will be expansion in their financing sources, including loans from commercial banks, factoring and leasing, trade credit, and reinvestment of profit in their financing portfolio. Venture capital and development financing schemes remain as the important sources of financing for SMEs. When they have reached a stable stage, their sources of financing will further expand—equity investments from capital market and securitization of loans and long term-loans from banks become the next available sources of SME financing. If these institutional and market arrangements are in place, SMEs can easily access financing at each and every stage of their development.

Various researches reveal that there are many available alternative formal sources of financing schemes for SMEs in many countries. These include venture capital, credit guarantee, import trade financing, export trading financing, trade credit, factoring, leasing, loan terms from banks, securitization of loans, and capital market<sup>56</sup>.

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<sup>56</sup> These can be found in various literatures on SME financing. Some of these are: (1) "SME Finance Working Group, Supporting SME Finance in Developing Countries," Turin, Sept, 16, 2002; (2) Juliet Mckee, "Financing SMEs: Challenges and Options," Pacific Economic Cooperation Council, 2003; (3) Chaipat Poonpatpibul and Watsaya Limthammahisorn, "Financial Access of SMEs in Thailand: What is the role of the Central Bank?", 2005; and (4) SME Information and Advisory Centre. SMIDEC, Malaysia.

<sup>57</sup> For example, Mekong Project Development Facility (MPDF), which is founded by International Financial Corporation (IFC) and commenced operation in 1997 funded by Austria, EU, Finland, IFC, Japan, Norway, Sweden, Switzerland, and the UK as well as Asian Development Bank (ADB) provide funds to assist and accelerate the development of productive, self-sustained SMEs in Cambodia, the Lao PDR, and Vietnam. The targeted SME is an SME that employs a minimum of 10 staff and has a financing requirement between US\$150,000 and \$10 million. Companies must be either 100 percent locally owned or joint ventures with significant local ownership, have sound business concept that is financially and economically viable, and be in the productive sector, excluding tobacco and military products. The estimated project cost is \$0.3 million for the period between 2004 and 2008.

Moreover, developing countries can access special aid and loan assistance schemes from International financial institutions such as the Asian Development Bank (ADB), International Financial Corporation (IFC), and various international donor institutions<sup>57</sup>.

Unfortunately, such kind of international assistance is not available to SMEs in Myanmar. Moreover, most of the above alternative sources of financing are non-existent in Myanmar. Myanmar lags behind other countries in the ASEAN region in the area of financing SMEs<sup>58</sup>. The only available sources of financing for SMES in Myanmar are trade credit, mostly from business-to-business relationship, and short-term loans from banks that require collaterals consisting of unmovable properties. There are no special sources of long-term financing that will allow businesses expansion, investment in fixed assets such as plants and machineries, as well as research funds for product and market developments and training. Although short-term loans and trade financing can meet the need for a working capital, equity financing and long-term debt instruments are more appropriate to finance fixed capital investments, which require longer gestation periods.

Providing the right type of financing that can match the needs of the SMEs in each stage of their development is crucial in their survival and growth. Without appropriate sources of formal financing, SMEs are forced to rely on internally generated profits and retained earnings that take considerable time to accumulate. The inability to expand production capacity results in missed opportunities that, in turn, limit the rate at which firms can grow. The lack of financing could also have widened the gap between the modern, larger and export-oriented SMEs in leading ASEAN countries and the traditional, smaller and localized ones in Myanmar.

Lack of financing seriously retards further investment so Myanmar SMEs are unable to expand as well as boost their competitiveness. With limited access to financing from formal sources, SMEs with promising products and entrepreneurs with

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([www.adb.org/Documents/Profiles/GMS/MPDF.doc](http://www.adb.org/Documents/Profiles/GMS/MPDF.doc)). Also, the German Bank for Reconstruction and Development provided EUR 2.5 million for SMEs in 2004 in Cambodia (REPSF Project 04/003: Final Main Report)

<sup>58</sup> Short to medium term loans are available for SMEs in both Cambodia and Laos where only short term loan is available in Myanmar. Unsecured loans, leasing and factoring services can also be available in Vietnam and Laos. In Lao PDR, apart from home, plant and unmovable properties, inventory can be collateralized at the bank (see more detail- SME Access to Financing: Addressing the supply side of SME Financing, RAM Consultancy Services Sdn Bhd, Final Main Report, July 2005)



exciting business ideas cannot execute their plans. This means not only loss of business and entrepreneurs but also a big loss for the Myanmar economy in general.

Though this problem in financing is common among SMEs in almost all developing countries, it is more severe in Myanmar due to the aforementioned reasons. SME owners in Myanmar have to rely on their personal savings, funds from relatives, and earnings from operation to expand and upgrade their businesses. The size of business expansion is limited up to the extent of their accessible funds from personal sources. Or, they have to turn to informal sources of financing from outside money lenders. Consequently, SMEs pay higher rates of interest, which places them under pressure and leads to high failure rate.

That is the reason why financing matters for SMEs in Myanmar.

### **6.1 Current state of SME financing in Myanmar**

Specialized researches on SME development in Myanmar are few and only a few of these give special focus on SMEs financing aspect. Thus, available literatures are unable to highlight the real financing situation of SMEs.

Financing problems of Myanmar SMEs are rather a complicated issue that has been in existence for a long time now, in both demand side and supply side. These are also related to the macroeconomic fundamentals of the country and influenced by the level of lending infrastructure in the country.

A survey conducted on 167 firms located in Yangon and Mandalay in 2003 reveals the limited access to formal financing sources (only eight owners borrowed from state-owned banks and 22 owners from private banks). Inability to access formal sector financing is one of the constraints of private sector enterprises in Myanmar<sup>59</sup>.

A survey conducted on the firms located in five industrial zones in the Yangon area<sup>60</sup> shows that out of 182 sample industries, only 78 firms availed of bank loans. The difficulties in financing involved high interest rate and only mortgaged short-term loans were available. A similar survey on selected industrial zones in Yangon conducted by the author in May 2007 also shows that, from the 164 firms surveyed, 87 firms said that they did not avail of financing from outside sources<sup>61</sup>. They used their own money for

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<sup>59</sup> See more details: Toshihiro Kudo, *Stunted and Distorted Industrialization in Myanmar*, IDE discussion paper No. 38, Oct. 2005, pp. 14-22

<sup>60</sup> *Industrial Development in Yangon; The Case of Hlaing Tharyar & South Dagon Industrial Zones*, a paper on "Industrial Development in Myanmar (2): Prospects and Challenges" (Toshihiro Kudo (Ed.) 2002), p. 279

<sup>61</sup> Aung Kyaw, *A survey on SMEs in selected industrial zones in Yangon, 2007* (forthcoming)

startup and expansion. Most of the financing for working capital came from suppliers in terms of trade credit. Their common answer for not using external financing was that they did not want to face complex banking procedures and tight collateral requirements. Another common answer was that bank loans were unreliable for business expansions, because they could be available only on short-term basis. Thus, business owners preferred expanding their businesses up to a certain level that their own finances could allow. They would usually reinvest further expansion the profits they earned from business operations. Some business owners argued that the current business environment was unfavorable for expansion and that they only continued their operations to maintain their current position. They did not want to lose their regular customers, as well as lay off their employees.

Fifty-two firms surveyed availed of financing from outside sources. These came from private banks, because banking procedures in these banks required relatively less time and were simple than what it would take when they borrowed from government banks. Some firms borrowed funds from the Myanmar Industrial Development Bank, a public company where shares are sold to general public but is managed by government officials and where almost all the procedures are undertaken in a manner typical in government operations. The bank was founded by the MIDC with the primary intention of financing companies in the industrial zones. In line with this objective, the bank mainly provides financing assistance for SMEs in the industrial zones throughout the country. Financing scheme in this bank is mainly based on collaterals and banking procedures are almost the same as those in other commercial banks.

For the SMEs owners, their main difficulty is the need to renew loan contract every year with the lending bank, and the renewal process is as complicated, and costly as in the process for applying for a new loan. To get bank loans, SME owners must supply a bundle of documents that proves the reliability of collateral property demanded by banks. The manager of the bank makes a physical check of the location of the collateral property and attaches value on the property. After checking the detailed procedures, accompanied by a comment/recommendation of the bank manager, the loan application will go through a review of the higher-level management (i.e., board of directors) for decision making.

The whole process for getting a loan takes one to two months and a lot of detailed procedures have to be dealt with. Borrowers can only get a loan of up to 30 percent to 40 percent of the attached value of collateral property. They also have to ensure that they follow the terms and conditions of the loan, as prescribed by the lending bank. This likewise requires understanding of the details in banking procedures. So some business owners hire agents who specialize in this process.

Twenty-seven businesses surveyed responded that they had to acquire loans not only from banks but also from their personal network, such as their relatives and friends, for additional financing requirements. For these loans, they had to pay a higher interest rate. Normally, the interest rate is 5 percent per month if the lending party is the person who has close relationship with borrowers. Otherwise, if they borrowed from outside money lenders (gray market), they would have to bear higher interest rates that would usually go up to 10 percent to 20 percent.

At present, the most prevalent and available form of financing for SME owners is trade credit from suppliers, especially from those in the same line of business. In the trading of rice, wheat, beans, and pluses, as well as in the distribution of consumer goods from manufactures to wholesalers and from wholesalers to retailers, the practice of paying cash down payment is very rare. In consumer goods distribution, buyers pay in cash only during second delivery of the products. In some cases, this second delivery can be extended up to one month. In the same vein, manufacturers who distribute their products on credit term also purchase raw materials on credit from their suppliers. The average credit term is one month in most businesses, but in some businesses, it can be longer. Businessmen in the same line of business quite know each other so business transactions are done by mutual trust without formal documents on receiving and delivering goods and cash payments. This practice can even be observed in businesses where the volume of transaction and the amount of money circulated is hefty, such as in bean and plus trading, gold and gems trading, etc.

From the perspective of banks, lending to SMEs is too risky. This is because of their bitter experience in the past on giving loans to SMEs. According to a bank manager from the Myanmar Economic Bank (MEB), which is the largest state-owned banks, made available a vast amount for loans to SMEs around 1996 when the private sector was in a boom the first time. At that time, banks did not have enough experience in providing loans to private sector and were not familiar with lending techniques. Also, the regulations by the central bank were somewhat relaxed at that time. Borrowing from banks even turned into a business opportunity between businessmen who wanted to borrow and freelance agents who had connections with the banks. This situation resulted in many people arbitrarily setting up businesses only with the intention of acquiring loans from banks. Business owners could easily access bank loans with the help of freelance agents and by offering their lands and buildings as collaterals, even though they did not know anything about banking procedures. The agent would only make minor repair works on the exteriors of a collateral building to deliberately create a perception that the building was more valuable than its actual value. He or she would then take photos of the building, fill out the loan application form, and submit it to the

banks with other necessary documents. The owners, as well as the agents themselves, had no intention to pay both the principal and interest of their bank loans. Their objective was only to get a bank loan as much as possible on the collateral property whose actual value was very low.

Due to their lack of experience and analytical skill on the one hand and probably corruption on the other hand, bank managers at that time made soft loans to these businesses. In many cases, the loan amount was more than the actual value of the collateral properties. The agents received high commission for their services, while the business owners got a large amount of money. Consequently, this led to a bank crisis, where banks had to deal with a high number of nonperforming loans (NPL), which reached up to 50 percent at that time<sup>62</sup>. But today, banks can maintain the level of NPL within the 2-percent-to-3-percent range by practicing strict collateral requirement on loans.

Aside from the fact that business owners had no intention of paying their bank loans, they also did not possess business acumen and lacked skills on how to manage the loans they acquired from banks. According to the author's personal experience in Kyauntpataung, a small town located in central Myanmar, most business owners who acquired large bank loans use their money for donations and purchasing goods for personal use, like motorcycle and TV set, instead of actually investing their money in business. When payment was already due, they did not have enough money to fulfill their obligation with the lending bank. Consequently, they lost their collateral properties and at the same time, the banks also had to bear a large amount of NPLs. The MIDB had to face a large number of NPLs and court cases in this area (Kyauntpataung, Mahlaing, and Wuntwin) during the last five years.

Due to these bitter past experiences and especially after the banking crisis in February 2003, the central banks as well as private banks started to take much caution when it comes to providing loans for SMEs. Consequently, if an SME owner wants to get a bank loan, he has to submit the following documents to the lending bank:

1. Business license granted by the local municipal authority (for example, license from Yangon City Development Committee);
2. Industrial license granted by the Directorate of Industries Inspection and Registration;
3. Photos and location map of land and building intended as the collateral (building must be built of bricks; that made of wood is not acceptable as collateral);

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<sup>62</sup> Interview with the bank manager of the Industrial Loan Department of MEB, October 2007

4. Documents on the collateral property with the title of business owner (who is applying for a bank loan);
5. Documents showing payment of profit taxes, land taxes, etc. on the collateral property;
6. Documents of fire insurance for the collateral property;
7. Full sets of accounting statements on the operation of business for the successive three years up to the year of loan application (income statement, balance sheets, and cash flow statement); and,
8. Company registration, memorandum of association, and articles of associations, if the borrowing party is registered as a Limited company. If there are some wooden houses near the collateral property, the loan amount may be substantially reduced.

In the case of a factory building used as collateral, supplementary information are required. These include:

1. List of plants and equipment in the factory and their market value;
2. Maintenance costs;
3. Costs of utilities and supplies;
4. Labor employed and cost of salaries and wages;
5. Input to output ratio;
6. Maximum and average capacity;
7. By-products and disposal method;
8. Fire Insurance certificate;
9. Raw material requirements; and
10. History of business.

In every case of loan application, the bank manager of the township branch personally visits the site of business. He or she evaluates the situation of business and collateral property for loans less than 10,000,000 kyat. If the loan amount is between 10 million and 20 million kyat, the state/division manager makes an actual visit of the property; above 20,000,000 kyat, it is the manager from head office who makes the visit. This procedure of making loans is almost the same for both state-owned and private banks.

The time taken to complete processing of loans depends on the lending bank. For MIDB and most private banks, the process is completed within one month. For the MEB, it takes about one to two months, depending on the amount of the loan and the collateral made. Larger loans require approval from the bank's head office in Naypyidaw, so processing takes longer time than smaller ones.

In most cases, MIDB grants loans of up to 30 percent of the market value of the

collateral, but these may go up to 40 percent, depending on the financial soundness of the business. The MEB allows up to one-third of the value of the collateral. The threshold for loans permitted by the central bank is up to 50 percent of the value of the collateral property. The term of loan is up to one year, and if business owners want to a longer term, they can renew their loan after paying back their old loan in full. The renewal process is the same as in the new-loan application process, but it usually takes lesser time because most of the required documents are already with the bank. State-owned and private banks offer an interest rate on loans of 17 percent per annum. Some banks collect an additional 2 percent as service charge. MIDB charges an interest rate of 2 percent for bank loans granted but not yet utilized; MEB charges only a 1-percent interest for a similar case.

MIDB used to issue loans only to businesses in the industrial zones. But now it extends its loan portfolio to the businesses located outside industrial zones. However, industries located in industrial zones are prioritized, but the same interest rate is charged for loans made by a business regardless of its location. Recently, MIDB issued loans to bus owners who wanted to install CNG kits in their buses. In this case, the bank received the book of ownership of the bus (vehicle registration book) as the collateral.

Loans to industrial sector have seen a decline in recent years due to the policy of extending loans to new sectors. In an interview with the manager of loans department at the MEB, it was revealed that the decline in the loans for the industrial sector because of a lesser demand for new loan applications from this sector due to unfavorable business environment.

Because of the aforementioned difficulties, the formal source of financing is now no more accessible to most of SMEs in Myanmar. The government offers no special financing program for SMEs at present, even though there was a syndicated loan program to make special loans to the companies in industrial zones. It was not as successful as expected due to complicated loan application procedures and many business owners did not know about this program<sup>63</sup>. There is no arrangement for factoring, inventory financing, export and import financing, leasing and special-purpose vehicles on financing schemes for the private sector and particularly for SMEs. Even as banks would want to offer loan services in such areas, the central bank does not allow them to do so, according to the existing rules and regulations. Only two viable forms of lending techniques—trade credit and collateral-based (asset-based financing)—are adopted in the present setup of SME financing in Myanmar.

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<sup>63</sup> Interview with one private bank counselor in 2004

There are no venture capital fund, credit insurance scheme, credit rating institutions and specific development financing schemes for financing SMEs in Myanmar. More importantly, there are no provisions for financing SME expansion and development efforts, such as business expansion, research and development, investment in fixed assets, and product and market development. Since bank loans can only cover short-term capital requirements, they cannot be used for expansion and further development. For this purpose, SMEs have to finance themselves. This greatly limits the development of SMEs in Myanmar in terms of size, product, market, and competitiveness.

## **6.2 Demand-side problems**

SMEs are partly responsible for their problem on access to adequate external financing. First, many SME owners surveyed did not have enough collaterals required by banks, so they had difficulty accessing credits from banks. All banks in Myanmar accept only unmovable properties like lands and buildings as collaterals. And even if business owners have lands or buildings, they cannot use these assets as collaterals if they do not have the title of these properties. Because of high cost of lands and buildings, most business owners prefer to rent a land or a building rather than make an outright purchase of these properties. If they did, there would be less money to be used in operating the business. This means then that SME owners are not entitled to acquire bank loans.

When they put their own lands and buildings as collaterals, banks only finance up to 30 percent to 40 percent of a property's market value. This may not be sufficient enough as capital. Moreover, they cannot get an additional financing from collateral assets. This limits the amount of their investment that can be financed with debt capital. And also, they need to renew their loan contract every year for the amount they borrowed from the banks. This would result in additional transaction costs and administrative burdens. Eventually, their interest to borrow from banks has already waned.

Second, most of the SMEs in Myanmar are informally structured, being that they are typically owned and managed by entrepreneurs. They rarely keep accounting records of their business in a systematic manner. This generates the problem of information asymmetry between the business and the bank.

The absence of proper financial accounting in many SMEs may be due to various reasons, ranging from inadequate financial accounting knowledge to the practice of deliberately hiding the true state of business affairs for tax purposes. The limited knowledge of business owners on accounting and how accounting records can be used in

business decision making keep them from providing the banks complete and systematic set of accounting so these banks can make a credit review. Some businesses even maintain dual set of accounting statements. One is for internal use (true one) and another one, which will be submitted to tax authorities, is designed to reduce the taxes business owners have to pay. They are not willing to present their internal records to the banks in order to get bank loans. In this case, they use independent accountants to prepare a set of accounting records for them that can be useful only for loan application purposes. Consequently, most of the accounting records submitted to the bank for loan application are not totally reliable, since they do not reflect the true states of the business. Therefore, banks do not rely on these financial statements to make objective analysis for their loan decisions.

The third reason for these business owner-generated problems is that many SME owners in Myanmar do not have the skill to make a business plan that can be used to assess the feasibility of a project. Most small businesses usually start without a formal business plans. Banks also rarely demand business plans to review the risk of their customers' businesses in making loan decisions. They solely rely on the viability of their collaterals in making loans decisions. Due to this, SME owners cannot systematically and objectively make judgments on the potentials of their planned business. Instead, they use subjective judgment and personal experiences to run and manage businesses. This can lead to reduced quality of their decision making as well as missed opportunities. Indeed, a good business plan can help in gaining access to a more favorable credit line offered by the banks and can be used as part of collateral requirement.

Fourth, some SMEs cannot effectively manage the money they have borrowed. Traditional SMEs do not know how to manage their cash flow to meet their payment business obligations on time. This problem leads to overspending in some occasions and over borrowing in other occasions. Some traditional SMEs cannot even distinguish between personal income and business income, as well as personal spending and business spending. When they get a large amount of money from the bank, they do not use the money in their businesses and instead, they use it for personal expenditures. In some cases, they offer longer credit terms to their customers more than what they can actually manage. Thus, they would have no enough money to pay the banks the principal amount of their loans. As a consequence, businesses go bankrupt.

Aside from inadequate collaterals, lack of proper accounting statements, inability to prepare comprehensive business plans, and poor cash management, the difficulty in obtaining loans also lies on the existing perception of banks that lending to SMEs proves too risky. This has been compounded by the instances of high NPLs in the history



of SMEs in the past few years. Thus, banks, including the central bank, are extra careful when it comes to lending to SME sector; they practice onerous banking procedures for loan applications, high demand for collaterals, and allow only short-term loans. As a result, bank loans cannot be used for business expansion and the acquisition of fixed assets that are crucial in the long-term survival of the business.

### **6.3 Supply-side Problems**

As in the demand side, there are also problems on SME financing in the supply side. First, there are no SME financing programs funded by the state. State funds are dedicated for subsidizing inefficient SEEs in the public sector.

Second, due to the bitter experience of banking crisis in the recent past (February 2003), the central bank has issued too many regulations on the activities of commercial banks in both structural and operational aspects, including reserve requirements, deposit-to-loan ratio, branching allowances, loan processing procedures, and so on. Commercial banks cannot determine their own interest rate based on the characteristics and quality of their borrowers or borrowing businesses. Virtually, interest on deposit paid and charged for loans by the banks are almost the same across all banks. Thus, banks cannot compete with one another based on interest rate differentials. They only have to compete on the volume of processing and other services.

Loans made to businesses largely depend on the quality of collaterals. The quality of business is not an important consideration. Once loan decisions have been made, interest rate is the same for all borrowers, whether they have good or bad reputation or creditworthiness or they are the bank's regular customers or not. For creditworthiness and regular customers, the only benefit offered by the bank is an easy access to overdraft facilities. According to the central bank's regulation, banks can make loans up to 50 percent of the value of the collateral. But most banks stay on the safe side by financing only up to 30 percent in most cases and 40 percent in exceptional cases, that is, when the creditworthiness or the reputation of the borrowers is reliable. This has led to a situation where credit evaluation skill is not important in running banking operations in Myanmar. Only the skill to assess the value and quality of collateral property is enough for successfully running banking business operations. This hampers the capability of banks staff in making systematic assessment on the borrowers and effective evaluation on their business plans, and consequently this will reduce the long-term competitiveness among banks.

Taking too much caution on making loans to business has resulted in onerous and daunting banking procedures in processing loan applications. This has led to high transaction costs on the part of banks that reduced their profit from providing loans to

SMEs. Limited deposits and unstable pattern of withdrawals made by depositors also hinder the structuring of the amount of loans that can be made. Some private banks informally request their customers to inform the bank a couple of days in advance if they intend to withdraw a large amount of money. According to the new money laundering act, all banks are required to report to authorities the money deposited or withdrawn worth more than a predetermined amount i.e. Kyat 100 million. This can effectively reduce the deposits made by some depositors.

Due to tightened control by the central bank, private banks cannot implement their own risk management systems. For example, they cannot make loans without collaterals based on the soundness of business plans or other characteristics of the business; they cannot reduce or raise interest rate levels beyond the point predetermined by central bank. They cannot make loans based on inventory and account receivable collaterals other than unmovable property. They are not allowed to serve other credit facilities such as factoring, export and import financing, and leasing. And also, they cannot make long-term loans to promising business enterprises.

Another problem on the part of banks is that they do not have closer relationship with the SME sector. This has led to insensitive banking procedures because banks do not know the true requirements and nature of SMEs. Banks do not keep a database of SMEs that let them to be able to use credit scoring techniques in processing loan decisions. And also, there is no national central credit bureau in Myanmar like the ones in other Southeast Asian countries such as Singapore, Malaysia, and Vietnam. Some private banks keep profiles of previous borrowers but not in a systematic manner, so these profiles cannot be used as a guide for future lending decisions. As a result, banks cannot make systematic credit analysis on their borrowers.

The number of private banks is still small to make lending facilities sufficient for the private sector. The number of private banks and the services they offer have been on decline since 2000. Now there are only 15 private banks in the nation and no new banks have been allowed to register since 2000<sup>64</sup>. The establishment of new branches by the existing banks is extremely limited by the central bank at present. MIDB and Industrial loans branch of MEB provide loans to private industrial firms but their scope of operation is limited<sup>65</sup>. These factors limit the sources and amount of credit available to SMEs.

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<sup>64</sup> The list of private and state-owned banks in Myanmar can be seen more detail in appendix 2.

<sup>65</sup> For example, MIDC can made loans up to 2.84 billion kyat to 562 industrialists in 2003.

The inability of banks to provide medium- and long-term loans<sup>66</sup> severely limits the growth of SMEs, because there are no other specialized financial institutions to finance their long-term capital requirement. For long-term financial investment in business expansion and upgrades, SMEs have no choice but to use their own funding.

As a result of limited financing in the supply side, a financing gap has occurred in SME sector of Myanmar economy and this effectively limits their growth and competitiveness. Financing gap pertains to the financing requirements of a business sector that cannot be fulfilled by formal financing sources of the economy. Since most of the SME owners cannot afford to spend a large amount of money to buy fixed assets or for use in business development, there is a wide financing gap in the area of long-term investments and, to some extent, working capital requirement. There is also a mismatch between the supply side and the demand side of financing. The supply side can only offer short-term funds to be used as working capital, whereas the demand side requires long-term funds for business expansion and further development. Unless this situation can be improved, the development of SMEs has little chance to be realized.

#### **6.4 Lending Infrastructure, Policy, and Institutional Constraints**

Lending infrastructure determines the rights and flexibility of financial institutions to finance SMEs using a lending technology that best fits between the institution and the borrower. It includes: commercial and bankruptcy laws that affect creditor rights and their judicial enforcement; regulation of financial institutions; restrictions on lending; barriers to entry and direct state ownership of financial institutions; information infrastructure including the accounting standards to which potential borrowers must comply; organizations and rules for sharing information; taxes that directly affect credit extension; and other factors that provide the economic environment in which financial institutions may lend in a given nation<sup>67</sup>.

This lending infrastructure greatly affects the availability of credit for SMEs in financial institutions and the lending technology used by these financial institutions. Lending infrastructures are greatly heterogeneous between developed and developing countries as well as from one developing country into another. Lending infrastructures

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<sup>66</sup> As mentioned above, private banks are only allowed to make short-term loan. Although there are some development banks like MIDB, MICB and MADB (Myanmar Agriculture Development Bank), they also make short-term loans to customers. There is also no interest rate differential between development banks and private banks at present.

<sup>67</sup> See more details in Berger and Udell, *"A more Complete Conceptual Framework for SMEs Finance,"* 2004.

can explain why lending technologies used, the flexibility of financial institutions, and SMEs credit availability are greatly different even among developing countries.

Without improving lending infrastructure in the country, no new sources of financing for SMEs will be successfully introduced. As discussed in previous sections, the lending infrastructure in Myanmar is relatively poor in many aspects. Banks in Myanmar do not accept as collaterals anything other than a fixed charge on titled real estate. However, many landowners in Myanmar do not possess legal titles of the properties they own or occupy. Registering process for a land title takes much time. The absence of such land title is an impediment in SMEs' effort to access bank financing.

Concerning creditors' rights, Myanmar does not have separate bankruptcy law. The provision for bankruptcy is only included in the Myanmar Company Act (1914) as a subsection. When insolvency occurs, solving it through court proceeding takes much time; it may even more than a year and a costly affair. Therefore, most of the insolvency cases are resolved by means of informal negotiation between debtors and creditors. Consequently, creditors are very reluctant to make loans without collaterals.

Strictly controlled by Central bank and restrictive financial measures greatly restrict the flexibility of the banks. Central bank does not issue new banking license after 1997. As a result, there is small number of banks in Myanmar relative to its population and number of businesses. This retards supply of financing to business sector and reduce competition to offer better services among the banks. Banking regulations require borrowers have to present Company registration, Industry license, business license, tax and insurance registration certificates that make difficult for the banks to lend SMEs without complete documentations as well as it also creates lengthy time and costly to complete full set of documentations for the borrowing businesses.

Due to the policy of the central bank on controlling the interest rates of commercial banks, these banks cannot raise the interest rate depending on the level of perceived risks on the borrowers. That is why banks only give loans to established SMEs rather than the small and startup SMEs, because they have to charge the same interest rate regardless of how small or large this SME is and how much risky it is to lend to an SME.

In terms of business registration, SMEs formed as limited companies must register with the Company Registration Office located in NayPyiDaw. In addition, they also need to obtain other licensing requirements for the application of bank loan, such as industrial license from the Ministry of Industry (1), business license from local municipal authorities, fire certificate, and insurance certificate. Company registrations remain valid up to two years and must be renewed thereafter. Registration fee is one million kyat (approximately \$800 for two years). It is a rather big amount for SMEs in

Myanmar. Other fees paid for various licenses and permissions are also a rather big financial burden for them.

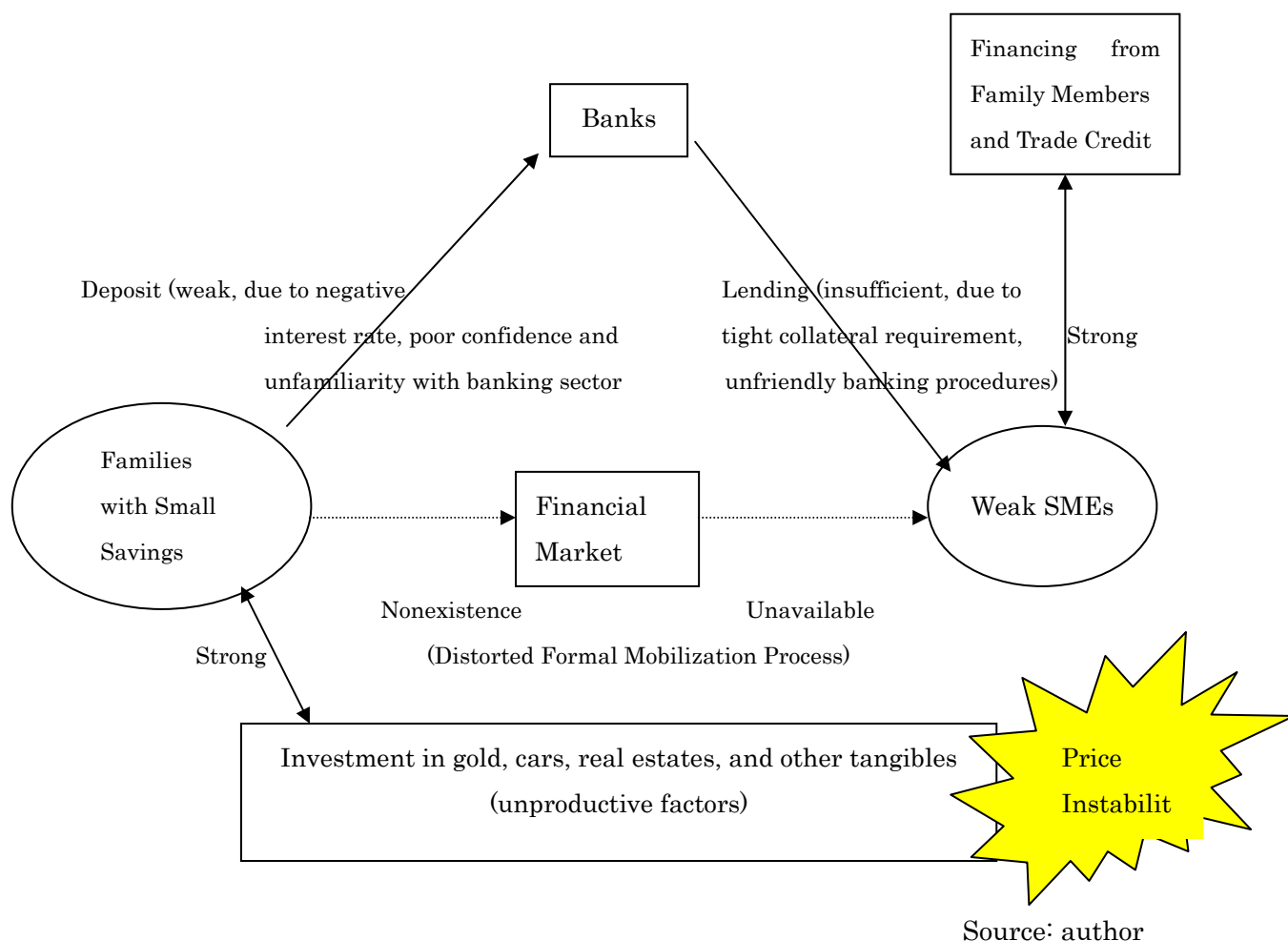
There is no centralized registration agency covering all business or company registrations. Every transaction is handled by separate ministries or departments, so SME owners have to separately go to each and every department. In order to get bank loans, SMEs need to present to the banks a full set of the above-mentioned documents. This would often result in additional transaction costs, administrative burden and create confusion for SME owners.

There are also many unregistered small businesses (including cottage industries) in Myanmar. As a consequence, they are not eligible to avail of bank financing. They have to turn to informal sector financing (gray market) for their additional financing requirements. These various registration requirements, poor coordination among government departments, and onerous administration procedures lead to high cost of financing and in turn, high cost of doing business in Myanmar.

Macroeconomic variables, like inflation, greatly limit the growth of the banking sector and the financing access of SMEs. The inflation rate ranged from 20 percent to 40 percent during the last decade. Inflation rate is above nominal interest rate, which caused negative interest rates for deposits in real term. Due to negative interest rates, people are reluctant to deposit their money in banks. They prefer to use their savings in inflation-floating items such as gold, foreign exchange, and cars. As people savings are not channeled to banks, bank deposits and consequently, bank lending activities to business sector have declined. This situation retards the development of banking sector and improvement on financing to business sector particularly to SMEs.

There are no other formal mobilization processes from savings to investment like financial market. In Myanmar's situation, there are many households with unused savings on one hand and many SMEs that hunger for financing on the other hand. These two need to be effectively integrated with a formal intermediation process. Due to weak banking sector and lack of formal mobilization process at present, household savings leak to the unproductive sectors like gold, real estate, apartments, and motorcars. This situation has led to price instability and created uncertainty in the business environment. People normally want to hold on to such assets to be used as inflation-hedging mechanisms. The pictorial representation of this situation is shown in Figure 2.

**Figure 2 Present Pattern of Domestic Capital Mobilization Process in Myanmar**



From the institutional aspects, the present number and the type of financial institutions are not sufficient to provide adequate financing to business sector. There is a large room for improvement in terms of the number of banking and non-banking institutions in Myanmar. Moreover, banking facilities and techniques, qualifications of human resources, and mindset of people in the banking sector need to be changed and improved. Non-banking institutions, like savings and loan associations and rural development funds (as in the case of Thailand), need to be existence to reduce SME financing gap. To improve SME credit availability, credit insurance and guarantee funds need to be developed and promoted. National credit bureaus need to be established in order to provide support for loan decision making and better support for SMEs. Checking and bill discount culture within the business sector needs to be nurtured and promoted. Banking regulations should be prudential but should not be restrictive insofar as the development of financial institutions.

## VII. SME FINANCING IN ASEAN COUNTRIES AND JAPAN

In the past few years, SME financing was not a priority policy area for the government as well as the banks in ASEAN countries. However, the more governments recognize the economic role of SMEs and change the paradigm in the competitive environment of banking business, the more they are forced to focus their attention onto this sector. As a result, governments will encourage SME financing as a priority area to strengthen SMEs in their countries. Banks also adopt new technologies to make profitable business dealings with the SME sector.

In general, SMEs are placed in disadvantageous position with respect to financing because of their inherently weaknesses in: (1) information asymmetry; (2) lack of transparency; (3) high perceived risk and transaction costs; and (4) weak governance structure. Information asymmetry and lack of transparency are caused by the lack of financial information due to incomplete accounting records regarding their business and inability to establish close relationship between banks and SMEs. High perceived risk and transaction costs arise from inadequate collateral and high NPL history of SMEs and small amount, plus the fact that large-volume transactions from this sector need to be handled by banks. The management of SMEs is often dependent upon the expertise of a single person, informal relationship in dong business and mixing roles in decision making result in weak governance structure for SMEs.

Nonetheless, SME sector now has been seen as a potentially large profitable area by many financial institutions including banks. Consequently, various new technologies have been developed to successfully deal with this area and to access the right level of risks and opportunities of SMEs as objectively as possible. These technologies help financial institutions to view financing SMEs as a business opportunity and develop ways to resolve the opaqueness of SME financing.

### 7.1 Common SME financing methods and programs in Asian countries

Generally, there are six lending methods available in SME financing, of which five belong to transactional-based lending technologies and where trade credit is included in relationship lending technology <sup>68</sup>. The difference between these two lending methodologies depends on whether banks use hard information (mainly from financial statements and objective analysis on the borrowers) and soft information (off-balance sheet information and information from personal sources) in making loan decisions.

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<sup>68</sup> Inter alia Berger & Udell, *A more complete conceptual framework on SMEs financing*, 2004 pp 20-27

There are some additional lending programs sponsored by financial institutions and governments and which are designed to enhance SME financing requirement such as import trade financing, export trade financing, credit guarantees, government subsidies, venture capital, and securitization of loans. Although most of these methods originated from the United States and other Western countries, they are widely used in Asia and some ASEAN countries like Japan, Singapore, and Malaysia. The five transactional-based lending technologies involve financial statement lending, small business credit scoring, asset-based (collateral-based) lending, factoring, and leasing<sup>69</sup>.

Relationship-based lending technology is designed to address information problems that are not feasible or costly, cannot be effectively solved by transactional lending technologies, and most likely to be found in the environment with poor lending infrastructure. Under this technology, the primary information used by lenders is based on the soft information about the borrower. Such information is largely generated from the close relationship between the lender and the borrower. Relationship lenders collect information beyond that which is available in the company financial statement. The lenders acquire such information as proprietary information and make the loan decision based on it. Because it is labor-intensiveness in nature, relationship lending is likely to be more costly than transaction-based lending technology. These costs may be passed onto the borrowers in the form of higher fees and higher interest rates. However, in Myanmar where interest rates are strictly controlled by the central bank, such practice of passing on these costs is not possible.

Trade credit is a widely available form of SME financing especially in an environment with weak lending infrastructures, as in the case of many developing countries. Soft information and mutual trust between borrowers and lenders play a key role in trade credit. Trade credit is particularly important in economies with weak financial systems. Figure 3 shows the spectrum of lending methods available for large and small financial institutions based on the type of environment.

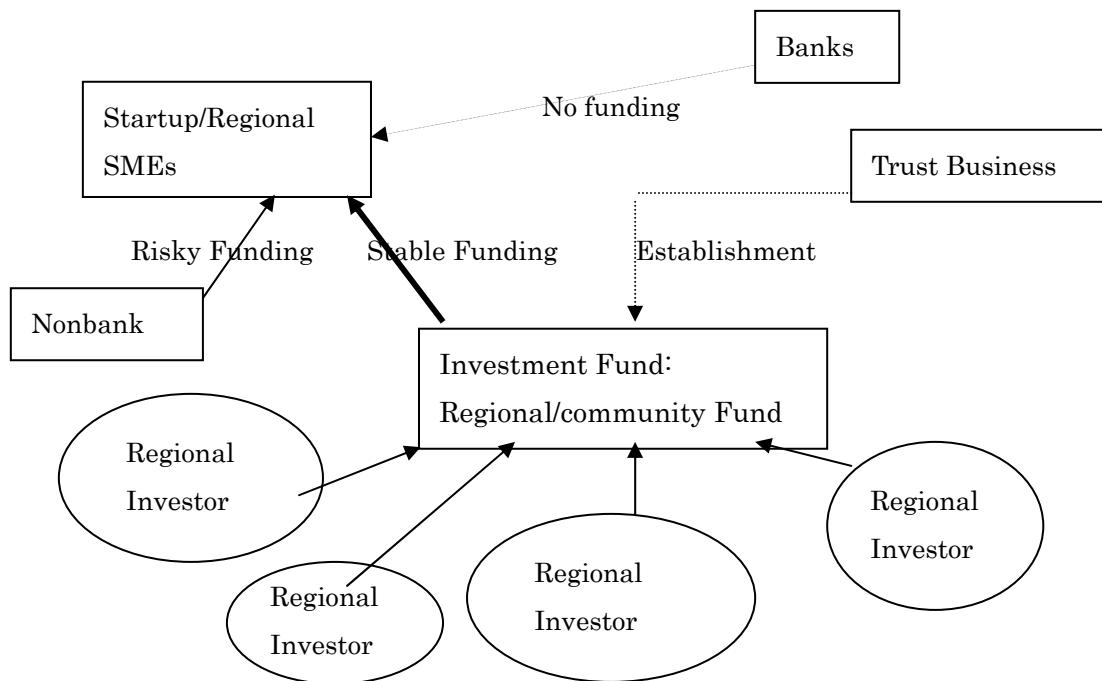
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<sup>69</sup> Ibid.





**Figure 4 Regional/Community Funds for SMEs**



*Source: Mamiko Yokoi Aria and Naoyuki Yoshino, Concept of Competitiveness in the Financial Sector*

The most sophisticated financing scheme for SME sector is securitization of SME loans through capital market. It is now adopted in Japan and Singapore to some extent, by combining credit guarantee scheme with sharing the risks arising from lending to SMEs. Under this scheme, a loan to an SME is securitized to distribute the risk of the original loan and attracting investors with a variety of risk appetite. The secondary market development could greatly improve the liquidity of such securities and give greater scope to SME loans as well<sup>71</sup>.

Japan has overcome the problem of banks' unwillingness to give loans to SMEs by providing credit guarantees in exchange for financial information from SMEs. The Credit Guarantee Association (CGA) extends credit guarantees to SMEs that borrow from banks. SMEs that receive such credit guarantees must submit their financial information to the Credit Guarantee Association. Based on this information, the CGA compiles the Credit Risk Information Database (CRD) which, in turn, can be used by banks providing loans to SMEs<sup>72</sup>.

Though it is difficult to implement such extended financing programs in

<sup>71</sup> Mamiko and Naoyuki, "Concept of Competitiveness in the Financial Sector" 2007. p. 24

<sup>72</sup> Ibid., p. 25

developing countries like Myanmar in the short term, they can be helpful in their policy consideration for development and better access of SMEs to financing in the long term.

## 7.2 Sources of SME financing in Myanmar and ASEAN Countries<sup>73</sup>

ASEAN countries have been actively promoting SMEs in recent years. Their governments offer grants, tax breaks and holidays, creation of development financial institutions and extend various business development services to enhance the competitiveness of national SMEs.

The credit guarantee scheme is a popular mechanism to facilitate SMEs' access to bank financing. Credit guarantee schemes and export financing schemes have been in practice in Malaysia, Thailand, Singapore, and the Philippines for many years. Guarantee schemes are important means to facilitate access to financing for a viable SME with no adequate collateral. It is available in all ASEAN countries, except in Myanmar, the Lao PDR, and Cambodia. Programs and schemes initiated by the government of ASEAN countries are shown in Table 3.

**Table 3 Types of Government Programs and Schemes for SMEs in ASEAN**

Country	Grant/ Incentives	Loan/fund Scheme	Guarantee Scheme	Tax Breaks	Development Financial Institutions	SME Bank
Brunei	-	/	/	/	-	-
Indonesia	/	/	/	/	/	-
Malaysia	/	/	/	/	/	a
Philippines	/	/	/	/	/	-
Singapore	/	/	/	/	/	-
Thailand	/	/	/	/	/	/
Vietnam	-	/	/	-	/	-
Myanmar	-	-	-	-	/	-
Cambodia	-	-	-	-	/	-
Lao PDR	-	-	-	-	/	-

Source: RAM Consultancy Services 2004

*Note (a): Now Malaysia has already set up SME bank since October 5, 2005*

<sup>73</sup> Interalia RAM Consultancy Services Sdn Bhd, "SME Access to Financing: Addressing the Supply Side of SME Financing," 2005

Developmental financial institutions (DFIs) have played only a minor financing role in ASEAN countries. Myanmar also has DFIs such as the Myanmar Industrial Development Bank (MIDB) and the Myanmar Agriculture Development Bank (MADB). However, they have limited reach and capabilities in providing developmental financial services to SMEs.

The banking sector of the ASEAN-6 (except CLMV) offers a wide range of short, medium-term and long-term credit and various supplementary financing instruments, including trade credit, export financing, factoring, and discounting.<sup>74</sup> In a survey conducted by RAM Consultancy Services in 2004, 71 percent of 52 respondent banks in the ASEAN-6 have a unit specializing or focusing on SME financing, with some banks wholly devoted to SME lending. By contrast, 70 percent of banks in the ASEAN-4 do not have a special unit dedicated to SME. Accordingly, no banks in Myanmar have a special unit for financing SMEs.

Concerning the duration of SME loan, over 70 percent of financing instruments in Lao PDR are short term, while in Vietnam, 55 percent is short term and 22 percent is medium term. In Cambodia, only 20 percent is short term and the remaining 80 percent is medium term. However, in Myanmar, 100 percent of SME loans are short term. Table 4 shows the distribution of loans by duration in ASEAN bank.

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<sup>74</sup> Ibid p.9

**Table 4 Distributions of Loans by Duration in ASEAN Banks**

SME Loans	ASEAN-6					
	Brunei	Philippines	Malaysia	Singapore	Indonesia	Thailand
Overdraft/	-	-	19.0%	-	-	28%
Revolving	-	41%	13.3%	-	16.46%	13%
Short-term	-	46%	36.0%	-	79.39%	24%
Medium-term	-	13%	33.0%	-	7.15%	31%
Long-term	-	-	-	-	-	4%

SME Loans	CLMV			
	Cambodia	Lao PDR	Myanmar	Vietnam
	Overdraft/	-	-	-
Revolving	-	-	-	-
Short-term	20%	77%	100%	55%
Medium-term	80%	18%	-	22%
Long-term	-	5%	-	15%

Source: RAM Consultancy Service, 2004 (Myanmar data were supplied by author)<sup>75</sup>

Collateral-based lending is the most common method adopted by banks in CLMV, while other transactional lending methods prevail in the ASEAN-6. On average, 85 percent of SME loans were secured throughout ASEAN in 2004. The most common form of security is plant and property, followed by home mortgage. Factoring, trade credit, and other forms of financing are available for SMEs in ASEAN. In Myanmar, the most common form of security is home mortgage, followed by plant and equipment. Table 5 shows percentage of secure and unsecured SME loans in ASEAN banks.

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<sup>75</sup> RAM Consultancy Service Ltd made survey and analysis SME financing of ASEAN countries between 5 Dec 2004 and 22 Jan 2005. However, their study could not cover Myanmar, So Myanmar data in the tables are those provided by author.

**Table 5 Percentages of Secure SME Loans and Unsecure SME Loans in ASEAN Bank**

		2004		2003		2002	
		Secure	Unsecur e	Secure	Unsecur e	Secure	Unsecur e
ASEAN- 6	Brunei	-	-	-	-	-	-
	Philippines	85%	15%	80%	20%	50%	50%
	Malaysia	73%	28%	80%	20%	80%	20%
	Indonesia	100%	0%	100%	0%	100%	0%
	Thailand	93%	7%	93%	7%	94%	6%
CLMV	Cambodia	100%	0%	100%	0%	100%	0%
	Laos PDR	67%	33%	-	-	-	-
	Myanmar	100%	0%	100%	0%	100%	0%
	Vietnam	77%	23%	94%	6%	92%	8%

Source: RAM Consultancy Service 2004 (Myanmar data is included by author)

In order to evaluate loan application from SMEs, banks demand various documents, including business plans, financial statements, and proofs of asset ownership and income. Banks in the ASEAN do not automatically reject loan applications of those that cannot fulfill the required documents<sup>76</sup>. They approve the loan but attach some conditions, find alternative evidence of creditworthiness, or assist the borrower in preparing the necessary documents. But in Myanmar, banks automatically reject loan applications that do not meet the criteria determined by the bank<sup>77</sup>.

The average time taken to process a loan application in ASEAN countries is between 15 days and three months. In Myanmar, processing time for most private banks is less than one month; it takes one to two months for state-owned banks. In the ASEAN-6, banks rely on various sources of information in order to evaluate the appropriateness of SMEs loan. On some occasions, banks share information with other banks to determine and appraise creditworthiness of a particular SME. In Malaysia, Thailand, and the Philippines, banks can access some information on SMEs from central database either maintained by the government or by private information providers. Malaysia, Thailand, Indonesia, Singapore, and Vietnam have established central credit bureaus, operated by either government or private sector, to provide

<sup>76</sup> Ibid., p. 16

<sup>77</sup> Interview with bankers from MIDB and some private banks by author (2005)

required information to financial institutions. Such kind of central credit bureaus are non-existent in Cambodia, the Lao PDR, Brunei, and Myanmar. Databases on SMEs or industries maintained by government agencies consist of just the number and raw data, like capital employed and number of workers. These are thus unreliable references when assessing the creditworthiness of a particular SME.

Venture capitalists play active role in financing SMEs in the ASEAN-6, including Thailand, Malaysia, and the Philippines. The availability of venture capital in CLMV is limited. In Myanmar, venture capital is virtually non-existence. Mekong Capital Ltd undertakes venture capital activities in Vietnam, the Lao PDR, and Cambodia. In Vietnam, there is another venture capital, Vietnam Enterprise Investment Ltd (VEIL) managed by Dragon Ltd. These two venture capitals both aim to invest in larger SMEs.

As to the other credit facilities offered by banks to SMEs, trade credit, equipment leasing, and factoring are available in most ASEAN countries. In terms of the portfolio, term loan is the dominant facility offered to SMEs in ASEAN. It comprises 50 percent of all credit facilities in the Philippines, Malaysia, and Thailand, and 65 percent of SME loans in Vietnam banks<sup>78</sup>. Factoring and leasing are less- common facilities offered by banks to SMEs. Trade financing is more popular than factoring in ASEAN countries. In Myanmar, banks offer only short-tem loans to SMEs and no other facilities such as trade credit, leasing, factoring, and revolving loans are available (see Table 6).

**Table 6 Types of SME Financing Facilities Offered by ASEAN Banks**

		Term Loan	Trade Financing	Revolving Loans	Factoring	Leasing	Others
ASEAN-6	Malaysia	43%	31%	17%	0%	3%	7%
	Thailand	50%	5%	37%	2%	0%	6%
	Philippines	55%	32%	9%	1%	1%	4%
CLMV	Lao PDR	10%	20%	45%	25%	0%	0%
	Vietnam	65%	8%	7%	0%	2%	0%
	Myanmar	100%	0%	0%	0%	0%	0%

Source: RAM Consultancy Service, 2004, (Myanmar data are supplied by author)

Due to poor arrangements in formal sector financing, the informal sector has become the main channel of credit for SMEs in CLMV. The informal sector is made up of lenders from family and friends, savings and credit associations, and money lenders

<sup>78</sup> Report by RAM Consultancy Service Ltd (2004), p. 20

(gray or black markets)<sup>79</sup>. In Vietnam, informal channels finance up to 70 percent to 80 percent of SME needs. Among the available sources of financing in Cambodia, the Lao PDR, and Myanmar, the main channels of funding consist of family and friends as they are easier to approach. If SMEs borrow from gray markets, they have to pay higher interest rates—as much as 20 percent per month for loans without collaterals.

With globalization and speedy economic integration, intra- and inter-regional competitions among nations become tighter than ever. In order to sharpen national competitiveness in global market, governments of ASEAN countries rely more on the competitiveness of their SMEs in the private sector even as they continue to reduce their reliance on inefficient SMEs. Now these countries have dynamic, export-oriented, and internationally competitive SMEs. As the main engine for economic growth, ASEAN countries continually develop and promote their SME sector with various promotional tools such as strengthening inter-firm linkages, offering various kinds of business development services, improving technological innovativeness, and particularly improving financing access. Now, leading ASEAN countries have adequate formal sector arrangements for SME financing, which are suitable to their financial requirement for each stage of SME development.

In this comparative analysis on Myanmar and its counterparts in the ASEAN countries, it can be seen that the gap between Myanmar and other ASEAN countries especially with ASEAN-6 is too wide in the area of SME financing. Formal arrangements for SME financing in Myanmar lag behind other countries in the ASEAN region, even within CLMV. Inadequate formal sector financing sources, together with other various obstacles, are major impediments to further development and growth of SMEs in Myanmar. If no appropriate corrective actions in this area are done, the gap between dynamic and competitive SMEs in other ASEAN countries and the traditional and locally focused SMEs in Myanmar will be further widened and affect the national economies as well.

### **7.3 Models of SME financing in Thailand and Japan**

In Asian countries, Japan, Taiwan, and South Korea boast of best practice models in SME development. Within ASEAN, Singapore, Thailand, and Malaysia also have their own models in promoting SMEs. In the area of financing, they provide various channels and sources of funds to cater to the different needs of SMEs in their countries. In this section, Thailand and Japan models on SMEs financing is presented to provide inputs on the efforts to develop a successful SME financing program for Myanmar in the

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<sup>79</sup> Ibid., p.21



future.

In Thailand, SMEs represent 99.7 percent of total registered enterprises. In 2002, they contributed about 70 percent of employment and 40 percent of GDP and exports. As such, their role is very important in Thailand's economy. Accordingly, Thailand government has regarded SME sector as an engine for sustainable economic growth after the 1997 Asian economic crisis. In 2000, the Small and Medium Enterprises Promotion Act was enacted with the aim to promote SMEs. Subsequently, the national plan for SME promotion (2002-2006) was launched in 2002 with explicit objectives, as follows:

- Increase contribution of SMEs to the national GDP to 50 percent by 2006;
- Increase employment in SME sector by 181,700 employees a year;
- Reach a minimum growth of 6 percent in export value in SMEs, or 436.5 billion bath, by 2006;
- Increase the number of SME businesses by 50,000 a year; and,
- Reach a minimum increase of 10 percent per year of professional groups with entrepreneurial capability and have 6,300 business clusters by 2006.

The SMEs Bank was established in December 2002 as a specialized financial institution providing financial support to SMEs and promoting new SMEs. In order to promote SMEs, short-term, medium-term, and long-term financial funding measures have been initiated.<sup>80</sup> The measures were focused on vital aspects, from loans, collaterals, and venture capital to capital market.

The Thai government has taken a major role in providing financial assistance to SMEs by setting target loans provided through the Specialized Financial Institutions (SFIs) and promoting loans provided by commercial banks. Likewise, the government launched the Village Fund Project aiming to alleviate poverty problems particularly in rural areas and to boost economic recovery. This project provides working capital for people and small home industry in villages, amounting to one million baht per village<sup>81</sup>. Bank of Thailand (BOT) is also actively involved in financial assistance programs for the SME sector, which started in 2000. Such financial programs extend to financing the working capital of SMEs by providing low-interest loans.

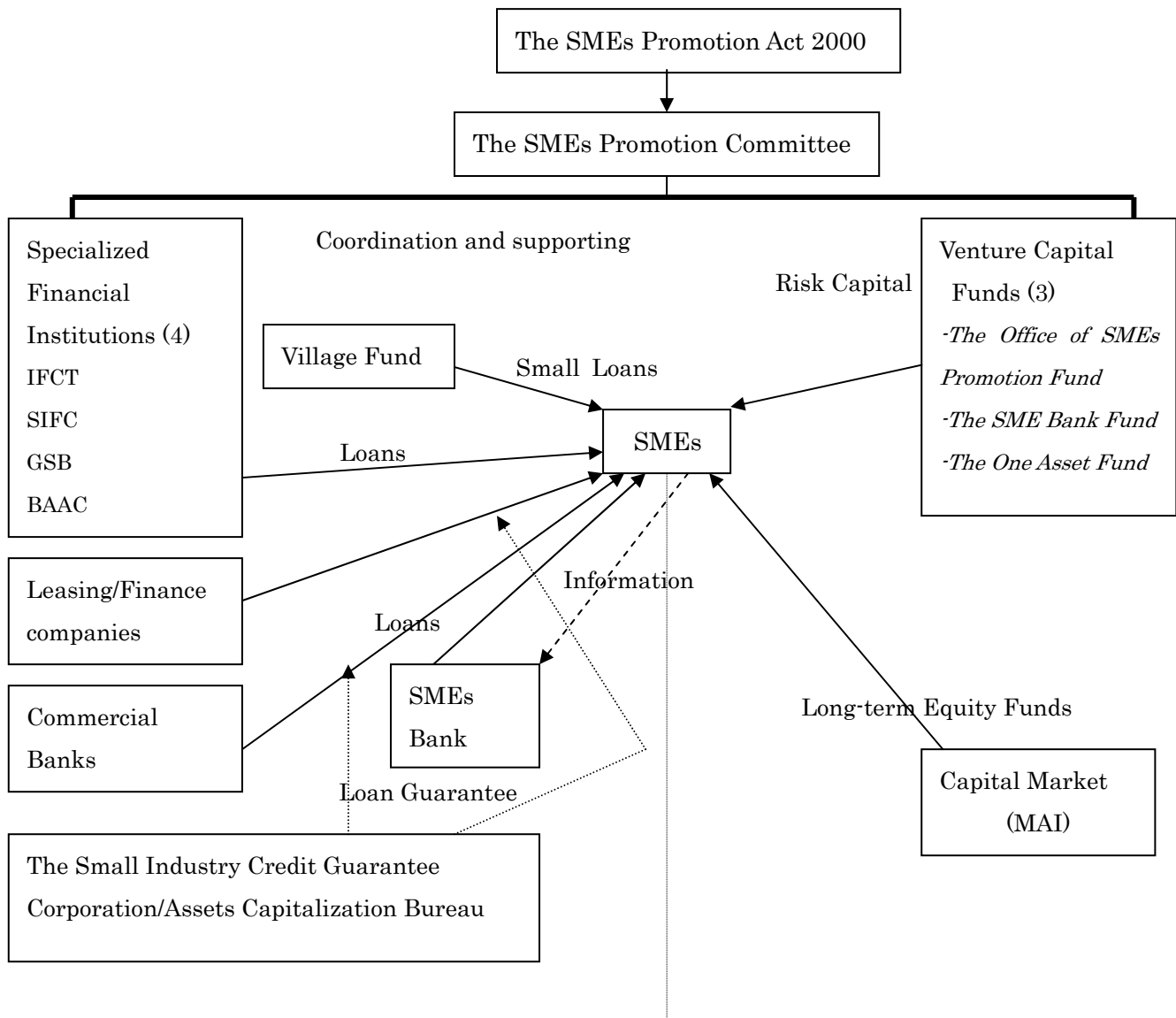
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<sup>80</sup> Chaipat Poonpatpibul and Watsaya Limthammahisorn, "Financial Access of SMEs in Thailand: What are the roles of the Central Bank?" June 2005

<sup>81</sup> This program was launched in 2001 when the government of Thailand promised to provide a million baht (about US\$32,000) to every village and urban community in Thailand and the VRF committees had lent a total of about \$8 billion, with an average loan of \$466 in May 2005.

To provide credit insurance and credit guarantee, the Small Industry Credit Guarantee Corporation was founded in 1991. It provides credit guarantee for the loans granted to SMEs by commercial banks. And also, the Assets Capitalization Bureau was founded in 2003 to lessen collateral problems faced in financing the SME sector. As for equity funding, venture capital funds were established and the stock exchange for SMEs, called Market for Alternative Investment (MAI), was initiated. The government established three venture capital funds and promotes this type of funding by offering tax incentives. The goal is to promote investors who want to invest in SMEs and help them improve their business capability and efficiency. The MAI has started operations since 1999 to provide an alternative funding channel for SMEs and to offer a greater range of investment alternatives for investors. This funding channel allows for lower funding costs compared with bank borrowing. Figure 5 shows a model of SME financing in Thailand.

**Figure 5 Alternative Financing Sources for SMEs in Thailand**

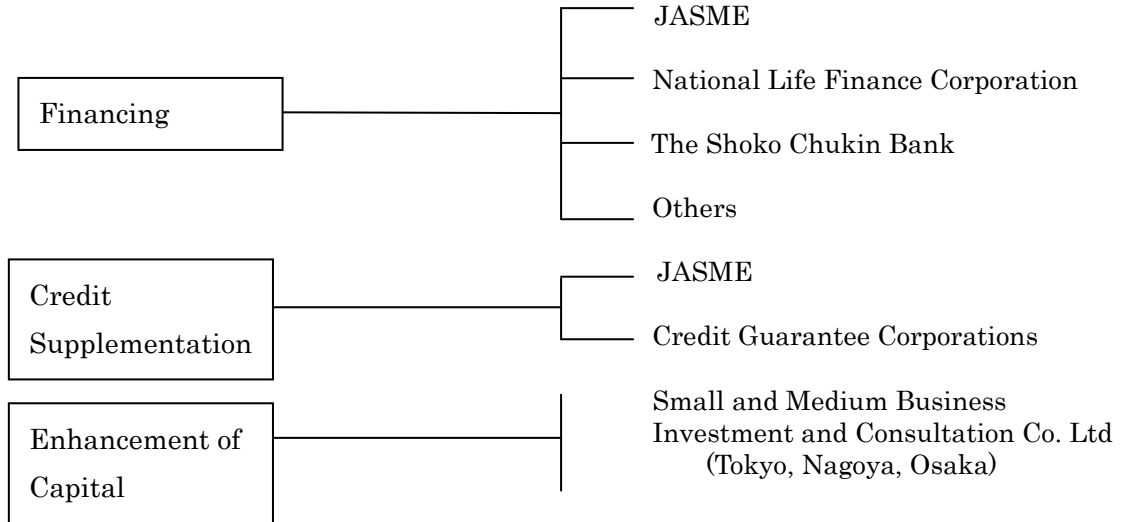


Two credit bureaus in Thailand —the Central Credit Information Service Co. Ltd and Thai Credit Bureau—provide information to make better credit decisions for SMEs. The database is estimated to cover approximately 80 percent of the debtor’s information in the country. The bureaus disseminate both positive and negative information. To create an alternative low-cost financing for SMEs, Thailand plans to securitize loan schemes in the near future.

In Japan, SMEs are considered the foundation of Japanese economy, since they represent 99 percent of all businesses. Every large corporation in Japan, like Toyota, Nissan, Yamaha, Suzuki, and Honda, has strong networking relationships with the SME sector. SMEs contribute over 55 percent to GDP and account for over 70 percent of the total number of employees in Japan. Their support components and supplies to large enterprises are competitive in the international marketplace. Financing is also available from government financial institutions. Private sector financial institutions and cooperatives actively play in financing SMEs, and these contribute 90 percent of total financing in this sector. SME loans are guaranteed by credit guarantee corporations (CGCs) that provide 100-percent guarantee cover on loans made by banks and financial institutions. The CGCs are funded by local government, industry organizations, and financial institutions. The contributions made by financial institutions to CGCs are tax deductible. The CGCs receive further backing from a government-funded credit insurance system that is implemented by the Japan Small and Medium Enterprise Corporation (JASME). All SME loans guaranteed by CGCs are insured by JASMEC, the coverage of which ranges from 70 percent to 90 percent.

Japan practices the scheme of government’s reinsurance on credit guarantee for loans made to SMEs. The objective of this scheme is to facilitate financing SMEs by distributing the risk that arises from lending SMEs among various institutions in the financial system. Figure 6 shows three financial measures for financing the SME sector in Japan.

**Figure 6: Three Systems of Financial Measures for SMEs in Japan**

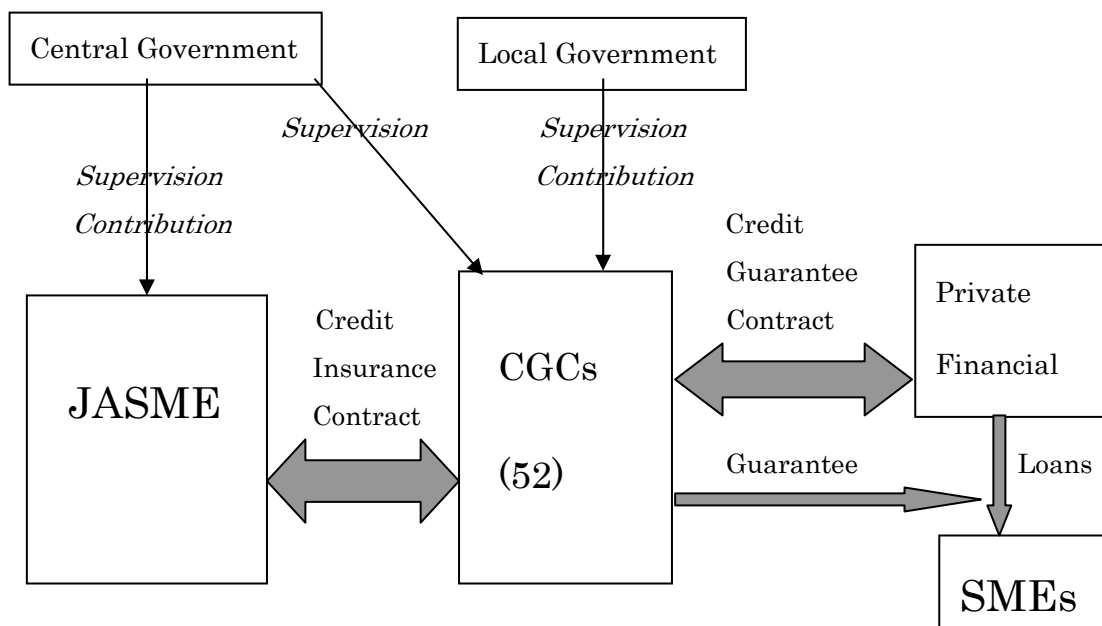


*Source: Osamu Tsukahara (2005)*

JASME was founded in 1953 and it plays active role in financing SMEs by initiating three business programs, namely, loans programs, credit insurance programs, and securitization support programs.

The Japanese practice of credit supplementation combines credit guarantee and credit insurance simultaneously, as shown in Figure 7.

**Figure 7: Credit Supplementation System in Japan**



┌──────────────────────────────────┐  
Credit Insurance System

┌──────────────────────────────────┐  
Credit Guarantee System

*Source: Osamu Tsukahara (2005)*

Under this system, loans made to SMEs by private financial institutions are guaranteed by credit guarantee corporations (there are 52 CGCs in Japan at present) up to 100 percent. The guarantee arrangements are again reinsured by JASME up to 80 percent of insurance payment. Central governments and local governments also monitor and supervise these institutions and arrangements to ensure the proper functioning in the area of SME financing. JASME also conducts three types of securitization support programs, namely, purchase type, guarantee type, and synthetic CBO type (by accepting unsecured loans extended to SMEs or unsecured bonds issued by SMEs and securitizing them). It is also actively making direct financing to SMEs<sup>82</sup>.

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<sup>82</sup> Osamu Tsukahara, *Recent Development in SME Finance in Japan*, JASME, July 2005

## VIII . PROPOSALS AND SUGGESTIONS FOR IMPROVING SME FINANCING IN MYANMAR

### 8.1 Suggestions for policy considerations

#### *Government's policy on SME financing*

Economic development is the ultimate objective of every government in the world. Toward this end, industrialization is viewed as a phenomenon that plays a very important role in the economic development of a country.

In Myanmar, every successive government tried to achieve industrialization ever since the country gained independence, but they failed in this area. The strategy they mainly used was state-led industrialization with import substitution sentiment. So, the effectiveness of this strategy should be revisited. The development histories of Japan, Taiwan, Korea, and Hong Kong, as well as the very recent success stories of Thailand, Malaysia, and even Vietnam also show that private sector plays a key role in industrialization efforts. In the 1960s, Southeast Asian countries like Malaysia, Thailand, and Indonesia, even though they adopted import substitution strategy in the past, abandoned such strategy and shifted to export-oriented strategy. They have achieved private sector-driven economic growth since then.

Combined with the lessons in the past and learning from the experience of other countries, an industrialization effort through private sector development may be the only viable strategy for Myanmar economic development. This change in the sentiment of policy makers may lead to changes in resource allocation between private and public sector development.

At present, the government of Myanmar encourages private-sector participation in the economy and recognizes their role in industrialization and economic development. However, present efforts and institutional arrangements provided by government seem insufficient to help private sector industries gain momentum in their development process.

As discussed in Section 4, government budget is dedicated to subsidizing inefficient SEEs. Some policy considerations should be made here. First, government should speed up the privatization process of inefficient SEEs. Instead of subsidizing inefficient SEEs, these funds should be channeled to set up a specialized SME funding to assist efficient SMEs in the promising business industries. National SME promotion funds may be set up to finance SMEs through credit guarantee schemes for SMEs loans

granted by private banks or direct lending through government-owned special financial institutions. The strategy should aim to promote SMEs instead of subsidizing them. The rate of interest charged for loans should be in line with the existing market rate, and such interest rate should also be liberalized. The objective is to facilitate easy financing access for SMEs that show development potential. With the support of government, the situation needs to be changed from unavailable financing to available financing and then to easily accessible financing for SMEs.

Export-oriented SMEs should be given priority in providing loans, to finance their activities without collaterals (or at least partial) and backed by state guarantee. In this way, the government may target industry based on their strategic importance and export performance. Funds should be made available on long-term basis, should be business friendly, and require less collateral from these industries, in order to provide adequate investment for business expansion and growth. The effective risk allocation system among government, banks, and entrepreneurs should be implemented through credit guarantee schemes to provide financing for SMEs that show potential for development.

Second, the government should attempt to boost efficiency of SEEs in some product categories, where SMEs in the private sector cannot produce efficiently, even as it speeds up the privatization process of inefficient SEEs in other sectors. It should also realize that the markets for products that SEEs produce (foodstuff, textile and household appliance) are already saturated by the proliferation of products from local SMEs and imported products from neighboring countries. This will lead to a no-win situation of a head-to-head competition between SEEs and SMEs in the domestic market. To avoid this situation, SEEs should diversify into products that SMEs cannot produce efficiently because of technology and capital constraints, such as diesel engines, personal computers, heavy machineries and equipment, etc.

Third, the relationship between SEEs in the public sector and SMEs in the private sector is very rare in the form of backward or forward linkages. SEEs have large capital investments and take the lion's share of large-scale enterprise niche in Myanmar, while SMEs dominate the small-scale enterprise niche. These two sectors should be effectively integrated by means of inter-company relationship. For example, SMEs can serve as services and input providers or output distributors for SEEs. The public sector enterprises should only specialize in projects that require heavy capital investment, high-technology, and specialized skill where SMEs cannot afford to invest in. The inter-company relationship between SEEs and SMEs should be promoted. Technology diffusion process between these two should be encouraged. In this way, both will prosper and the national objective of industrialization will be achieved in the long-term.

### ***Policy on financial sector development***

As discussed in section 6.4, the high inflation rate in Myanmar is one of the major impediments in financial sector development and, in turn, in SME financing. So, the government should keep inflation rate in check and maintain it within the one-digit range by adopting effective macroeconomic measures. Higher inflation rate results in a negative interest rate, and that leads to lower saving and deposit rate in the financial sector. Again, it hampers capital accumulation and bank financing efforts for the business sector.

Higher inflation rate also causes higher interest rates and this, in turn, leads to high investment cost for businesses. The government should then adopt prudential but not overly restrictive policies for the banking sector. The tightened control over private banks may damage their efficiency in the long run. So, the central bank should allow private banks to maintain their own risk management and lending policy for the business sector. Central banks should encourage private banks to provide medium- to long-term loans to the business sector and to diversify the range of services they offer. This is important for the growth of SMEs. Also, the establishment of new banks should be allowed to increase competition, efficiency, and services in the banking sector, while the prudential financial policy is in place.

On the other hand, financial market for effective mobilization of domestic capital from public savings to investment should be fostered and encourage as another source of long-term capital for SMEs and businesses in the private sector. Regulatory and institutional framework for setting up financial market in Myanmar should be further developed and strengthened. Well-regulated and functioning financial market provides a lot of help to stabilize general assets and prices in the economy, offers alternative investment opportunities and income sources, diversifies risks, generates employments, and enhances productivity of the businesses.

### ***Policy on institutional and market development***

Many countries with good SME financing infrastructure have adopted credit guarantee mechanisms as a vital feature in their program. Credit guarantee scheme ensures risk sharing among participants who have a stake SME financing. UMFCCI can play a key role in credit guarantee and insurance scheme, since it possesses intimate knowledge on member businesses. Nonbank financial institutions, such as finance companies, leasing companies, rural funds, and saving and mutual funds are best suited for SME lending, so they should be developed into formal structure, promoted, legalized, and well regulated. These nonbank financial institutions are quite



active in SME lending in Indonesia, and the Philippines. The Myanmar government should then assess the potential of said financial institutions to participate in SME lending and provide these institutions with incentives to allow them to grow, if they show good potentials. The government should also consider the potential of linking banks and nonbank financial institutions so as to promote SME lending. The government should find ways to improve efficiency of the present banking sector, to promote checking and billing culture, and to set up basic infrastructures to develop capital market on a step-by-step basis. Among CLMV, Cambodia recently opened security stock exchange and Vietnam already has two well-developed national stock exchanges (Hochimin City Stock Exchange and Hanoi Stock Exchange).

Myanmar should not delay this process. Regulatory and institutional infrastructures for upgrading financial sector and security market development should be introduced in line with market development.

### ***Policy on strengthening institutional capabilities***

The Myanmar government should initiate the establishment of annual national forum on SME financing. Such forum will serve as a meeting place for bankers, government policy makers, and SME owners where they can discuss specific issues related to SME financing and present issues from each of their own perspective. The objective is to uncover hidden factors that impede SME financing on each side but cannot be easily solved through formal relationship.

The government and the central bank should encourage banks to develop and maintain a lending database on the SME sector. Data on financing such as their business profile, their access to financing, capitalization, number of workers etc should be compiled by each individual bank. These data will be extremely useful in setting up national central credit bureau in the future. This data can also be distributed to all interested parties.

Like the banks, other relevant agencies such as the UMFCCI and industrial authorities should be encouraged to maintain comprehensive database on SME. These data can be compiled and turned into macro level data, such as banking/lending statistics of SMEs in terms of sector/industry/type of product, their NPL rate, etc., as well as company data such as data on financial statements like turnover, profitability, assets, liabilities, etc. The availability of such data clearly eliminates information asymmetry between business and financial sectors. These data will become useful in measuring the effectiveness of SME policy that is currently taken by the government, and they can also serve as inputs for adopting future SME policy.

In order to make easier assessment on the creditworthiness and potential of SMEs

in systematic manner, nationwide and simple accounting standards for SMEs should be adopted by the government in conjunction with the accounting bodies in the nation. The existing sets of standards are rather difficult to meet for SMEs, since many of them do not possess adequate knowledge or capacity. Therefore, a minimum acceptable standard with simple format of accounting should be made available to the SME sector.

## **8.2 Suggestions to improve demand-side conditions**

Suggestions to improve demand-side conditions are designed to directly deal with the problems in the demand side, as discussed in section 6. Lack of qualified collaterals is an important impediment for many SME owners who want to access bank loans, since banks in Myanmar make loans only on a collateral basis. Some business owners possess land and buildings that can be used as collateral, but they do not have the land or building titles. In such case, the government could help by making simple and easy the process of land and building titling.

Banks only grant loans that are between 30 percent and 40 percent of the value of collateral property—this is another constraint for SMEs that want to avail loans. By using credit guarantees on loans to SMEs by government or trade associations like UMFCCL, the amount of credit grant based on the value of collateral property may be increased. Concerning with bank loan, one of the major problems is that SMEs can only access for short-term loans and that these loans need to be renewed annually. This makes high transaction cost and additional administrative burden for SMEs. By allowing private banks to implement their risk management system and to encourage them to grant medium- to long-term loans to SMEs and to diversify the services they offer, this problem could be reduced, if not totally eliminated.

Inadequate financial record keeping, the lack of ability to use accounting information and neglecting the role of accounting and financial information in business decision making are some negative characteristics of SMEs in Myanmar. Some business owners deliberately hide or fail to keep proper accounting records for tax reasons. This leads to the problem of information asymmetry between the businesses and banks.

Banks have no chance to assess the soundness of a business and the quality of business governance that reflect on the proper accounting statements, which can serve as a partial substitute to collateral. To eliminate this problem, business owners should be encouraged to use proper accounting records on their business transactions by educating them to know the benefit of accounting and financial information, by giving them incentives such as tax holidays and easier access to bank loans, by offering accounting courses in the industrial zones, and by setting up simple SME accounting standards. These programs could be made by government agencies in conjunction with

relevant industrial committees and associations in an area-by-area basis.

A well-conceived business plan can serve as a roadmap for a business owner concerning his business activities, a guide for proper allocation and mobilization of available resources, and a way to keep all stakeholders in the business informed on its viability. However, most business owners do not have the ability to prepare proper business plans. A moderate knowledge on management and finance is a prerequisite in preparing a good business plan. So these courses should be offered within the industrial zones or business training schools organized by trade associations and industrial committees. Banks should be encouraged to rely on the business plan submitted by a loan applicant in making loan decisions, that should include the term and size of loans. Programs like seminars and workshops should be initiated to help business owners realize the importance of a good business plan before starting a business as well as throughout the entire life of a business. More importantly, the skills of preparing business plans and project proposals should be taught in business schools and institutes of economics, where students are trained to become business entrepreneurs in the future.

A working knowledge on financial management, especially on how to manage cash flow, is necessary for business owners to be able to maximize the use of money they borrowed from banks. Again, workshops, seminars, and training courses are necessary to introduce such skills and knowledge to businessmen, especially the traditional businessmen in the countryside.

Government and trade associations should initiate moves to build a good relationship between businessmen and bankers by participating in discussions, seminars, and symposiums. By developing a close and good relationship among these players, each side will understand and be able to sensitize the problems and constraints of the other side. This is the best way to reduce lack of understanding banking procedures by the businessmen and use of onerous and unfriendly banking procedures on the part of banks in making loans to business.

By using demand-side remedy programs as discussed above, SMEs owners in Myanmar will become well-qualified customers not only for financing from banks but also from other emerging financing institutions for the SME sector, such as venture capital funds, regional trust funds, and financing and leasing companies.

### **8.3 Suggestions to improve supply-side conditions**

Supply-side problems are caused by the lack of specialized funding programs for the SME sector, tighter regulations on the activities of commercial banks, and the small number of banking and non-banking financial institutions in Myanmar. Like other countries in the region, Myanmar has development banks (Myanmar Agriculture Bank,

Myanmar Investment and Commercial Bank, and Myanmar Industrial Development Bank are examples). They offer loans to their respective targeted industry, but the scope is very limited and long-term loans are not available. In this regard, development financing that specializes on SMEs to fulfill long-term funding needs is urgently needed in Myanmar. Developing specialized SME financial institutions like the SMEs Bank of Thailand and JASME in Japan to facilitate SME financial requirements in all stages is a recommended.

Too much regulation by the central bank in both structural and operational aspects of the commercial banks impedes bank efficiency in terms of SME financing. The banks cannot determine interest rate on their own based on the characteristics of borrowers or borrowing businesses. Loan granted to businesses largely depends on the quality of collaterals. The quality of business is not an important consideration. Once loan decisions have been made, interest rate is the same across all borrowers, regardless of their reputation or creditworthiness or if they are regular customers. Only skill that can assess the value and quality of collateral property is enough to successfully run banking business operations. This can hamper the ability of bank employees in making systematic credit assessment. Therefore, each existing regulation should be thoroughly analyzed to remove those that impede the efficiency of banking operations. Private Banks should be allowed to implement their own risk management system if they meet predetermine performance criteria. The central bank should focus on the surveillance of the efficiency of the whole financial management system and on taking prudential views on any problematic issues in the banking business. It should not focus on the details of the operational aspects of commercial banks. Efficiency of banking operations and competition in the banking business should be encouraged. Promoting new lending technologies, credit assessment skills, diversification on loans, and credit to preferential sectors should also be made. The central bank should also encourage private banks to reduce full reliance on collateral-based lending practices. Private Banks should be allowed to serve other credit facilities, such as factoring, export and import financing, and leasing. And also they should be allowed to make long-term loans to promising business sectors.

Capacity-building programs for private bank personnel should be fostered to accommodate the changing nature of banking operations and offer new services. Credit assessment skills on business proposals and financial statement should be developed and nurtured.

Private Banks should develop closer ties with the SME sector and do away with insensitive banking procedures. They should keep an SME database and learn how to utilize such database in making decisions for new loans. Bank personnel should be

trained in making systematic credit analysis on their borrowers. New lending technology, such as credit scoring, should be initiated and practiced.

The present number of private banks is not sufficient to accommodate the growing demand from the private sector and to promote competition in the banking sector. Thus, new banks should be allowed to enter the field, if they are qualified. Establishment of branches and capital additions by existing banks should be allowed and promoted. Nonbank financial institutions should be encouraged to form under appropriate surveillance measures. Legal and institutional framework should be established to promote fair competition among players in the financial sector and to effectively regulate them.

By undertaking such appropriate measures, alternative sources of financing for SMEs would be expanded and the range of financing services will become wider. These new emerging sources could meet different financial needs of SMEs in each stage of development. In the future, their financing gap could be hopefully eliminated or at least reduced.

#### **8.4 Suggestions to improve lending infrastructures**

Lending infrastructures determine available sources of financing and types of lending techniques that financial institutions offer. Without improving lending infrastructures, no new sources of financing can be introduced successfully. Lending infrastructure includes information and legal environments, judicial and bankruptcy environments, and tax and regulatory environments.<sup>83</sup> The shortcoming in lending infrastructure may restrict the availability of SME credit by limiting lending techniques used by the financial institutions and creating both demand-side and supply-side problems. For example, some transaction lending technologies like financial statement lending and credit scoring cannot be available in a poor lending infrastructure.

Information environment has significant impact on the lending techniques available. Accounting environment is one important aspect of information environment. Without consistent and reliable accounting standards, as well as technically competent accounting personnel and honorable and responsible auditors, financial statement lending cannot be feasible. Myanmar should try to improve this particular aspect of accounting environment. Limited information available from individual banks concerning SMEs, lack of SME information-sharing among financial institutions, and absence of credit bureau limit the use of credit scoring as an effective SME financing technique in Myanmar. Therefore, there is a large room for improvement in this aspect.

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<sup>83</sup> Berger and Udell (2004)

Legal, judicial, and bankruptcy environment also affect lending techniques and type of collaterals covered by loan covenants. In the country with lengthy and costly judicial process, no one wants to go to court in cases of default, so they take extra care in granting loans without sound collaterals. This also leads to a lengthy credit assessing process. It limits the use of movable assets, such as account receivables and inventory, as collaterals. The inadequate provision on bankruptcy process makes it difficult for creditors to take action when a debtor is unable to repay loans. In such environment, factoring, and export and import financing may not be viable options for the lenders. The protection on credit rights and property rights, effective dispute resolution process, and arbitrations on contract law are very important aspects of both financial institutions and venture capital funds.

As discussed in previous sections, Myanmar has a lot of weaknesses in this area that make some lending techniques not feasible. Such limitations on financing SMEs should be assessed extensively and improved in a timely and correct manner.

Taxes and regulatory environment also has a direct effect on SME credit availability. Some taxes do not favor certain types of lending techniques. Experiences of some countries show stamp taxes on factored invoices, and certain types of value-added taxes can have a negative impact on factoring. Enforcement by regulatory authorities to make sure that rules and regulations are complied with is very important to create effective lending infrastructure for SME financing as formulation of rules and regulations themselves.

### **8.5 Suggestions to introduce new lending techniques and financing sources**

As discussed in the beginning of Section 7, there are six lending methods available in the field of SME financing. To improve SME credit availability, there are some additional lending programs that financial institutions and governments initiate, such as import trade financing, export trade financing, credit guarantees, government subsidies, venture capital, and securitization of loans.

Now only asset-based (collateral-based) lending technology is commonly used by both state-owned and private banks in Myanmar. Relationship lending technology is not practiced even though small financial institutions and high context culture of Myanmar favor this type of lending. It may be due to the regulations of the central bank on available lending technologies and the gap between banks and businessmen. Trade credit is commonly used among all kinds of businesses. Export and import financing, leasing, factoring, credit guarantee, and other forms of financing are not found in Myanmar. And also, venture capital funds are totally absent in Myanmar.

To improve sources and size of SMEs financing, present lending infrastructure

need to be improved and government policies that are conducive towards SMEs sector should be adopted. Some of these measures include financial sector reform, tightening monetary and fiscal policy to control inflation, developing and strengthening institutional and market infrastructures and building up existing institutional capabilities. These require medium to long-term effort and commitment by the government. The role of government is essential to improve in all aspects of SMEs development not just on financing. By taking such appropriate actions, nearly all types of lending technology can be available from various types of financial institutions and venture capital funds. This leads to the situation in which SMEs and private sector would be flourished.

In the short term, the appropriate measures for improving SME credit availability are: (1) deregulations on banking sectors to a certain extent (e.g., allowing banks to grant medium- to long-term loans, reducing collateral requirements or allowing new types of collaterals other than premises) to increase their flexibility, allow the emergence of new private banks and non-banking institutions, and bring about new types of banking services; and (2) setting up of a national fund for SME promotion and using this fund to develop credit guarantee and insurance schemes.

These two measures significantly improve supply-side conditions and SME credit availability within one or two years. New lending techniques, such as leasing and factoring, may be available, and account receivables and inventory can also be used as collateral by supporting them with a credit guarantee scheme. New lending programs, such as export financing and import financing, can be made possible in this new context.

In the medium term, the improvement on accounting environment should be emphasized by setting up accounting standard for SMEs, capacity building for accounting firms, distribution accounting knowledge, cash flow management and business plan preparing skills through training courses, workshops and seminars. At the same time, credit assessment skills and capacity building programs for the staffs in private banks should be encouraged. Encouraging them to set up SME data base and initiate to form national wide credit bureau. By doing so, credit scoring method, one of the economized techniques for making large volume and small number of SMEs loans can be used in large financial institutions. Organizing national forum to meet SME owners, bankers and policy makers to discuss and exchange their opinions should also be initiated.

In the long term, the government attention should turn to equity side of SME financing by promoting venture capital and regional and village funds to improve SME credit availability after establishing sufficient lending infrastructures and institutional

capacity in the country. The securitization on SME loans to further SME financing should be initiated after these fundamentals have been completely set up. The government should allow financial institutions to introduce new lending techniques in line with improving lending infrastructures, institutional and market capabilities, and demand- and supply-side conditions. A suggested model of financing SMEs in Myanmar is shown in appendix 3.

All of these SME financing programs should be neatly integrated with other SMEs development programs, such as technological and business development services, in order to effectively implement the whole comprehensive SME development strategy for the nation.



## IX. CONCLUSION

With an increased economic integration, both competition and cooperation among nations are much more intense than ever, both inside and outside the ASEAN region. In order to take advantage of speedy economic integration to achieve economic progress and to sharpen the nation's competitiveness, countries rely more on private sector. Since SMEs represent the lion's share in the private sector in a country, governments focus on promoting their SMEs in all aspects. Their efforts are more apparent in recent years.

ASEAN countries also increasingly cooperate as well as compete against one another in many areas, such as export, FDI, technology, as well as product and market development. As the main engine of economic growth, SMEs can determine a country's competitive position. Weaker SMEs means weaker private sector and consequently, means a weaker competitive position of a nations in the international arena, since no forces can deter the free flow of goods and services in the era of economic integration and globalization. Thus, countries in the ASEAN try to enhance their SMEs' competitiveness and export potentials. They adopt various forms of SME developments programs as a part of a country's development strategy. Financing SMEs is one of the most important aspects of SMEs development programs in every ASEAN country.

SMEs in Myanmar have long been in existence, and they had survived for a long time even in the era of closed economy during the socialist regime. After 1988, they had the chance to play a bigger role in Myanmar's economy. The number of SMEs in Myanmar has rapidly increased soon after the economy was opened to private sector. However, they are facing a number of constraints that deter their further growth. Inadequate financing, power shortage, availability of skilled labor, and increasing prices of inputs are only a few of problems SMEs have to hurdle. At the same time, cheaper imported products from neighboring countries squeeze their market shares. This pressure tends to increase in the future due to liberalization of trade and greater economic integration in the region.

Free entry of products within the country has to be allowed in the near future. This situation could hamper their survival in future because most of the Myanmar SMEs are traditional: they focus on the local market, they are inefficient producers, they already struggle with many difficulties, they have outdated machineries and technologies, and they lack modern management thinking and skills. So their products cannot effectively compete with the products from other countries in the region. This

means Myanmar needs to adopt a rescue program for its SME sector. A comprehensive and effective SME development strategy is urgently needed to deal with the aforementioned problems and to promote SME competitiveness and export potential in this age of greater economic integration.

Myanmar needs to create an enabling environment for its SMEs. For this purpose, it needs to stress on human resources development for SMEs, business clusters development for SMEs, and financing infrastructure for SMEs. SME financing is one of the important pillars in the development of SMEs in Myanmar.

The various surveys on Myanmar SMEs found that financing is one of the major top problems of SMEs. Insufficient financing may create subsequent problems, such as inability to upgrade machinery and skill of workers, as well as lack of business expansion and product and market development. These problems can reduce their efficiency and competitiveness.

The problem on SME financing has been in existence for a while now; it is a deep-seated problem because it is concerned with major policy and macroeconomic issues. The problem exists in both demand and supply sides and macroeconomic fundamentals.

If Myanmar can effectively solve this problem, many barriers that impede SME competitiveness and further development could be eliminated. Therefore, this paper focuses on various aspects of SME financing problems in Myanmar and discusses ways to solve such problems in short, medium, and long terms. By integrating proper SME financing with other SMEs development programs, this paper's author believes that Myanmar can enhance the efficiency and competitiveness of its SME sector and take advantage of the opportunity of greater economic integration in the region for the benefit of the nation.

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## APPENDICES

### Appendix I- Definitions of SMEs in ASEAN Countries

ASEAN Country	Number of Workers	Capital Investment	Assets	Annual Sale
<b>Singapore</b> SME	Less than 200		Less than US \$15 million	
<b>Malaysia</b> Microenterprise Small - Manufacturing - Services Medium - Manufacturing - Services	Less than 5 Between 5 and 50 Between 5 and 19 Between 51 and 150 Between 20 and 50			Less than RM 250,000 Between RM 250,000 and RM 10 million Between RM 200,000 and less than RM 1 million Between RM 10 million and RM 25 million Between RM 1 million and RM 5 million
<b>Thailand</b> Small -Manufacturing and services - Wholesale trade - Retail trade Medium -Manufacturing and services - Wholesale trade - Retail trade	Less than 50 Less than 25 Less than 15 Between 51 and 100 26 to 50 persons 16 to 30 persons	Less than 1.7 million USD \$1.7 to \$4.47 million	- Less than \$0.7 million Less than \$0.7 million - \$0.7 to \$1.4 million	



			\$0.7 to \$1.4 million	
<b>Indonesia</b>				
Small	5 to 19 persons		Less than \$20,000	Less than \$0.1 million
Medium	2 to 99 persons		\$20,000 to \$50,000	\$0.1 to \$5 million
<b>Philippines</b>				
Cottage	1 to 9 persons	\$1.9 to \$28.8 thousand		
Small	10 to 99 persons	\$28.8 to \$287.9 thousand		
Medium	100 to 199 persons	\$287.9 thousand to \$1.15 million		
<b>Brunei</b>				
Small	Less than 10			
Medium	10 to 100 persons			
<b>Viet Nam</b>				
Small	Less than 30 persons	Less than \$65,000		
Medium	30 to 200 persons	65 to 260 US\$		
<b>Myanmar</b>				
Cottage Industry	Less than 9	-		-
Small	10 to 50 persons	Up to 1 million kyat		Up to 2.5 million kyat
Medium	50 to 100 persons	Between 1 and 5 million kyat		Between 2.5 and 10 million kyat
<b>Cambodia</b>				
Microenterprise	Less than 10 persons			Less than \$50,000
Small	Between 11 to 50 persons			Between \$50,000 and 250,000
Medium	Between 51 to 100 persons			Between \$250,000 and 500,000

<b>The Lao PDR</b>				
Small	Less than 19 persons		Less than 250 million kip	Less than 400 million kip
Medium	Less than 99 persons		Between 250 million and 1, 200 million kip	Between 400 million and 1,000 million kip

Note: In Myanmar, one more dimension used to specify SME is power usage, which is as follows:

Power usage below 3 horsepower – Cottage

Between 3 and 25 - Small

Between 26 and 50 - Medium

Sources: <http://web.asiaseed.org/lbps3a/country.html> (accessed on Dec. 11, 2007)

[www.mof.go.jp/jouhou/kokkin/tyousa/0712asiancompany05.pdf](http://www.mof.go.jp/jouhou/kokkin/tyousa/0712asiancompany05.pdf) (accessed on Jan. 21, 2008)

[www.dbj.go.jp/english/IC/service/seminar/datafile/singapor.pdf](http://www.dbj.go.jp/english/IC/service/seminar/datafile/singapor.pdf) (accessed on Jan. 22, 2008)

Private Industrial Law, Myanmar (1990)

## **Appendix II-Myanmar Financial and Banking Sectors**

Up to present, Myanmar has no financial market. Though there are about 20 publicly traded companies in Myanmar, secondary market for stocks trading is almost nonexistent. The first attempt to establish stock exchange in Myanmar has been initiated by Myanmar Security Trading Company Limited (MSTC). It was founded through a joint-venture agreement between Diawa Research Institute of Japan and Myanmar Economic Bank (MEB), but only two public companies, namely, Myanmar Forest Product Joint-venture Company Limited and Myanmar Citizen Bank Limited were registered. Therefore, the scope of its operation is very limited. Myanmar Insurance, a state-owned institution, monopolizes the nonbanking financial service sector as private sector is not allowed to play in this sector. The banking sector is relatively an active part in Myanmar financial sector as a whole.

However, Myanmar banking sector is still highly undeveloped. It had been long dominated by state institutions, and it was only in 1990 that private banks were allowed to set up after the promulgation of the Financial Institution of Myanmar Law. By 2002, there were 20 private banks competing against five state-owned banks. Most of the new private banks, except for four or five banks (Asia Wealth Bank, Yoma Bank, Kanbawza Bank, and Myanmar Mayflower Bank) were small and had limited scope. In their early years, the performance of private banks was quite impressive. The number of private bank branches all over the country rapidly increased up to 350 in 2000. In the same year, private banks accounted for almost two-thirds of savings in Myanmar. This figure was up from 10 percent in 1994.

The Financial Institution of Myanmar Law permits foreign banks to open branches in Myanmar. These offices serve as trade and commercial liaisons for local and foreign clients. However, due to slow business climate and slow liberalization in the banking sector, most of the original 49 foreign bank branches closed shop. There were about 32 foreign banks representative offices located in Myanmar in 2000, and at the end of November 2005, there were only 15 representative offices of foreign banks and three representative offices of foreign insurance companies in Myanmar.

The Central Bank of Myanmar, which is under the Ministry of Finance and Revenue, has the authority to oversee and control banking operations in Myanmar. The state-owned banks in Myanmar are Myanmar Economic Bank (MEB), Myanmar Investment and Commercial Bank (MICB), Myanmar Foreign Trade Bank (MFTB), and

Myanmar Agriculture Development Bank (MADB). In the banking sector, only MEB, MICB, and MFTB are allowed to handle foreign exchange operations. However, most of the foreign bank operations are undertaken by MICB and MFTB. MFTB handles foreign currency transactions of government organizations, businesses, and individuals. MICB primarily deals with companies and joint ventures. MEB handles foreign currency transactions in border trade regions. No private banks are allowed to handle foreign exchange transactions in Myanmar.

The interest rates in the banking sectors are negative in real term due to high domestic inflation. Previously, the Central Bank of Myanmar determines interest rates and allows private banks a 3-percent leeway to set their own rate. For example, the central bank determines interest rate at 12 percent, then private banks are not allowed to set less than 9 percent interest rate for deposit. Similarly, private banks cannot set their lending rate to more than 15 percent. In 2006, the central bank hiked interest rate for deposit and loan up to 12 percent and 17 percent, respectively. All banks are required to determine their interest rates according to this new rate.

Inflation rate in Myanmar ranged from 20 percent to 40 percent for the past years. The banking crisis in Myanmar, which occurred in February 2003, was triggered by the collapse of a series of service firms (so called *A-kyoe-saung*). These companies normally started their business as brokerage firms in real estate and automobile. However, they started conducting informal financing activities (even though this activity was not legally permissible) to many private businesses that do not have financing from formal sector or inadequate financing from formal sector. They acquired funds from public investors by offering very high interest rates of 3 percent to 5 percent per month. Such returns were vastly excessive than the interest rate that banks offered. The investors had little chance to know where to invest their money via these service firms. Most of the service firms lend this money to private businesses with very high interest rate of about 7 percent to 8 percent per month, but it was still lower than informal sector interest rate, which ranged from 10 percent to 20 percent. Most of the private businesses paid the interest and the principal regularly when the business cycle prospered, but during the economic crisis, they could not pay both interest and principal. A crisis emerged, and it quickly extended into the country's emerging private banking sector. Long lines of people in panic could be seen in front of private banks, waiting for their turn to withdraw their money. The banks faced liquidity problems and the required amount of money was partly supplied by the central bank, but was inadequate. Therefore, some measures to limit the amount and number of withdrawals had to be made and loans were recalled whether or not they reached maturity, to solve liquidity problem. The manner of restrictions upon withdrawals and the recall of loans from

borrowers greatly impaired the trust in the banking sector, which is an indispensable ingredient of financial stability. The image of Myanmar's private banks and banking sector had been seriously damaged during the crisis.

Following the banking crisis, most private banks returned to business under strict new central bank regulations, but their operations did not reach the level before the crisis. This situation was further worsened by suspected money laundering activities of two large private banks, which were subsequently shut down by the government in 2005. Also in August 2005, the central bank revoked the license of another private bank for violating the Financial Institution Law. The government enacted anti-money laundering law in June 2002, which required banks to report to the government all suspicious deposits, withdrawals, and transfers above 100 million kyat. By the end of 2005, there were 15 domestic private banks operating in Myanmar's banking sector after three private banks had been shut down by the government and the merger of three other cooperative banks to form a single cooperative public-listed bank.

Outside the formal banking and financial sector, there is the active informal financing sector that exists countrywide. Pawnshops, which acquire licenses from city and township municipal authorities, scatter all over the country. They charge monthly interest rate on small loans, 4 percent or 5 percent on average. Unofficial money lenders charge very high interest rates, from 10 percent to 20 percent per month, depending on the quality of collateral property. For remittance system, most of domestic remittance activities are made through the branches of private banks. In fact, the service fees from the domestic remittance are one of the major sources of revenue for private banks. For foreign remittance, most of Myanmar citizens working abroad use informal and illegal remittance system called *hondi*, since private banks are not allowed to handle foreign exchange transactions. There is much gap between market exchange rate and informal exchange rate in Myanmar (more than 200 times) and 10 percent tax is imposed on all money transfer, so individuals who want to avoid 10 percent export tax and to take advantage of the more favorable market exchange rate use *hondi* to send money to their relatives in Myanmar. The black market *hondi* banking networks exist in all countries where Myanmar citizens are working, such as Thailand, Malaysia, Singapore, Australia, United Arab Emirates, Korea, Japan, Taiwan, China, India, United States, and the United Kingdom. They take the largest share of foreign remittance transactions for Myanmar citizens working abroad. The remittance via *hondi* is relatively more easy and speedy (no document is required, and within 24 hours, money is already sent) than formal remittance system via banking system.

Myanmar people's traditional practice is to keep their wealth in the form of gold, precious stones, and other tangibles such as real estate. Necessary borrowing money

from relatives and private money lenders remained the dominant form of financial services in the informal sector and it was even more strengthened in recent years. This type of culture largely impedes the development of formal sector banking and financial sector.

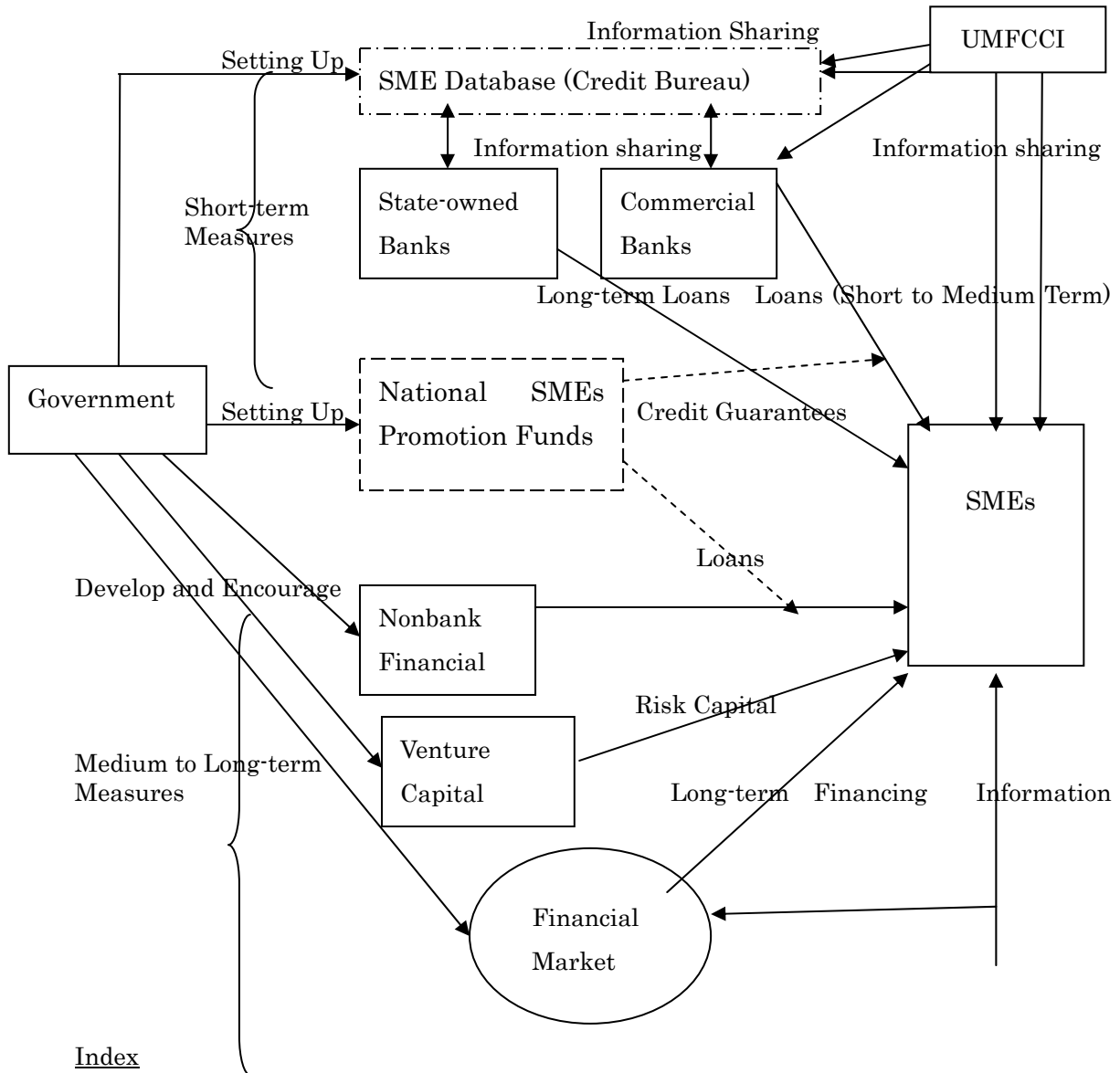
**Table: List of Domestic Private Banks in Myanmar (as of November 2005)**

Number	Name of Bank	Date of Issuance of License
1	Myanmar Citizen Bank Ltd	May 25, 1992
2	Yandanabon Bank Ltd	August 27, 1992
3	First Private Bank Ltd	May 25, 1992
4	Myawaddy Bank Ltd	January 1, 1993
5	Yangon City Bank Ltd	March 19, 1993
6	Yoma Bank Ltd	July 26, 1993
7	Myanmar Oriented Bank Ltd	July 26, 1993
8	Tun Foundation Bank Ltd	June 8, 1994
9	Kanbawza Bank Ltd	June 8, 1994
10	Asian Yangon International Bank Ltd	March 17, 1994
11	Myanmar Industrial Development Bank Ltd	January 12, 1996
12	Myanmar Livestock and Fishery Development Bank Ltd	February 9, 1996
13	Sibin Tharyaryay Bank Ltd	June 26, 1996
14	Innwa Bank Ltd	May 15, 1997
15	Cooperative Bank Ltd (merger with former three cooperative banks)	N/A

Source: Central Bank of Myanmar, Myanmar Bank Information



### Appendix III-Suggested Model of SME Financing in Myanmar





The Institute of Developing Economies (IDE) is a semigovernmental, nonpartisan, nonprofit research institute, founded in 1958. The Institute merged with the Japan External Trade Organization (JETRO) on July 1, 1998. The Institute conducts basic and comprehensive studies on economic and related affairs in all developing countries and regions, including Asia, the Middle East, Africa, Latin America, Oceania, and Eastern Europe.

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