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# ACCESS TO FINANCE BY SMALL AND MEDIUM ENTERPRISES IN THE ARAB REGION: POLICY CONSIDERATIONS

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## Abstract

This paper discusses policy considerations on access to finance by Small and Medium Enterprises (SME) in the Arab region. It shows that although uneven, financial penetration in the Arab region remains low and SMEs in the region have more difficulties to access finance than those in other parts of the world. The paper presents the factors underlying such performance looking at demand, supply of credit, and financial infrastructure. While the most common policy measures are valid, they focus on expanding the supply of credit. Greater efforts must be made towards ensuring a financial infrastructure conducive to the development of the market, as well as to improve entrepreneurial skills. The timing of the policies (and the incentives associated with it) will have to be taken into account, and the right combination of policies will have to be tailored to each specific country.

## 1. *Introduction*

The importance of Micro, Small and Medium Enterprises (MSME) for the economy in general – and job creation in particular- is widely recognized[1]. SMEs represent 95% and up to 99% of total companies in the vast majority of economies worldwide (OECD, 2006), and provide 40-80% of total job opportunities (Elasrag, 2010). In the Arab region the phenomenon is similar, if not stronger. For instance, SMEs constitute more than 99% of all non-agricultural private enterprises in Egypt (ibid). In Kuwait, SMEs constitute approximately 90% of the private workforce (ibid). In Lebanon, SMEs constitute more than 95% of all enterprises and contribute about 90% of the jobs (ibid). In the United Arab Emirates (UAE), SMEs account for about 94% of the economic projects in the country, employing about 62% of the workforce (ibid). In 2005, SMEs contributed 96% of the GDP in Yemen and 77%, 59%, 25% in Algeria, Palestine and Saudi Arabia, respectively (ibid).

The great question is then, how to promote MSMEs? The determinants of entrepreneurship have been deeply looked into, from the personality features of entrepreneurs (Littunen, 2000), to how a group of alien entrepreneurs interacts within a larger society (Kilby, 1983), to the influence of the policy environment (Elkan, 1988). Considering the investment climate conditions, one of the main obstacles for SMEs to thrive is access to credit: to start up and in the initial stages of a company, entrepreneurs tend to use their savings (and those of their family and friends), as it is often difficult for them to borrow money from banks (especially if compared to well established firms). Thus, the question of access to financing has obvious implications on firms' capital structure, an aspect closely linked with job creation. For instance, it has been estimated that greater use of debt to finance firm activities increases firms' employment in the Arab region, with a ratio of 4,833 USD for every new job (Turk Ariss, 2011).

Based on the most recent research and data available, this paper describes the overall performance of SME finance in the Arab region in section 2, and presents the factors underlying such performance. The structure of the paper is as follows: sections 3 and 4 cover the demand and supply of credit, respectively. Section 5 discusses aspects relating to the regulatory framework, and section 6 suggests policy recommendations to promote the development of SME financing in the region. Finally section 7 concludes.

## 2. *Performance of SME Finance in the Arab region*

With regards to accessing credit, the performance of Arab countries' SMEs has room for improvement relative to other regions of the world. Table 1 shows selected indicators of financial inclusion and access to credit across world regions. SMEs in the Middle East and Northern Africa

[1] In this article, the terms MSME and SME are used indistinctly.

(MENA) region[2] are less likely to have checking or savings accounts than the world's average. The proportion of loans that require collateral is the highest in the world, and in line with that, the percentage of firms that have a loan or line of credit is one of the lowest.[3] It is also visible that while the percentage of firms that do not need a loan is one of the highest, the rate of firms whose last loan application was rejected is the highest in the world.

TABLE 1. REGIONAL COMPARISON WITH REGARDS TO INDICATORS ON 'ACCESS TO FINANCE'

| Economy | World | East Asia and the Pacific | Eastern Europe and Central Asia | Latin America and the Caribbean | Middle East and North Africa | South Asia | Sub-Saharan Africa |
|---|---|---|---|---|---|---|---|
| Percent of firms with a checking or savings account | 87.9 | 89.6 | 90.8 | 92.9 | 75.6 | 81.5 | 86.6 |
| Percent of firms with a bank loan/line of credit | 35.6 | 40.4 | 43.3 | 47.6 | 27.1 | 30 | 22 |
| Percent of loans requiring collateral | 77.9 | 78.1 | 81.1 | 72.4 | 81.8 | 80.9 | 80.1 |
| Value of collateral needed for a loan (% of the loan amount) | 164.5 | 172.9 | 135.5 | 197.3 | 155.9 | 197.3 | 160 |
| Percent of firms not needing a loan | 39.8 | 42.4 | 39.9 | 42.1 | 42 | 39.9 | 34.7 |
| Percent of firms whose recent loan application was rejected | 19.4 | ... | 26.4 | ... | 28.5 | 8.5 | 18.1 |
| Percent of firms using banks to finance investments | 26.3 | 27.5 | 36.3 | 33.6 | 10.1 | 29.7 | 15.1 |
| Percent of investments financed internally | 68.7 | 64.7 | 59.8 | 63.2 | 77.7 | 70.9 | 79.3 |
| Percent of investments financed by banks | 16.9 | 18.5 | 22.8 | 20.3 | 10.9 | 20.2 | 9.9 |
| Percent of investments financed by supplier credit | 4.5 | 2.8 | 4.7 | 7.5 | 3.7 | 1.1 | 3.6 |
| Percent of investments financed by equity or stock sales | 4.5 | 5.1 | 9.3 | 4.3 | 1.9 | 3 | 2 |
| Percent of firms using banks to finance working capital | 29.8 | 30.9 | 39.3 | 43 | 19.6 | 31.3 | 19.9 |

[2] This note deals with SME finance in the Arab region. It is acknowledged that the correspondence of the MENA region with that of the Arab region may not be exact. However, it is usually accepted as a good proxy, and since the data available relate to the MENA region, they are used here for convenience.

[3] In all the data related to the World Bank Enterprise Surveys, "firms" refers to all the companies (not only MSMEs or SMEs).

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Percent of working capital financed by banks | 12.2 | 15.6 | 14.4 | 16 | 8.5 | 15.3 | 8 |
| Percent of working capital financed by supplier credit | 11.7 | 5.3 | 6.4 | 18.1 | 5.2 | 6 | 12.2 |
| Percent of firms identifying access to finance as a major constraint | 31.7 | 19.2 | 24.6 | 30.8 | 36.3 | 25.5 | 44.9 |

*Source*: Enterprise Surveys (IFC, 2012).

Based on these facts, it is not surprising that the MENA region has the lowest percentage of firms using banks to finance their investments. Furthermore, in table 1 we see that the share of firms' investments for which they rely on banks is one of the lowest, only ahead of Sub-Saharan Africa (SSA). Concurring with those figures, firms tend to finance their investments internally, rarely recurring to equity or stock sales and less often that in the rest of the world using supplier credit. Finally, firms in the MENA region follow a similar pattern when it comes to finance their working capital. All in all, the Arab region has the second highest rate of firms identifying access to finance as a major constraint (after SSA).

The figures presented so far, however, do not show the evolution over time of indicators of SMEs' access to finance. While such data are scarce, some financial inclusion indicators relating to SMEs can be found in table 2 (below) for Iraq, Jordan and Palestine.

Some of the facts are quite positive. For instance, between 2004 and 2011 the weight of SME deposits as a share of GDP in Iraq increased 3.5 times from 1.52% to 5.27 %, while SME loans from commercial banks multiplied by 56, growing from 0.012% of GDP to 0.682% of GDP.

Other countries have mixed results. In Jordan, while the number of SME deposit accounts increased slightly between 2004 and 2011 –the funds in those accounts almost doubled in the same period-, the importance of those deposits relative to the economy decreased from 107.1% to 82.9%. In Palestine, between 2009 and 2011 the volume of SME deposits in commercial banks decreased relative to its GDP (from 3.3% to 2.9%), although the number of SME depositors increased 77.3% in the same period. Furthermore, while the outstanding SME loans from commercial banks increased (from 2% to 2.5% of Palestine's GDP), the number of borrowers witnessed a dramatic fall of 50.3% in only three years (from 45,800 to 22,743 borrowers).

As a way to overcome the lack of data for the other countries in the region (and be able to compare them), table 2 shows a 'proxy' indicator of financial penetration: deposit accounts with commercial banks per 1,000 adults. While such indicator does not relate only to SME accounts (but to all accounts), we can see great heterogeneity in the region's financial sector development (e.g. compare Kuwait's 2,100 accounts per 1,000 adults with Yemen's 111).

Thus, several groups of countries can be identified based on a development–growth combination: high penetration – high growth (e.g. Oman), high penetration – low growth (e.g. UAE), low penetration – high growth (e.g. Morocco), low penetration – low or negative growth (e.g. Yemen). Remarkably, four countries have seen the number of deposits shrink since 2004 (and they have low to medium levels of deposits): Algeria, Egypt, Jordan and Yemen. Thus, although such indicator does not relate to SMEs only, this deterioration implies that the expansion of financial services must not be taken as granted.

TABLE 2. SELECTED INDICATORS OF FINANCIAL ACCESS FOR SELECTED COUNTRIES IN THE ARAB REGION (WITH AN EMPHASIS ON SMES)

| Country | Concept | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| Algeria | Deposit accounts with commercial banks per 1,000 adults (Number) | 635 | 645 | 677 | 721 | 718 | 513 | 503 | 513 |
| Egypt | Deposit accounts with commercial banks per 1,000 adults (Number) | | | 373 | 377 | 386 | 376 | 368 | |
| Iraq | Outstanding SME deposits with commercial banks (% of GDP) | 1.518 | 1.186 | 0.992 | 5.093 | 2.205 | 2.473 | 2.928 | 5.272 |
| | Outstanding SME loans from commercial banks (% of GDP) | 0.012 | 0.049 | 0.076 | 0.281 | 0.219 | 0.494 | 0.385 | 0.682 |
| Jordan | Commercial banks: of which: SME deposit accounts (Number) | 2,582,963 | 2,748,683 | 2,940,332 | 3,051,610 | 3,207,729 | 3,292,796 | 2,699,747 | 2,800,143 |
| | Commercial banks: of which: SME Outstanding Deposits (National Currency, Millions) | 8,666 | 9,154 | 10,241 | 10,919 | 11,803 | 13,486 | 14,825 | 16,196 |
| | Outstanding SME deposits with commercial banks (% of GDP) | 107.111 | 102.562 | 92.323 | 86.689 | 73.274 | 75.698 | 75.917 | 82.937 |
| | Deposit accounts with commercial banks per 1,000 adults (Number) | 796 | 825 | 869 | 892 | 919 | 934 | 749 | 773 |
| Kuwait | Deposit accounts with commercial banks per 1,000 adults (Number) | | | | | | | | 2,100 |
| Lebanon | Deposit accounts with commercial banks per 1,000 adults (Number) | | 1,052 | 1,089 | 1,138 | 1,255 | 1,344 | 1,456 | 1,483 |
| Morocco | Deposit accounts with commercial banks per 1,000 adults (Number) | 321 | 303 | 337 | 381 | 411 | 659 | 682 | 706 |

| Country | Concept | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| Oman | Deposit accounts with commercial banks per 1,000 adults (Number) | 654 | 712 | 780 | 862 | 949 | 1,006 | 1,083 | 1,282 |
| Saudi Arabia | Deposit accounts with commercial banks per 1,000 adults (Number) | | | | | | 820 | 839 | 866 |
| United Arab Emirates | Deposit accounts with commercial banks per 1,000 adults (Number) | | | | | | 1,104 | 1,127 | 1,175 |
| West Bank and Gaza | SME depositors with commercial banks (% of non-financial corporation depositors with commercial banks) (Number) | | | | | | 25.046 | 38.480 | 44.414 |
| | SME borrowers from commercial banks (% of non-financial corporation borrowers from commercial banks) (Number) | | | | | | 45.800 | 27.491 | 22.743 |
| | Outstanding SME deposits with commercial banks (% of GDP) | | | | | | 3.311 | 3.434 | 2.870 |
| | Outstanding SME loans from commercial banks (% of GDP) | | | | | | 2.032 | 2.173 | 2.531 |
| | Deposit accounts with commercial banks per 1,000 adults (Number) | | | | | 880 | 874 | 915 | 1,066 |
| Yemen | Deposit accounts with commercial banks per 1,000 adults (Number) | | | | | | | 116 | 111 |

*Source*: IMF Financial Access Surveys (IMF, 2012).

## 3. *Factors underlying the performance of SME Finance in the Arab region*

### 3.1. *The demand side*

The very fact of being an MSME does not necessarily mean to be new. There are MSMEs long established, which are very different from new-coming innovative MSMEs seeking funds to develop new products or services, and that usually have negative cash flows and untried business models (OECD, 2006). Hence, the second group represents a higher risk to banks and cannot be assessed in the same manner as traditional SMEs or large firms. For instance, an MSME that has been established for a long time will have a clear idea of its cash flow seasonal variations. Therefore, it is vital to know SMEs to better understand their needs.

Most research about SME financing relates to the supply of credit. Among the exceptions, it has been noted that in the Arab region “lack of finance, lack of clear strategies, lack of skilled HR, and low technological capabilities are proved by surveyed CEOs as main challenges for their SMEs developments” (Emine, 2012).

A key component in human capital is education. In this regard, data show that the Arab region is far from being the most innovative and research-oriented in the world. For instance, only three universities in the Arab world (all of them in Saudi Arabia) are included in the list of the world’s top 500 universities (Jiao Tong University, 2012). In such valued studies of education systems as ‘Trends in International Mathematics and Science Study’, “out of 48 countries tested all 12 participating Arab countries fell below the average” (Ghiles, 2012). Not surprisingly, the gap in education quality between Arab and other countries at similar socioeconomic level has been qualified as “frightening” (ibid).

Education is not the only factor favoring successful businesses, however. Another way of promoting SMEs is improving entrepreneurial skills. Such skills can be fostered in the Arab region through business incubators. For instance, the Arab Incubators Network seeks to further develop and support existing incubators in the Arab World, by supporting entrepreneurs’ skills development, knowledge sharing and education on relevant topics, as well as raising awareness between regional entrepreneurs and funding entities with the objective of generating employment in the region (Al Maktoum Foundation, 2013). However, relative to other areas of the world, business incubators spread in the Arab region very late, e.g. 1995 in Egypt) (Business and Tenders, 2013). At present, while incubators exist in many Arab countries, they do not have a significant role in the development process, which requires the provision of the legislative and legal environment to give them a greater role and learning from experiences abroad (ibid).

The main financial services and products MSMEs want are i) simple products and services (with short application forms and turnaround times from one to four days), ii) unsecured loans (even at higher prices, given that MSMEs often do not have collateral), and iii) trustworthy, convenient channels - which can be interpreted as “branch” in the traditional way, but also more flexibly as bank agents who visit MSME owners (Chironga et al., 2012).

3.2. *The supply side*

There are various types of sources through which MSMEs can access finance. Broadly speaking, those sources could be associated to the lifecycle of the enterprise.[4] At the very beginning of their existence, entrepreneurs often turn to their family and friends for support,[5] an option which has recently been expanded by 'crowdfunding'.[6] Assistance can also come from risk capital firms, which are firms that support promising projects in exchange of a share in the company. In a similar fashion, but "favoring larger projects at later stages in the lifecycle" venture capital firms also support MSMEs. When MSMEs are consolidated, it is much easier for them to access credit through microfinance institutions (MFIs) or commercial banks.

Relative to the rest of the world, MFIs are probably not a strong-enough option for SMEs to access finance. The microfinance sector in the Arab region is very little developed (MIX and Sanabel, 2012) and their lending for SME creation is more conservative than in other areas of the world (and MFI's sustainability is rarely ensured). As a consequence, the percentage of MFI-financed microenterprises that are startups in the Arab region is 34.1%, compared to 56.5% in the rest of the world.[7] Furthermore, given the small amounts of MFI loans, SMEs may still need to look for additional financing elsewhere.

Within the commercial banks' category, state banks tend to have a more socially oriented approach than private banks (which tend to be more profit-oriented), a phenomenon that has been confirmed for countries in the Arab region (Emine, 2012). Although some authors contend that the Arab world is a flourishing market for venture capitalists (Mansour, 2012), data and research on venture capital in the region are also scarce. Therefore, based on available data this paper must focus on MSME's access to commercial banks' finance.[8]

Previous research has indicated that MSME banking revenues in the MENA region in 2010 were estimated at 6 billion USD, expected to grow by 18% per annum to approximately 15 billion in 2015 (Chironga et al., 2012). The opportunity that such MSME future growth represents is very

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[4] This classification is for illustrative purposes only and recognizes that its boundaries may not be clear-cut, as some of them could overlap; e.g. support from a bank to a particular promising product/project, or family support combined with risk capital.

[5] Investors that offer very favorable terms for their funding and focus on helping the business succeed are sometimes referred to as 'business angels' or 'angel investors'.

[6] The JOBS Act (2012) in the USA fostered a phenomenon known as 'crowdfunding', whereby businesses can accept small contributions from private investors without making an initial public offering (IPO). Entrepreneurs who have good innovative ideas for projects can receive support (in exchange for equity or even as donations) through online platforms such as kickstarter.com, indiegogo.com or fundable.com. The concept has been extended to the Arab region through websites such as aflamnah.com or mawwell.com.

[7] Based on a simple arithmetic mean with available yearly data provided by MFIs from 2002 to 2011. Source: The Mix MFI full database (The Mix, 2012).

[8] While it is acknowledged that the picture is not comprehensive, it seems reasonable to believe that commercial banks channel most of the financing to SMEs. According to the MIX, the Arab region has the lowest outreach of microfinance services in the world (0.8 borrowers per hundred people). And out of all those clients, only 5% are corporate and SME clients. Hence it is not surprising to see that the region has the lowest average MFI loan balance in the world, at 16% of GNI.

important, since 41-50% of MSMEs in the region are either under-served or entirely unserved, and MSME revenue in all emerging markets is likely to be larger than the combined growth of several other banking service lines (ibid).

Banks in the Arab region consider the SME segment as profitable, and most of them already provide financial products to such segment (Rocha et al., 2011). The reasons they give include "the potential profitability of the SME market, the saturation of the large corporate market, the need to enhance returns, and the desire to diversify risks. Larger banks do not play a more significant role in SME finance in the region, but banks "with a larger branch network and/or that have set up SME units seem to do more SME lending, suggesting relationship lending" (ibid).

Consequently, banks in the region have established targets for the development of their activities in the SME segment. However, their emphasis on SME activities is rather limited. Lending volumes are still not very large. The share of SME lending in total lending is only 8 percent, of which 2 percent in the GCC (Gulf Cooperation Council) countries, and 13 percent in the non-GCC countries (ibid). The low share of SME lending in the GCC reflects largely the characteristics of concentrated oil economies. The share of SME lending in the non-GCC is higher, but still lower than the shares of SME lending in developing and developed countries. Most importantly, the shares of SME lending in total lending in both the GCC and non-GCC regions are substantially below the banks' own long-run targets, also suggesting substantial room for further lending to SMEs (ibid).

Considering the different types of banks in the region, the role of both state-owned and private banks is crucial: "state-owned banks in the MENA region play an important role in providing finance to SMEs, with an average share of SME lending similar to that of private banks, reflecting their mandates in this area." (ibid). Nevertheless, there are differences in their practices, as state banks take greater risks than private banks in their SME lending business: "they are less selective in their strategies to target SMEs, have a lower ratio of collateralized loans to SMEs, and a higher share of investment lending in total SME lending. At the same time, they also seem to have less developed SME lending technologies and risk management systems. A lower share of state banks has dedicated SME units, makes use of credit scoring, and conducts stress tests." (ibid).

### 3.3. *Regulatory framework*

Relative to other regions, the financial infrastructure and regulatory framework in the Arab countries are weak. Table 3 shows a comparison for the component 'Getting Credit' of the Doing Business indicators. We can see that the MENA region has the lowest strength of legal rights index (considerably lower than, e.g. SSA). However, the depth of the credit information is ahead of that in other developing regions such as SSA or South Asia (SA). In a similar vein, the coverage of the registries is better than in SSA and SA, although lower than other developing regions such as Latin

American & Caribbean (LAC) and East Asia & Pacific (EAP). It is also worth noting that the coverage between regions' public and private registries' is the most equal.

Table 3 also shows data for selected countries. They are all quite homogenous with regards to 'Strength of legal rights index' and none of the countries exceeds 5 out of 10. On the other hand, they are very heterogeneous with regards to credit information: some of them have a high depth of it (e.g. Egypt), but others are very weak in that regard (e.g. Iraq, Sudan). The nature of those registries is quite variable too. While some countries rely strongly on a public registry coverage (e.g. Oman, Qatar), others base such coverage on private bureaus (e.g. Bahrain, Saudi Arabia).

TABLE 3. REGIONAL COMPARISON WITH REGARDS TO ONE ASPECT OF DOING BUSINESS: GETTING CREDIT

| Region | Strength of legal rights index (0-10) | Depth of credit information index (0-6) | Public registry coverage (% of adults) | Private bureau coverage (% of adults) |
|---|---|---|---|---|
| East Asia and the Pacific | 7 | 2 | 9.1 | 19.2 |
| Eastern Europe and Central Asia | 7 | 5 | 17.3 | 29.8 |
| Latin America and the Caribbean | 6 | 3 | 11.1 | 33.8 |
| Middle East and North Africa | 3 | 4 | 8.6 | 9.7 |
| OECD high income | 7 | 5 | 10.2 | 67.4 |
| South Asia | 6 | 3 | 2.7 | 6.4 |
| Sub-Saharan Africa | 6 | 2 | 4.2 | 5.6 |
| Country | Strength of legal rights index (0-10) | Depth of credit information index (0-6) | Public registry coverage (% of adults) | Private bureau coverage (% of adults) |
| Bahrain | 4 | 3 | 0 | 23.5 |
| Egypt | 3 | 6 | 4.3 | 16.4 |
| Iraq | 3 | 0 | 0 | 0 |
| Jordan | 2 | 2 | 1.9 | 0 |
| Lebanon | 3 | 5 | 18.6 | 0 |
| Morocco | 3 | 5 | 0 | 17.2 |
| Oman | 4 | 5 | 37.3 | 0 |
| Qatar | 4 | 4 | 25.2 | 0 |
| Saudi Arabia | 5 | 6 | 0 | 33.3 |
| Syria | 1 | 2 | 4.9 | 0 |
| Sudan | 4 | 0 | 0 | 0 |
| Tunisia | 3 | 5 | 27.8 | 0 |
| United Arab Emirates | 4 | 5 | 5.9 | 31.7 |
| Yemen | 2 | 2 | 0.9 | 0 |

*Source*: Doing Business Indicators (World Bank, 2013).

Financial infrastructure (weak credit information, weak creditor rights and collateral infrastructure) represents one of the main complaints of banks in the region, who qualify them as the main obstacles for further engagement in SME finance (Rocha et al., 2011). Other obstacles often noted are the lack of SME transparency and the poor quality of business plans (ibid). This feedback has led economists to explicitly argue that the financial infrastructure weaknesses in the region are one of the main reasons why private banks have not engaged more in SME finance in several countries, although many private banks are making inroads in this area, suggesting that these banks have better SME strategies and lending technologies (ibid).

Relating to financial infrastructure, Central Banks (CBs) have several key roles. Beyond monetary policy making, CBs design the 'rules of the game' for financial institutions on vital aspects such as banking regulation and supervision (e.g. through regulation prescribing banks' minimum solvency ratios such as the Basel Accords). Thus, CBs' monetary policy and financial regulations have implications on access to credit (Boldbaatar, 2011), although the impact of specific measures is not always clear (and not even necessarily the same across countries). For instance, while the Basel II Accords have been praised for rendering the banking sector more solvent (which may reduce the borrowing cost to SMEs), it has also been argued that, by increasing the banks' minimum capital requirements, Basel II may increase the cost of capital for SMEs (Telesca, 2003).

## 4. *Policy recommendations*

Based on the nature of the different problems exposed, the question naturally raised is: What initiatives have the highest impact in terms of SME promotion in Arab countries?

First of all it must be recognized that the label "Arab countries" conceals a great heterogeneity. Therefore, to reach the most efficient combination of policies such interventions must be tailored to each country's particular conditions. For instance, while policy measures to stimulate an educated demand into becoming entrepreneurs (e.g. business incubators), may be very effective in some countries, other countries may find it more profitable to work on further financial penetration.

To be able to tailor policies, countries must start by acknowledging (and then working to mitigate) the great data deficiencies of many countries in the region, e.g. for most of them there are no publicly available data on basic indicators such as deposit accounts or loans held by SMEs in financial institutions. Even worse, some other times data may exist but authorities may be jealous to share it.

Regarding the demand of credit, first it must be strongly stimulated, and then it should be transformed. In the short term, financial inclusiveness must be strongly promoted. Furthermore, in the short to medium run the role of business incubators should be strongly strengthened. In the medium run, the education system must be restructured significantly to promote research and innovation –some analysts indicate that this change may already be under way (The Economist, 2013).

Fourth, Arab countries have adopted measures to promote access to financing by SMEs, with a strong emphasis on the supply of credit side. Some of the measures utilized have been: State Banks, programs including exemptions on reserve requirements, credit subsidies and partial credit guarantee schemes. Guarantee schemes have been popular and are in operation in several countries of the region. Evidence seems to support that guarantee schemes have contributed to more SME lending.

A different way of expanding the supply curve is through efficiency gains. Such gains can be achieved by innovating on aspects related to lending to make it more flexible and less costly. For instance, it is clear that assessing innovative startups on criteria conceived to assess larger, well established corporations is not adequate. This mismatch fails to take into account the innovative wealth potential that may make those startups a great success (e.g. as they are new they do not have a collateral). New credit scoring techniques, psychometric testing and/or insurance of loans (instead of collateral) have shown to be more suitable to the MSME segment (Chironga et al., 2012).

Similarly, a deep understanding of SMEs is useful for lending institutions to assess them more appropriately. Such knowledge must include the financial instruments and services that best suit them, as well as the business model in which SMEs operate (e.g. sectors with a great turnover of products that have a small margin vs great margin products with little turnover). Such knowledge can be achieved through dedicated analysts, and can easily evolve towards informal partnerships whereby banks support entrepreneurs in basic aspects related to running a business (e.g. inventory management, financial reporting, etc.).

Furthermore, costs can often be lowered through innovations in the methods to cover the ‘last mile’ to reach potential new clients. Low cost branches, correspondent banking agreements and mobile banking are approaches well known by now, as they have been tested across many countries.

Undoubtedly, banks have to invest in developing and implementing such innovations (and obviously, not all banks will have the same efficiency gains out of the same measures). But the potential for payback is very considerable (as very few financial institutions have started doing so, which means that pioneers will have a great hedge to capture the shadow market). The consulting firm McKinsey has estimated that following efficiency-enhancing measures like the ones noted, banks’ Return on Equity in the MSME segment could increase from 14 to 33 percent (Chironga et al., 2012).

The financial infrastructure must be one of the main priorities in the regulatory agenda. In particular (although all the countries do not have exactly the same pressing needs), Arab countries must significantly strengthen creditors’ legal rights and the coverage of the population with regards to credit information. In this regard, it should be relatively easy for public authorities to engage with lending institutions (as it is in the interest of the latter) to, e.g. create and/or further develop credit bureaus. In order to guarantee the highest confidence in the financial system and avoid political interferences, Central Banks -not Governments- must pilot such processes (although clearly, Governments should facilitate them as much as possible).

Finally, since the banking sector in the Arab region is not as developed as elsewhere and its lending practices are more conservative, more competition should not be discouraged. For instance, a greater presence of international banks with leadership in SME finance may have spillover effects in the region: in the medium term, e.g. as banking executives change employer within the same sector, the know-how of innovative banking practices tends to be shared and replicated.

## 5. *Conclusion*

MSMEs are vital for economic growth and employment, as they are often driven by innovative businesses seeking to put new ideas into practice. MSMEs in the Arab region have less access to finance than those in other areas of the world, and Arab banks are often ‘blamed’ for such outcome. Therefore, Arab countries have put significant efforts in implementing supply-side measures to address the issue. While those actions seem valid, they ignore that an economic equilibrium is determined by both “the upper and the under blades of a pair of scissors” (Marshall, 2009).

This paper has separated between supply and demand of credit, and financial infrastructure factors, showing that policy measures to stimulate the market can be adopted on the three fronts. Beyond supply-side measures, far greater efforts must be made towards ensuring institutions (i.e. financial infrastructure) conducive to the development of the SME finance market. Similarly, important efforts must be made to improve the entrepreneurial skills in the region and make them more innovative, knowledge and research-based (e.g. improving the education systems in the region), as well as to translate that knowledge into productive endeavors (e.g. enhancing the role of business incubators).

While the analysis deals with the entire region, to reach the highest efficiency each country should adapt different combinations of policies. In tailoring those, leaders must remember that inter temporal tradeoffs must be made, as the timing of the different measures adopted often differs (and sometimes leaders may have incentives to adopt only short-term initiatives that are in their favor). Measures to expand the supply of credit do seem to stimulate the market in the short-to-medium term. Institutions related to strengthening the financial infrastructure are of outmost importance as they have a great catalytic power, but the implementation and consequences of some of those measures may relate to the medium term for a full effect. Last but not least, the development of new generations of well-educated, financially-aware, innovative entrepreneurs and knowledge-based business leaders relates to the longer term, but it is equally vital so that Arab countries’ SMEs can achieve the highest levels of competitiveness.

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