

# THE ROLE OF CREDIT IN THE DEVELOPMENT OF SMALL AND MEDIUM-SIZED ENTERPRISES IN BELARUS: ESTIMATING THE STATE OF THE MICROFINANCE SECTOR

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## Summary

This publication discusses the results of the research on the access to credit by small and medium-sized enterprises (SMEs) in Belarus, and the role of microfinance and credit unions in this process. The research has established that the vast majority of small and medium enterprises in Belarus does not borrow. Also, they do not perceive a lack of credit as a problem. In Belarus, bank microcredits are the most widespread form of borrowing, while loans provided by credit unions occupy a very small share in the total volume of loans. The weak development of microfinance sector and the loan market in general are tended to be caused by a relatively high inflation (until recently), gaps in the existing legislation regulating the functioning of credit unions, the absence of necessary information for small and medium business, underutilization of international loans, and, finally, a range of psychological factors. Currently, companies spend a lot to pay taxes and fines and to cover the costs related to accounting. A fraction of these expenditures could certainly be redirected for investment into fixed assets. Also, it can be used to increase the volume of circulating assets. Finally, the policy recommendations made for the development of microfinance sector could be used, in the first instance, by local authorities: 1) the creation of local information centers for supporting of private business; and 2) cooperation with international financial organizations.

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## 1. Introduction

Small and medium business in Belarus has a substantial potential for development. This potential depends to a considerable degree on the financial opportunities available so that investment into fixed assets can be carried out and the volume of circulating capital increased by small and medium-sized enterprises (SMEs). International experience shows that loans often become the major source of funds for development of business. For small and medium-sized enterprises, it is very important to have an access to small-scale loans allowing them to replenish the volume of circulating assets or to buy inexpensive equipment. In Belarus, microcredits are provided by commercial banks and credit unions. However, internationally, non-governmental credit organizations and microfinance banks are also widespread.

Within the framework of a research project, a survey has been conducted among 253 small and medium-sized enterprises registered in Belarus to study in details the barriers towards their development<sup>1</sup>. The results of this research have been used to conclude on the role of loanable funds in the development of small and medium-sized business (SMB) in Belarus, to estimate the development of the market for microcredits and credit unions, and to devise policy recommendations.

## 2. The role of loans in the development of small and medium-sized business in Belarus

The most important finding of the research is that the problem of access to credit is a secondary one in contrast to such issues as taxation, inspections and fines, complicated accounting and paperwork, price and wage regulation, and obtainment of licenses and permits.

This claim is based on the results of the survey conducted. Interviewees had been offered to rank 16 barriers to business between 1 and 5 (1 – not a problem; 5 – a very big problem). No access (complicated access) to financial resources and to microcredits have been evaluated 2.6 and 2.4, respectively. Accordingly, these issues had been placed at the end of the list of the barriers (places 12 and 16, respectively) (table 1). In both cases it is very important to emphasize that more than a half of the respondents (52.2% and 57.2%, respectively) has either not treated these two factors as barriers (estimate 1) or considered them to be low-profile (estimate 2).

Table 1.

### Answers to a question: ‘How Serious are the Following Factors to Activity of Your Company?’

	Problem evaluation					Average
	1	2	3	4	5	
1. Taxation	2.8	24.1	29.6	24.1	19.4	3.35
2. Inspections and fines	2.8	21.4	35.7	21.0	19.0	3.33
3. Excessive paperwork	7.9	21.4	29.0	22.6	19.0	3.25
4. Permits	8.3	25.7	26.1	24.9	15.0	3.14
5. Licensing	10.3	22.9	31.2	19.0	16.6	3.10
6. Price regulation	8.4	23.9	39.8	18.3	9.6	2.98
7. Registration	10.4	27.9	29.5	19.1	13.1	2.98
8. Statistical reporting	7.1	28.2	36.5	20.6	7.5	2.94
9. Insufficient protection of property rights and interests of private business	11.6	28.0	33.2	15.2	12.0	2.89
10. Unequal conditions for conducting business between private and public sectors	16.2	27.7	23.7	20.9	11.5	2.84
11. Wage regulation	14.2	27.3	33.6	19.0	5.9	2.77

<sup>1</sup> The survey has been conducted in November 2006. 253 SMEs have been interviewed (the sample is representative). The results of the research ‘Problems of Development and Small and Medium Business in Belarus’ can be found at <http://research.by/rus/surveys/f9953d723aa828f2.html>.

	Problem evaluation					Average
	1	2	3	4	5	
<b>12. No access (complicated access) to financial resources</b>	<b>18.7</b>	<b>33.5</b>	<b>23.9</b>	<b>17.1</b>	<b>6.8</b>	<b>2.61</b>
13. Administrative (i.e. not specified by the existing legislation) intervention of local authorities	18.7	33.9	25.5	17.9	4.0	2.54
14. Administrative (i.e. not specified by the existing legislation) intervention of central authorities	20.7	34.7	25.9	13.9	4.8	2.48
15. Employment regulation	22.4	35.6	23.2	14.0	4.8	2.43
<b>16. No access (complicated access) to microcredits</b>	<b>25.6</b>	<b>31.6</b>	<b>23.2</b>	<b>14.0</b>	<b>5.6</b>	<b>2.42</b>

Note. 1 – not a barrier, 5 – very serious barrier.

As for a direct question ‘Whether Your Company Needs Loans’, it is only 32.8% of representatives of enterprises in the sample answered in the affirmative (table 2). A more precise picture can be obtained by looking at the answers given to a question ‘Does Your Company Borrow?’. It is two-third of these enterprises (that gave the affirmative answer), or 67.9%, maintained that they used credits (table 3). It follows that in fact loans are used by only 22.5% of the enterprises observed (57 of 253)<sup>2</sup>.

Table 2.

### Answers to a question ‘Does Your Company Need Loans?’

	Number of enterprises	%
Yes	84	32.8
No	172	67.2

Table 3.

### Answers to a question ‘Do You Borrow?’

	Number of enterprises that need loans	%
Yes	57	67.9
No	27	32.1

Table 4.

### Answers to a question ‘In Case of Borrowing, Please Provide Its Sources’

Institution	% of those that borrow
Bank loan	75.4
Leasing	26.3
State funds	8.8
Friends, mates, relatives	31.6
Credit unions/Mutual loan societies	1.8
Other sources ( <i>please specify</i> ):	1.8

Note: Respondents have been asked to mark all options appropriate

Another confirmation of the claim on the secondary role played by loans in the development of SMB is that today in Belarus about one-third (31.6%) of enterprises do not resort to any ‘civilized’ types of financial instruments. Instead, cash has been borrowed from friends, mates, or relatives (table 4). This has been registered even among the enterprises that use a more complicated legal form of doing business in contrast to private entrepreneurs. One of the chief reasons here is that in a relatively

<sup>2</sup> The results of our research show that the bigger the enterprise, the more often it borrows. The question ‘Do You Experience a Need in Loans?’ has been answered in the affirmative by 34% of the respondents representing enterprises employing less than 10 people, 30% - employing between 11 and 50 people, and, finally, 49% - employing more than 50 people. The affirmative answers to a question ‘Do You Borrow?’ have been given by 47%, 73%, and 72% of the enterprises in the sample (among those that need loans) employing less than 10, between 11 and 50, and more than 50 people, respectively.

high inflationary environment the use of loans provided by relatives and mates is very inexpensive, and, in many cases, appears to be free of charge.

#### 4. Evaluation of the microfinance sector development and the state of credit unions

In Belarus, there are two types of microcredit institutions: commercial banks and credit unions. Of these two, commercial banks dominate microcredit provision (by the volume provided so far). The vast majority of enterprises in the survey have used bank loans (table 5). It is only 1.8% of them have been provided with the funds of credit unions (table 4). Currently there is only 1 officially one registered credit union in Belarus that provides money for small companies<sup>3</sup>. In fact, the domination of banks credits over loans provided by credit unions is a distinct feature of Belarus. In other countries of the region, credit unions actually dominate: they provide up to 40% of the total volume of microcredits, while their share in the microcredit organizations is 96%<sup>4</sup>.

Table 5.

##### Answers to a question: ‘What Bank (Lending Agency) Have Been Lending to Your Company?’

	Number of enterprises	% of those that borrow
Belgazprombank	2	10.5
Priorbank	8	42.1
Astanaeksimbank	1	5.3
Minskiy Transitniy Bank	1	5.3
Absolutbank	2	10.5
Other (Belagroprombank, Belarusbank, Belinvestbank, RRB bank, Transbank)	5	26.3

Table 6.

##### Answers to a question ‘Have You Ever Used Any Microcredit Programs?’

	Number of enterprises	% of those that borrow
Yes	22	38.6
No, but made attempts	6	10.5
No, no attempts made	23	40.4
Don’t know what it is	6	10.5

It can be claimed that recently microfinance sector has been developing in Belarus rather quickly. The data in the use of microcredit by enterprises tend to confirm this claim: almost a half (49.1%) of the managers interviewed has been dealing with microcredits in either way. This is a good indicator anyway (table 6). It is only 10.5% of the enterprises that borrow are unaware of a microcredit option.

It is important to note that a quick and easy access to credit is fundamental to SMB. It is not exaggeration to say that enterprises really need short-term, small loans. This assertion can be confirmed by the results of the survey shown in tables 7 and 8.

As it can be seen, the major need of enterprises that borrow is to increase the volume of circulating assets (62.3%). Indeed, microcredits help to solve the problem of the lack of additional circulating assets.

<sup>3</sup> See also GET-IPM PP/11/06 ‘Development of Cooperative Financial Institutions in Belarus’.

<sup>4</sup> More detailed information is provided in Pytkowska, J. and Bankowska, E. ‘2004 Microfinance Sector Development in Eastern Europe and Central Asia’, 2004. The fact that microcredit operations are concentrated in the banking sector has been confirmed in other studies like ‘The Problems and Prospects for Microfinance Development in Belarus: Economic and Legal Aspects’, UN Development Program in Belarus, 2005.

Table 7.

### Answers to a question ‘How Do You Use Loans?’

	% of those that borrow
<b>Purchase of raw materials and intermediate goods (to increase the volume of circulating assets)</b>	<b>63.2</b>
Purchase of new equipment	42.1
New technology	24.6
Purchase of used equipment	24.6
Purchase of spare parts	17.5
Payment of wages	10.5
Purchase of real estate (buildings, production facilities)	7.0
Other ( <i>please specify</i> )	3.5

*Note.* Respondents have been asked to mark all options appropriate.

Table 8

### Answers to a question ‘How Do the Existing Barriers (see Table 1) Impact the Activity of Your Enterprise?’

	Number of enterprises	%
1. Produce considerable losses of energy and time	118	46.6
<b>2. Does not allow to increase output/volume of services provided</b>	<b>104</b>	<b>41.1</b>
3. Considerably increase financial costs	96	37.5
<b>4. Block innovations (new technologies, modes of work, etc.)</b>	<b>73</b>	<b>28.5</b>
5. Force company closure	58	22.7
6. Make to switch to a new sphere of economic activity (where barriers are less significant)	56	21.9
7. Decrease competitiveness against products/services of foreign companies at the Belarusian market	35	13.7
8. Decrease external competitiveness	28	10.9
9. Other ( <i>please specify</i> )	7	2.7

*Note.* Respondents have been asked to mark all options appropriate.

A paradoxical situation is observed when the principal barriers for SMB development (as shown in the table 1) are compared to the answers to a question provided in the table 8. On the one hand, managers denote that taxation, inspections and fines (see table 1) are the most significant barriers to doing business in Belarus, producing considerable losses of energy and time (46.6% of managers among 253 enterprises in the sample – table 8). On the other hand, managers of 104 enterprises out of 253 in the sample (41.1%) claim that the existing barriers do not allow to increase output or volume of service provided, but at the same time they rank the absence of access to financial resources quite low in the long list of the barriers. In fact, output and volume of services provided can only be expanded after the volume of financial investment is increased. The situation looks even more paradoxical, if positions 2 and 4 are considered jointly in the table 8, namely limited opportunities for increasing output and for making innovations. Each of them is indeed secured first of all by finance external to enterprise.

This paradox can largely be explained by the fact that managers of small and medium-sized enterprises do not have enough information about the borrowing opportunities, including the use of microcredits to increase the volume of circulating assets. It appears that there is a lack of information about ‘civilized’ ways of doing business, like the advantages that the bank lending has for companies, long-term planning, outsourcing, and so on. In the next section the causes are explored in a greater detail.

#### 4. Major obstacles to the microfinance sector development in Belarus

The study of the factors behind the early development of microfinance sector in Belarus reveals their similarity with factors in other transition economies. The economic situation in Belarus has not allowed to expect a boost of microcredit, while measures to stimulate it always have a rather limited effect. Accordingly, the growth of volume of microcredits could only be expected as soon as the influence of the factors described below is mitigated; the factors ranked according to their importance:

- A relatively high level of inflation until 2005 that led to *high interest rates*. This reason is the most ‘objective’ one: the development of SMB in the country is hardly possible if there are high inflation and weak domestic currency. In this case, banks are inclined to set up high interest rates (due to high levels of risk) and to reduce volume and period of loans. As a result, there is no space to provide loans to increase the volume of circulating assets due to high-risk environment. Microcredits are then provided by state banks. In 2005, consumer price index in Belarus went down below 10% threshold to 8%, and in October 2006 it was 6.2%<sup>5</sup>. This reason largely explains the domination of commercial banks and the absence of credit unions in Belarus in the microfinance sector.
- The absence of the appropriate legislation regulating the activity of credit unions: there is no law in Belarus today that regulates the activity of credit unions. Legal regulation is based on the Council of Ministers Regulation No. 1972 on December 21, 1999 ‘On Mutual Loan Societies of Subjects of Small-scale Entrepreneurship’; also, it is partially regulated by the Civil Code of the Republic of Belarus. Accordingly, credit unions (or mutual loan societies) can be treated as consumer cooperatives. Therefore, their activity is also partially regulated by the ‘Law on Consumer’s Cooperation’ that sets up the rules for the functioning of consumers associations.
- Underutilization of the potential of international credit institutions: International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) have provided about EUR 36 ml over 2004–2005 for the development of microfinance sector (EBRD: EUR 16.7 ml, IFC: EUR 19 ml<sup>6</sup>). These credit lines have been mainly transferred to ‘Priorbank’ and ‘Belgazprombank’. There are the reasons to believe that these credit lines have become the backbone of the total volume of microcredits given by all Belarusian banks. Since the vast majority of microcredits has been provided by commercial banks, it follows that cooperation with international financial institutions directly influences the development of the microfinance sector in Belarus. Unfortunately, the official doctrine of limited cooperation with Western financial institutions adversely impact the number and the volume of credit lines provided by international credit organizations;
- The absence of information: the amount of information about microcredits available at the market of small and medium-sized enterprises is very small; there is also a severe lack of information about ‘the rules of doing business in a civilized way’, namely about the advantages related to bank borrowing and activities of credit unions, price competition, human resource management, strategic planning, etc. Contrary to conventional claims about the irrelevance of these areas for the Belarusian business today, there is nevertheless a direct linkage between the quantity of microcredits and the number of business-plans prepared by SMEs;
- A psychological factor: it still plays an important cause of a relatively low popularity of microcredits in Belarus. There are such aspects as unwillingness to deal with banks and to pay interest, fear of non-paying a loan back, peculiar ethics ‘doing business for own money’ and a low degree of trust to banks and credit unions. As a result, there is a high level of using cash borrowed from relatives and mates for investment into circulating assets. The psychological factor is related to

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<sup>5</sup> Information is taken from the Ministry of Statistics and Analysis, see [www.belstat.gov.by](http://www.belstat.gov.by).

<sup>6</sup> Source: [www.ifc.org](http://www.ifc.org).

the lack of information described above. In fact, the case of Poland also shows that this factor might put a brake on the development of microfinance sector not only in Belarus, but in other countries in transition.

## 5. Conclusions and policy recommendations on the microfinance sector development in Belarus

The most important result of our inquiry is the claim that a limited access to credit is of secondary importance in comparison to such issues as taxation, inspections and fines, complicated accounting and excessive paperwork, price and wage regulation, and licensing and permission procedures. A more detailed investigation carried out in the previous section tends to confirm this thesis.

### Box 1: Polish experience of collateral-free microcredit provision

In Poland, collateral-free microcredit provision has become widespread. It is based on the mutual guarantee of 'clusters' of debtors and analysis of risk of every credit along with the use of partnership approach and mutual trust. The largest Polish organization of this type – 'Fundusz Mikro' – has been set up in 1994 by the Polish-American Entrepreneurship Fund. Over time, it has become one of the leading microfinance organizations in Poland. The total amount of credits provided by the Fund to about 42,000 small and medium-sized companies has amounted to USD 226 ml. The Fund has offered loans to mainly small enterprises that clearly see no other opportunity to expand their activity rather than applying for microcredit. In order to do so, enterprise's chief is simply setting a date with a Fund's representative at one of its 40 branches across Poland, filling in a form to explain the purpose of expenditures planned. The decision on credit provision is made within 2 days. The Fund offers credits ranging from USD 300 to 15,000 for a period up to 36 months.

Therefore, the development of SMB in Belarus in the short run can be related to the redirection of enterprise's expenditures from taxes, fines, accounting and paperwork costs, inefficient prices and wages, costs of licenses and permits to the increase in the volume of circulating assets and purchase of new equipment. We estimate that approximately USD 2 ml for every reduction of costs of the barriers by USD 10 (taxes, fines, accounting and paperwork costs, changes in prices and wages, licenses and permits) might be obtained. However, this would give a stimulus for SMB development in the short run only. What can be then used in the long run?

In the long run, state policies to assist the development SMB have to be based on the provision of a broader access to credit. Over the years, the absence of such access would become the major obstacle to the SMB development. In order to remove this obstacle, it is necessary to induce the increase in the volume of microcredits provided by commercial banks and credit unions. The executive authorities of Belarus possess considerable capacities to speed up the microfinance sector development in the country and, consequently, SMB development as a whole.

Below a number of policy recommendations is devised on how microfinance sector development could be spurred. The recommendations made are for the middle and low levels of the hierarchy of the executive authority (i.e. a regional/*oblast* level). In our view, local authorities in Belarus are capable of influencing the development of SMB rather effectively. For the purpose, the following policy tools could be used.

Creation of local centers for business support: A concept of 'one-stop-hub' is suggested for implementation. In every *oblast*, a special center could be created in order to provide the maximum number of informational services. Such centers should become the prime access points for all SMB units that need help of any kind. These centers should be recognizable, well-known so that entrepreneur would know where to refer to for assistance. In the beginning, these centers should focus its effort on the provision of a broad number of information and consultancy services (specifically, on institutional conditions for doing business, legislative and other requirements, etc.) and participate in the preparation and implementation of educational and retraining programs.

Later, centers could assume additional functions depending on the requirements of entrepreneurial environment and their organizational capacities, first of all what concerns 'internationalization' of companies, innovativeness, and provision of financial services (loan or guarantee funds).

These centers should not be subordinated, but only accountable to the local authorities (not being their department or something like that). Rather, they should be separate bodies with their budget, although the funds could be secured also by the state (or a combination of the budgetary, grant or any other sources of funding, like donations made by associations of entrepreneurs). Despite the plans that funding is to be provided either fully or to a large extent by the central budget, decision about the establishment of every single center has to be made locally with an account for specific factors, needs and opportunities of a given locality. Nevertheless, certain minimum framework requirements common for all centers have to be respected (i.e. all centers have to provide a certain minimum number of services). There are different options of establishing such centers, such as outsourcing (subcontracting), joint projects with other organizations, and so on.

A fully-fledged cooperation with international financial organizations: As it has been shown above, international credit organizations play an important role in the microfinance sector development in Belarus. The executive authority does not possess spare funds to provide direct support for domestic SMB. Therefore, borrowing (at interest, without interest, and sometimes even provision of non-repayable subsidy) are the necessary instrument for the microfinance sector development in Belarus. Foreign loans could be used for establishing the above-mentioned information centers and guarantee funds and for providing credits directly (in the latter case it is necessary to cooperate with a bank or a credit union in order to estimate the quality of business plans submitted in a professional way). It has to be emphasized that many international credit organizations today are even inclined to provide credits. What is required is the willingness of the executive authority to cooperate with them. In many cases these organizations provide loans at low interest rates or even charge no interest at all. The only requirement is to use funds in a rational and professional way and to manage investment and repayment risks. In Poland, cooperation between local executive authority and international financial organization often contains the setting up of a small department searching for and managing of international loans and grants obtained.

Therefore, today local executive authority (of *oblasts*, cities, and regions) is capable of exerting a considerable influence on the process of the microfinance sector development in Belarus. Such an influence is still possible to use despite the existence of significant problems with the absence of the necessary legislation for the development of credit unions and the generally weak level of development of financial and banking institutions in the country. The policy tools proposed could spur the development of the domestic microfinance sector. It seems that on the assumption that the annual inflation rate is less than 10% and at least some of the policy recommendations are implemented, one could expect a significant increase in the volume of microcredits in the near future. Consequently, the development of SMB in Belarus would be greatly enhanced.