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**Financial Crisis, Trade Finance,  
and SMEs: Case of Central Asia**

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**Abstract**

This paper surveys studies of the importance of Central Asian small- and medium-sized enterprises (SME) in the economy and their experience during the Russian financial crisis. It also uses survey data from the World Bank and the European Bank for Reconstruction and Development's Business Environment and Enterprise Performance Surveys to infer noteworthy characteristics, features, and dependencies on financing of Central Asian SMEs and, consequently, derive the potential impact of the crisis on the sector. The paper also assesses government support for SMEs and the necessary market reforms that will give a boost to the sector's development in the region.

**JEL Classification: E44, G01, G18, G28, G38**

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## 1. INTRODUCTION

Major stumbles in economic growth have had something to do with banking system problems. This was true of the Great Depression, true with the Asian financial crisis, and now again with the current global financial crisis. The illiquidity in the global financial market has affected the world, halting more than a decade of exuberant economic growth. It has particularly impinged on trade through reduced provision and high cost of trade finance. Problems in finance impact business operations, and usually especially affect the small- and medium-sized enterprises (SMEs) more. Thus, there is a need to focus research on SMEs and their performance during this time of crisis.

The chapter focuses on SMEs in Central Asia<sup>1</sup>. SMEs in the former Soviet Republics were newly born following the breakup of the Union of Soviet Socialist Republics in 1991. While they quickly adapted to the new market economy, they struggled through the very challenging transition period characterized by, among other problems, an institutional vacuum. Then, when the economy had relatively normalized, the Russian financial crisis hit them towards the end of the 1990s. Now, after experiencing stable growth throughout the first half of this decade, the global financial crisis is again threatening to undo many of their past gains.

The paper surveys SME importance and noteworthy features, and tries to assess, based on past surveys and in the absence of available official information, the likely impact of the crisis on this sector. Everywhere, government support is important for the development of SMEs, but in Central Asia, good economic stewardship and appropriate implementation of regulations by the government are more critical than any other form of government financial support.

The paper first provides a broad-brush discussion of how a financial crisis affects the real economy, the central role of banks in the lubrication of trade transactions, and why SMEs have difficulties accessing bank financing in general and trade finance in particular. Section 3 provides an overview of the Central Asian economy and discusses SMEs importance and discernible characteristics and features. Section 4 and Section 5 put forward a few pieces of evidence on the impact of the 1998 Russian and the current global financial crises on SMEs, drawing heavily from inferences based on firm surveys conducted in 1999 and 2005. The paper relies heavily on the Business Environment and Enterprise Performance Survey (BEEPS, or BEEP Survey) conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD) to derive plausible conclusions on the likely effect on SMEs of the two crises, basing them on sector characteristics and features as well as revealed perceptions by the respondent firms. Section 6 discusses government support of SMEs, particularly their financing needs and problems. Section 7 summarizes and provides policy recommendations.

## 2. FINANCIAL CRISIS, SMES, AND THE ECONOMY

### 2.1 Channels of Transmission From Finance to the Real Economy

The economic literature has identified various channels through which financial crises spread to the real economy<sup>2</sup>. There is a monetary channel, as well as channels for credit, bank capital, wealth effects, exchange rate, uncertainty and cost of capital that provides various explanations as to how, starting from a financial crisis, real economic output gets

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1 Central Asia is composed of Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

2 See Furceri and Mourougane (2009). Box 6 in their paper talks about transmission mechanisms from banking crises to activity.

depressed. Often, these channels may be active at the same time; for example, as a currency crisis ensues from the financial crisis—causing a rise in interest rates and bankruptcies as well as significant drops in domestic output and employment—significant asset price reductions can take place at the same time, leading to a decline in private consumption (wealth effect) and, thus, to further drops in output. For the current global financial crisis, the bank capital channel and credit channel may be the most relevant transmission mechanisms to understand. The ‘bank capital channel’ holds that financial crises can erode bank capital, making banks extremely averse to lend, thus leading to a deeper economic downturn (Bernanke, Lown, and Friedman 1991). The ‘credit channel’ argues that during financial crisis, banks tighten their lending standards and reduce credit availability. These credit constraints lower consumption and investment, thus worsening the economic downturn. Moreover, the credit channel holds that, on the demand side, the crisis reduces the value of collateral and thereby the ability of firms and households to borrow, leading once again to a deeper domestic output cut. Either of these transmission channels is likely to be the main reason for the current global slump.

Whether the increased risk aversion exhibited by banks is due to weak capitalization or merely motivated by extreme cautiousness, the effect is a cutback in available funds for trade finance which, in turn, impinge on the volume of trade. Trade finance is considered a relatively low-risk, routine activity, but where bank margins are also low. The low risk stems from the fact that the usual collateral for trade finance is clear and tangible—the value of the cargo it finances.<sup>3</sup> But the low margin income for banks means that, because lenders tend to concentrate most funding on the most profitable segments of financial markets, in times of a tight liquidity squeeze, low value-added products such as short-term trade finance can be easily abandoned or reduced. Besides its low margins, trade finance’s preferential treatment had changed since the 1980s sovereign debt crisis, leading banks to consider trade finance as a less preferred source of profit. Previously, trade finance had preferential treatment in London Club debt restructurings; today, they are no longer distinguished from other loans by creditors, and are hence subject to the same restrictions in the case of risks.

In the current global crisis, while only anecdotal evidence exists that point to difficulties in accessing finance, and, so far, there is no evidence that traders are unable to ship because of lack of trade financing, the cost of trade finance instruments has, nevertheless, tripled since last year. The increase in cost points to the same root causes as the lack of access.

## 2.2 Banks’ Role in Trade Finance

But what, exactly, are banks’ role in trade finance?<sup>4</sup> First, banks provide working capital to exporters, through short-term loans, credit lines or an overdraft facility, or advance payment of exporters’ bonds, or discounting of receivables. This pre- or post-shipment financing enables exporters to produce and ship products during the entire cash cycle. Banks in the exporting country can also extend buyer’s credit to a foreign buyer to finance the purchase of exports. Often, the availability of financing such as this can affect the relative competitiveness of the exporters and enable them to attract more contracts.

Second, banks render services that facilitate the receipt or transfer of payment in a less costly and risky way (from simple intra-bank money transfers to relatively complex instruments such as leasing, letters of credit [L/Cs], and foreign exchange-related services). They can accept and confirm L/Cs as a counterparty of the importers’ bank, or be the issuing bank in the case of importers’ L/Cs. Third, banks can provide insurance against trade-related risks, through freight and export credit insurance or forward contracts.

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<sup>3</sup> There are different trade financing instruments that require different collateral. These are further discussed subsequently.

<sup>4</sup> This part draws from Finger and Schuknecht (1999).

Of course, there are also forms of trade financing that do not require the intermediary role of banks. The transaction can be done purely between the importer and exporter on a “cash-in-advance” basis or on an “open account” basis (when shipment occurs before payment is due). The former is akin to a supplier credit while the latter is like a consumer credit. Companies can also directly issue Bills of Exchange or Promissory Notes<sup>5</sup>. Some countries also make use of counter-trade or barter system by which they exchange goods at an agreed value without cash or credit terms. All these different forms of exchange have varying levels of risks and would not apply to all types of enterprise. For example, only financially stable exporters and those linked with vertical production networks and have long history of buyer-seller relationship can afford to export on an open account basis, while almost 90% of trade transactions are done via documentary credits.

## 2.3 Finance and SMEs

Banks, in both normal and crisis period, usually give priority to low-risk borrowers like large enterprises with profitable investments and sound collateral. SMEs are usually at the bottom of banks’ preferred customers, except when the government requires banks to provide loans to this group. Why are SMEs, generally, unable to obtain financing? For banks, SMEs, especially in developing economies, are always considered higher risk because of their opacity, and lack of collateral and audited financial statements. Sometimes, they have no good, profitable projects, no clear titles to real estate and other collateral, no clear managerial targets and succession plans, and no available credit history. SMEs hesitate to approach banks because of a cultural barrier, i.e., they do not want the strict monitoring by banks. At times, too, they may not have adequate information of all that banks can offer. This is particularly true of trade finance instruments.

In the succeeding sections, this general interlinkage of bank liquidity problems, collateral issues, SME weaknesses, and trade financing will come into play as the effect of the crisis on SMEs is discussed.

## 3. IMPORTANCE OF SMEs IN CENTRAL ASIAN ECONOMY

To tackle the crisis effects on Central Asian SMEs, I first begin with a brief overview of the region’s economies. The section then proceeds with the discussion of SMEs’ importance in the economy, drawing from various previous studies, and extracts some noteworthy SME characteristics based on firm surveys.

### 3.1 Brief Overview of Central Asia

Central Asia was among the more underdeveloped regions in the world when the states comprising it became independent in 1991<sup>6</sup>. Per capita incomes ranged from just over 50% of the Soviet Union average (Tajikistan) to about 90% (Kazakhstan). The region is rich with agricultural, mineral, and fuel resources, but because of its landlocked geography, many countries were heavily dependent on the Soviet system of trade routes and energy pipelines to reach world markets. Transport and trade infrastructure were outdated and, except for the Kyrgyz Republic, all countries in the region either have internal and regional conflicts or are near conflict zones. None had tasted modern statehood; rather their political institutions were legacies of the old communist system, with closed, autarkic, and heavily distorted industry and infrastructure serving mostly military purposes.

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<sup>5</sup> In both, a buyer undertakes to pay by a specified future date but the latter offers less legal protection.

<sup>6</sup> This part draws from International Monetary Fund (IMF) (1999).

After the dissolution of the Soviet Union, fast reformers (Kazakhstan and the Kyrgyz Republic) embarked on privatization of many state-owned enterprises (SOE), while gradualists (Uzbekistan and Turkmenistan) moved much more slowly. Tajikistan was in a state of civil war until 1995. SMEs surfaced during the post-break up period amidst a challenging macroeconomic environment marked by hyperinflation, financial system collapse, major structural adjustments, and an institutional vacuum. Some of the privatized SOEs became medium-sized or large enterprises, while all small firms and some medium-sized enterprises were built up from scratch.

Buoyed by a more favorable external environment and the high prices of its main export products (e.g. natural resources), Central Asia recovered from a decade of transition-related problems. Now, the most advanced economy of the group, Kazakhstan, has a gross national income (GNI) per capita of more than US\$6,000, which is within the upper middle income bracket globally. The score remains below the average of that income group, but is close to other relatively developed economies like Argentina, Brazil, Chile, South Africa, Mexico, Malaysia, and Poland. The Kyrgyz Republic, Tajikistan, and Uzbekistan remain in the low income group of countries globally, but have GNI per capita figures that are more than 20% higher than the group average. Turkmenistan is in the lower middle income group, like many Southeast Asian economies.<sup>7</sup>

Table 1 summarizes salient economic features of Central Asia. Kazakhstan and the Kyrgyz Republic fully embraced the market economy, evidenced in the large share of the private sector in its economies, starkly contrasting with Turkmenistan where the private sector remains insignificant<sup>8</sup>. Poverty in Kazakhstan is well within advanced economy levels, but Uzbekistan's poverty level is extremely high. Literacy rates, even after the deterioration of education levels due to civil strife, remain high throughout Central Asia, reaching almost the same level as in high-income economies. Mortality rates are worse than the upper middle income group average for Kazakhstan, but the mortality rates for the Kyrgyz Republic and Tajikistan are significantly lower (better) than the low income country group average. Turkmenistan's mortality rate is higher than the lower middle income country group average. As for infrastructure indicators, Kazakhstan is again above the average of the upper middle income group in the number of internet users per 100 people, as is the Kyrgyz Republic with respect to the low-income group. Uzbekistan, though, has an extremely poor internet access figure, with only 1.5 out of every 100 people using the internet. Mobile and fixed telephone subscribers are again high for the three low income Central Asian economies relative to their income group's average, but Kazakhstan is slightly below the upper middle income group average. Although Turkmenistan might have a higher GNI per capita than the three other Central Asian countries, its infrastructure and social indicators are significantly worse than the three low income Central Asian countries.<sup>9</sup>

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<sup>7</sup> The World Bank uses the following income classification of countries: Low income <US\$935 GNI, Lower Middle Income US\$936–US\$3,705, Upper Middle Income US\$3,706–US\$11,455, and High Income >US\$11,456. A caveat is in order for Turkmenistan's GNI because statistics are considered state secrets in the country and the published GDP data are subject to wide margins of errors.

<sup>8</sup> In Turkmenistan, the private sector share is significant only in food processing and consumer trade and services.

<sup>9</sup> See Footnote 7 on Turkmenistan's statistics.



**Table 1: Central Asia: Selected Indicators, 2007**

	Kazakhstan	Kyrgyz Republic	Tajikistan	Turkmenistan	Uzbekistan	High Income Economies Average	Low Income Economies Average	Lower Middle Income Economies Average	Upper Middle Income Economies Average
GNI per capita PPP (current US\$)	6,134.8	695.8	701	1,373.7	701.2	37,571.6	574.4	1,905.0	7,107.0
GNI per capita : group average <sup>a</sup>	0.86	1.21	1.22	0.72	1.22				
FDI Inflows per capita (current US\$)	470	40	25	124	27				
FDI Inward Stock (% of GDP)	41.9	21.8	28.2	49.1	7.4				
Private Sector (share in GDP) - 2008	70.0	75.0	55.0	25.0	45.0				
Poverty headcount at less than US\$1.25 a day (% of population) <sup>b</sup>	3.1	21.8	21.5	—	46.3				
Land area ('000 sq. km)	2,699.7	191.8	139.9	469.9	425.4				
<b>Infrastructure Indicators</b>									
Mobile and fixed-line telephone subscribers (per 100 people)	100.5	50.6	39.9	16.2	28.7	150.4	25.5	54.1	106.7
Internet users (per 100 people)	12.3	14.3	7.2	1.4	4.5	65.7	5.2	12.4	26.6
<b>Social Indicators</b>									
Literacy rate, adult total (% of people ages 15 and above)	99.6	99.3	99.6	99.5	—	99.0	63.5	82.6	94.1
Mortality rate, infant (per 1,000 live births)	28.0	33.5	56.6	44.9	35.6	5.9	80.2	38.3	20.8
Population growth (annual %)	1.1	0.8	1.5	1.3	1.4	0.7	2.2	1.0	0.7

Notes: <sup>a</sup> Kazakhstan- Upper Middle Income; Turkmenistan - Lower Middle Income; Kyrgyz Republic, Tajikistan, Uzbekistan - Low Income

<sup>b</sup> Kazakhstan, Turkmenistan, Uzbekistan- 2003; Kyrgyz Republic, Tajikistan – 2004

PPP= purchasing power parity. GDP= gross domestic product..

Source: World Development Indicators, World Bank; <http://data.un.org/CountryProfile.aspx>

### 3.2 SMEs in Central Asia: Definition and Contribution in the Economy

The definition of SMEs varies per country and even per sector but is, generally, based on the number of employees and capital thresholds. According to a United Nations Economic Commission for Europe (UNECE) study<sup>10</sup>, Kazakhstan, Kyrgyz Republic, and Turkmenistan base SME definitions on maximum levels of capital, assets or income, and number of employees, while Tajikistan and Uzbekistan base the definition only on the number of employees. The threshold for the number of employees likewise varies per sector. For example, in Uzbekistan, to be considered “small”, the average number of employees should not exceed 40 in industry, 20 in construction, agriculture and other production spheres, 10 in retail trade and other nonproduction spheres. Other Central Asian countries likewise follow different thresholds for the maximum number of employees for different sectors of the economy. Of the five countries, only the Kyrgyz Republic provides a definition for medium-sized enterprises, while the rest leave medium-sized enterprises undefined (see Table 2).<sup>11</sup>

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<sup>10</sup> UNECE (2003a).

<sup>11</sup> Importantly, none of the official definitions of SMEs coincide with the classification that this paper uses in subsequent discussions. The paper follows other studies on SMEs that simply base firm classification on the number of employees or, if available, the amount of annual sales/turnover. Micro and small enterprises are those with less than 50 employees, medium with 50 to 249 employees, 250 and above are large firms.

**Table 2: Definition of SMEs in Central Asia**

<b>Country</b>	<b>Official Definition of SME</b>
Kazakhstan	<p>Small: Average annual number of employees not more than 50; Assets not exceeding 60,000 fold monthly estimated index (in 2002 the monthly estimated index equalled 823 tenge)</p> <p>Medium: No definition</p>
Kyrgyz Republic	<p>Small: Production sphere: Number of employees up to 50; Net turnover up to Som500,000;</p> <p>Non-production sphere: Number of employees up to 15; Net turnover up to Som500,000;</p> <p>Medium Production sphere: Number of employees: 51–200; Net turnover: Som500,000–Som2,000,000;</p> <p>Non-production sphere: Number of employees: 16–50; Net turnover: Som500,000–Som2,000,000</p>
Tajikistan	<p><i>Small enterprise:</i> The average number of employees should not exceed - in industry and construction – more than 50 - in other spheres of activities – 15</p> <p>Medium: No definition</p>
Turkmenistan	<p>To be considered as a “small enterprise,” 80% of an enterprise’s income should come from the sale of primary activity goods (services) in the reported quarter.</p> <p><i>Small enterprise:</i> 50 employees – for the enterprises that produce goods for industrial/technical consumption purposes, goods for public consumption and enterprises that carry out constructional and maintenance-constructional activities; 10 employees – for the wholesale enterprises and those deriving revenues from intermediary and supplying activities; 25 employees – for the enterprises with other types of activities</p> <p>Medium – No definition</p>
Uzbekistan	<p><i>Micro enterprise:</i> Average annual number of employees shall not exceed: 10 – in industry; 5 – in trade, services and other nonproduction spheres</p> <p><i>Small enterprise:</i> Average annual number of employees shall not exceed: 40 – in industry; 20 – in construction; agriculture and other production spheres; 10 – in retail trade and other nonproduction Spheres</p> <p>Medium – No definition</p>

Source: UNECE (2003a).

Various studies on SMEs compiled by the World Bank/ International Finance Corporation (IFC) from different sources usually define an SME based on the number of employees. On this basis, the collected information shows that Uzbekistan has more than 200,000 micro- and small- and medium-sized enterprises (MSMEs), 86% of which are micro-sized

enterprises (see Table 3). The Kyrgyz Republic has more than 100,000 MSMEs largely comprised of both micro- and small-sized businesses. There are close to 30 MSMEs per 1,000 people in the Kyrgyz Republic while the ratio is 14 and 10 MSMEs per 1,000 people for Tajikistan and Uzbekistan, respectively.

In terms of employment, MSMEs' share of total employment range from 25% (for Tajikistan) to 60% (Turkmenistan). Uzbekistan and Tajikistan's MSME share of employment is below the average of 58% for low income countries<sup>12</sup>, while the Kyrgyz Republic and Turkmenistan is slightly over the average. The average SME employment share for upper middle income economies, where Kazakhstan belongs, is 40%— much higher than the 25% employment share in Kazakhstan.

The importance of MSMEs in the economy is shown in the high contribution of MSME to total domestic production. In Uzbekistan, the MSME share of GDP is about one third, while it is more than 40% for Kazakhstan, Turkmenistan, and Kyrgyz Republic. The average GDP share of MSME for transition economies, based on data collected by UNECE<sup>13</sup>, is around 40%, while it is 37% for transition economies considered to be making slow progress on reform.

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<sup>12</sup> Based on the collected information from the IFC, I averaged all the collected share of MSME employment according to economic income category.

<sup>13</sup> UNECE (2003a).

Table 3: Importance of SMEs

Country Name	Year	Source of MSME Data	MSME Definitions (number of employees)			Structure of the MSME Sector (% of all MSMEs)			MSME Participation in the Economy			
			Micro	Small	Medium	Micro	Small	Medium	MSMEs	MSMEs per 1,000 people	MSME employment (% total)	MSME Share of GDP <sup>a</sup>
Kazakhstan <sup>c</sup>	1994	UNECE	0-9	10-49	50-249	59.4	35.3	5.3	170,612	11.3	24.6	43.1
Kyrgyz Republic <sup>e</sup>	2003	UNECE	0-9	10-49	50-249	99.4		0.6	142,475	28.3	59.0 <sup>f</sup>	42.7
Tajikistan <sup>b</sup>	2002	IFC	<50		51-200	99.8		0.2	92,964	14.3	25.0	—
Uzbekistan <sup>d</sup>	2003	IFC	<10	10-39	40-99	85.7	11.2	3.1	212,424	10.5	57.0 / 49.7 <sup>f</sup>	31.0
Turkmenistan											60.0 <sup>f</sup>	45.0

Notes:

a. UNECE (2003a).

b. Includes individual entrepreneurs and Dekhan farmers. Source: IFC. Business Environment in Tajikistan as seen by SME Businesses 2003

c. No. of MSEs and MSE Participation taken from USAID SME Statistics (as of October 2005, divided by population and employment in 2005). Share to GDP is for 2003. Number of operating MSMEs only, not total registered MSMEs

d. IFC. Business Environment in Uzbekistan as seen by SMEs. 2003 (without individual entrepreneurs, employment share is 9% and share in GDP is 15% (ADB, Private Sector Assessment for Uzbekistan. 2005). Active number only.

e. UNECE (2006).

f. Employment share data (alternative figure) is from UNECE (2003a)

Source: Kozak (2007), UNECE (2003a), UNECE (2006), IFC Business Environment Surveys, ADB.

More than one third of SMEs in Central Asia are engaged in trade. In the Kyrgyz Republic, services and manufacturing likewise constitute a big portion of SME totals, while in Uzbekistan, SMEs in manufacturing constitute the majority. Tajikistan has most of their small enterprises engaged in agriculture, primarily related to cotton farming and related services (Table 4).

**Table 4: Structure of Incorporated SMEs by Sector (2001)**

	Distribution of Small and Medium-Sized Enterprises (%)				
	Trade	Manufacturing	Construction	Services	Other Activities
Kyrgyz Republic	35.8	21.1	9.3	28.2	5.6
Tajikistan	38.4	15.0	12.1	11.0	23.5
Uzbekistan	34.0	43.0	8.0	8.0	7.0

Note: Other activities comprise of: agriculture; fishing; production and leading of electricity, gas and water; transport; public administration; institutions of education; extritorial organizations; financial mediation; real estate transactions; healthcare; arrangement of recreation and entertainment facilities

Source: UNECE (2003a).

### 3.3 SME Characteristics: Ownership, Establishment, and Export Activities

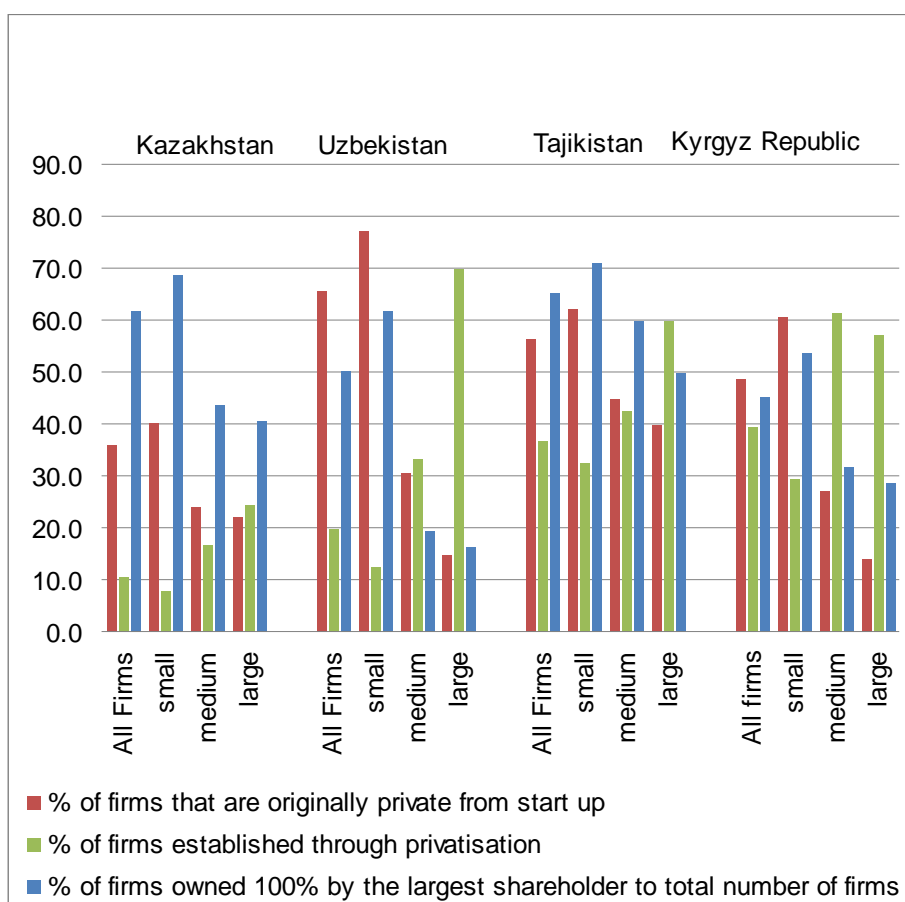
I use the 2005 BEEP Survey by the European Bank for Reconstruction and Development (EBRD) and World Bank to get a better look at SME characteristics in the region.<sup>14</sup> The 2005 sample is comprised of 1,002 respondent firms from Central Asia, of which 690 are micro- and small-sized enterprises, 209 medium-sized firms (micro, small, and medium hereafter), and 103 large firms, using the number of employees as the basis for classification.<sup>15</sup> I find that among small firms, the number of those that are single proprietor (where a shareholder owns 100% of shares) ranges between 54% and 71%, while among large firms, the share of single-owned enterprises is much less.

More than half of the firms in Central Asia have been private firms from the beginning. In Kazakhstan, the number of private start-ups was up to 75% while only 20% were established as privatized SOEs. Across all Central Asian countries, the number of private start ups exceeded the number of privatized SOEs which possibly implies a growing entrepreneurial class of citizens in these former communist countries. Among small firms, the majority were established as private start-ups. In Kazakhstan, for example, more than 80% of small firms started as a private enterprise right at the beginning. In the Kyrgyz Republic, the share is 61% and in Uzbekistan 77%. In contrast, relatively more medium and large firms were established from the privatized state-owned enterprises, rather than as private start-ups (Figure 1).

<sup>14</sup> The main BEEP Survey in 2005 is composed of 300 firms each from Kazakhstan and Uzbekistan, 202 from Kyrgyz Republic, and 200 from Tajikistan. For both 1999 and 2005, the survey sample used stratified sampling, with various quotas on the basis of sector, size (based on number of employees), and location. For the 2005 survey, additional targets were included in the sample design, namely: at least 10% small enterprises (2-49 employees), and 10% large (250-9,999 employees); at least 10% of firms should be foreign controlled (more than 50% shareholding) and 10% under state control; at least 10% of firms export at least 20% of total sales; and at least 10% should be from a small city/countryside. Furthermore, the sectoral composition of the sample was determined according to the relative share in GDP. The sample excluded firms with only one employee, or those in sectors that are subject to government price regulation and prudential supervision like banking, or utilities (electric power, rail transport, water). See methodological notes on the BEEPS from the European Bank for Reconstruction and Development at [www.ebrd.org](http://www.ebrd.org).

<sup>15</sup> In subsequent discussion, the results do not materially change when I used both number of employees and amount of turnover/sales. So I opted for the more simple classification using employment. See Footnote 10.

**Figure 1: Characteristics of SMEs: by Establishment and Ownership (in %)**



Source: BEEPS (2005).

How important are exports in SME activities? I grouped the firms in the BEEP Survey into those that export directly as well as those that export indirectly<sup>16</sup>. The sample contains few firms, only 14% of the total, that directly or indirectly export (i.e., with positive export sales). But for these few firms, average direct and indirect exports constitute 45% and 28% of their total sale, respectively. Direct exports as a share of total revenue range from an average of 27% for Kazakhstan to 62% for Tajikistan, while indirect export revenue is between 14% (Uzbekistan) and 45% (Kazakhstan). Only 10% of SMEs in the sample directly export,<sup>17</sup> yet in these firms, exports are a significant portion of their income. What is particularly striking is that, in Uzbekistan and Tajikistan, the share of export sales in small firms of 58% far exceeds the Central Asian sample average. In the Kyrgyz Republic, large firms' exports dominate their total sale, while in Kazakhstan and Tajikistan, large firms' exports were roughly a third of sales (Table 5).

<sup>16</sup> Indirect export is when firms sell to a distributor or direct exporter.

<sup>17</sup> This is merely the targeted quota for exporters in the sample.

**Table 5: SMEs and Export Activity**

	<b>Total No. of Firms</b>	<b>No. of Firms that Export Directly</b>	<b>Percentage share of direct exports to total sale (by exporting firms)</b>	<b>No. of Firms that Exported through a distributor</b>	<b>Percentage share of indirect exports to total sale (only firms that exported through a distributor)</b>
<b>Central Asia</b>	<b>1,002</b>	<b>136</b>	<b>45</b>	<b>21</b>	<b>28</b>
SME	899	93	45	15	27
Large	103	43	42	6	6
<b>Kazakhstan</b>	<b>300</b>	<b>31</b>	<b>27</b>	<b>7</b>	<b>45</b>
SME	268	21	24	5	45
Large	32	10	31	2	6
<b>Kyrgyz Republic - All</b>	<b>202</b>	<b>38</b>	<b>46</b>	<b>8</b>	<b>20</b>
SME	128	25	39	6	20
Large	21	13	62	2	10
<b>Tajikistan - All</b>	<b>200</b>	<b>25</b>	<b>62</b>	<b>2</b>	<b>25</b>
SME	123	19	58	1	40
Large	20	6	30	1	5
<b>Uzbekistan - All</b>	<b>300</b>	<b>42</b>	<b>49</b>	<b>4</b>	<b>14</b>
SME	219	28	58	3	8
Large	30	14	47	1	3

Source: BEEPS (2005) and author's own computations.



## 4. EXPERIENCE OF SMEs IN CRISIS

Central Asia experienced its first post-independence economic crisis in 1998, which lasted up to 1999 following the Russian financial crisis. The channel through which contagion spread was through trade when Russia devalued its currency by 68% in 1998 and 326% in 1999 relative to pre-crisis ruble to US dollar exchange rate levels. Russia and the Commonwealth of Independent States (CIS) were Central Asia's main trading partner in the 1990s. This devaluation led to a loss of export markets in Russia and globally, as well as import penetration by Russian products in Central Asia. The exchange rate devaluation and volatility was compounded by weak commodity prices and by the banking system disruptions related to the crisis.

### 4.1 Effect of the Russian Financial Crisis in General

The Russian ruble devaluation led to the relative appreciation of Central Asian currencies, causing their exports to slump in their major trading market. The hardest hit were the countries that had significant trade links with Russia and other members of the CIS, especially Kazakhstan. Kazakhstan's GDP contracted by 2% in 1998, but also quickly recovered in 1999.

Before the crisis, a significant share of Central Asian countries' exports went to Russia and other CIS countries. Russia was a key export market for Uzbek cars and electronics, Kazakh chemicals, metals, food items, and light industry products. Both these countries exported more than a third of their total exports to Russia. Tajikistan exported (and still does) a huge number of laborers for Russian construction sector. Thus the ruble devaluation caused a significant rise in the region's current account deficit as a percentage of GDP (Table 6). However, some countries like Kyrgyz Republic and Turkmenistan felt the export contraction not mainly through the depressed Russian market but, in the case of the former, more from the low prices and production problem in the mining sector, and in the case of the latter, from the suspension of gas exports to Ukraine<sup>18</sup>.

The imbalance in trade between Russia and Central Asia continued until the domestic currencies in Central Asia were allowed to float. Average depreciation in Central Asian currencies against the US dollar in 1998 and 1999 ranged from 147% in Kazakhstan to more than 1,500% in Turkmenistan. Kazakhstan's currency appreciated vis-a-vis the ruble by 39%, from a rate of 13.03 tenge to a ruble to 8.07, in 1998 and appreciated further to 4.85 in 1999, or a whopping 63 % exchange rate adjustment since the beginning of the crisis. Except for Turkmenistan, Kazakhstan had the deepest rate of adjustment from the precrisis levels relative to other Central Asian countries. The Kyrgyz Republic had the least exchange rate adjustment by 1999, appreciating only by 47% from the 1997 level (Table 6).

Aside from allowing their currencies to float, Central Asian economies also adopted various trade restrictions in a futile effort to initially maintain the peg to the ruble. Examples of these measures included: introduction of 20% value added tax (VAT) in Kazakhstan on all personal imports from Russia, Uzbekistan, and Kyrgyz Republic; imposition of import quotas after local producers complain about unfair competition from imports; new licensing procedures; etc. In Turkmenistan, the government required all export and import contracts to be approved by the State Commodity Exchange. In Uzbekistan, the government banned the free unlicensed sales of food, mostly imported from Russia. Except for the Kyrgyz Republic, none of the Central Asian countries was a member of the World Trade Organization (WTO) at the time of the crisis, hence they were able to make discriminatory tariff changes against imports from specific countries, a violation of the most-favored nation principle which is

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<sup>18</sup> For this subsection, the paper draws from IMF (1999) which discussed in greater detail the Central Asian crisis following the Russian financial crisis.

sacrosanct to the WTO. On exchange flows, Uzbekistan increased the surrender requirement on exports, while Kazakhstan increased it on invisible transactions<sup>19</sup> and current transfers. Other Central Asian countries adopted other similar measures to favor domestic producers.

Besides being hit by the ruble devaluation, Central Asia likewise suffered through the weakness in world commodity prices. At the time when oil prices were hitting a low of US\$10 per barrel, the heavily commodity export-dependent economies had little else to offset the adverse impact of the exchange rate volatilities. It was not until 1999 when the price of oil and metals increased that Central Asia was able to raise export levels and revenues.

The decline in capital inflows due to the crisis and the disruption in banking activities raised foreign borrowing costs for all emerging markets. Kazakhstan, in particular, was severely affected as its banks intermediated huge flows of foreign capital and plowed them into the domestic economy, especially the mining sector. But as foreign investors became more circumspect about the former Soviet republics, the sources of capital dried up. Reportedly, international banks limited total loan exposures to these countries and made granting them more stringent. For example, the approval of any loans to Kazakh entities had to be obtained from the highest level of their headquarter offices<sup>20</sup>. The Kyrgyz Republic, in turn, suffered from the drying up of liquidity when Russian and Kazakh bank subsidiaries operating in its domestic market limited funds and became extremely cautious.

Compared to the first half of the 1990s, with three or four digit inflation in some Central Asian countries, inflation was not a significant concern during the Russian crisis, except for the Kyrgyz Republic which saw its inflation soar to 36.0% in 1999 from 10.5% in 1998. Relative to precrisis inflation, price changes seemed to have slowed, perhaps as a result of the significant appreciation of their currencies with respect to the ruble, increased control in the regulation of monopoly markets, changes in VAT rates, and cheap prices for raw materials (Kalyuzhnova and Vagliasindi 2006).

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<sup>19</sup> This usually refer to services related transactions in a country's current account.

<sup>20</sup> IMF (1999).

**Table 6: Selected Crisis Indicators**

	1997	1998	1999	1997	1998	1999
	<b>GDP Growth (%)</b>			<b>Unemployment (%)</b>		
Kazakhstan	1.6	-1.9	2.7	13.0	13.1	13.5
Kyrgyz Republic	9.9	2.1	3.7	5.7	5.9	7.2
Tajikistan	1.7	5.3	3.7	2.6	3.2	2.2
Turkmenistan	-11.3	6.7	16.5	1.9	2.0	2.1
Uzbekistan	2.5	4.3	4.3	0.3	0.4	0.4
	<b>Inflation (% growth in CPI)</b>			<b>Current Account Balance (% GDP)</b>		
Kazakhstan	17.4	7.1	8.3	-3.5	-5.5	-0.2
Kyrgyz Republic	23.4	10.5	35.9	-7.8	-21.7	-14.5
Tajikistan	88.0	43.2	27.5	-4.0	-7.3	-0.9
Turkmenistan	83.7	16.8	24.2	-21.6	-32.7	-14.8
Uzbekistan	70.9	29.0	29.1	-4.0	-0.7	-1.0
	<b>Fiscal Deficit (% GDP, current prices)</b>			<b>Lending interest rate</b>		
Kazakhstan	-3.7	-3.9	-3.5	—	—	—
Kyrgyz Republic	-5.2	-3.0	-2.5	49.4	73.4	60.9
Tajikistan	-4.1	-2.7	-2.4	75.5	50.9	26.2
Turkmenistan	-0.2	-2.6	0.0	—	—	—
Uzbekistan	-2.4	-2.0	-1.7	—	—	—
	<b>Exchange rate (LCU/US\$)</b>			<b>Exchange rate index (LCU/Ruble, 1997=100)</b>		
Kazakhstan	75.4	78.3	119.5	100	61.9	37.2
Kyrgyz Republic	17.4	20.8	39.0	100	71.3	52.7
Tajikistan	0.6	0.8	1.2	100	79.5	47.0
Turkmenistan	4,143.4	4,890.2	5,200.0	100	70.4	29.5
Uzbekistan	62.9	94.5	124.6	100	89.6	46.5

Notes: CPI= Consumer Price Index; LCU= Local Currency Unit.

Sources: Asian Development Bank (2008); IMF (2009)

## 4.2 Effect on SME

### 4.2.1 Capacity Utilization

The Russian crisis had different effects on different sectors of the economy. For example, relative to other producers, import substituting sectors have felt the pinch harder due to the huge inflow of cheap Russian goods to Central Asia. Kalyuzhova and Vagliasindi (2006) validate this through a panel data econometric estimate of capacity utilization of firms in Kazakhstan. The argument is that when firms face reduction in demand, they run down inventory, thus leading to a lower level of utilized capacity.<sup>21</sup> The authors show that import substituting sectors exhibit lower capacity utilization during the period of the Russian crisis

<sup>21</sup> This actually depends on whether the reduction is temporary or permanent. The reduction in capacity utilization will ensue if reduction is permanent. However, because of demand uncertainty, firms can also cut capacity even if the demand reduction is temporary.

relative to other sectors, implying that the sector was more heavily affected by increased competition from cheap Russian imports.

One would have thought that many of the import substituting sectors must have been SMEs since the large enterprises in Kazakhstan are normally associated with the extractive sectors and export sector, and that, therefore, SMEs were those that should have suffered more severely from the Russian crisis. The authors, however, showed that this did not appear to have been the case. Their result, in fact, showed that, relative to other sectors, SMEs were less affected by the crisis evidence by their higher degree of capacity utilization.<sup>22</sup> According to the authors, the higher capacity utilization, in turn, is due to the more flexible production structure of SMEs compared to large firms that are mostly SOEs or still partially owned by the government which has, therefore, “social obligations” towards the community and forced to retain employees as much as possible.

#### 4.2.2 Sales, Investments, Exports, Employment, Debt

This apparently puzzling result appears to be also corroborated by the 1999 BEEPS. I consider only firms in the sample with annual sales not exceeding US\$15 million which, as per definition used by the World Bank, is the limit for medium enterprises<sup>23</sup>. I could not use the number of employees, as I did with the 2005 survey because the 1999 survey did not contain this information. As in 2005, the 1999 survey was conducted using a quota sample with targeted quotas on the basis of sector, size (based on number of employees), and location.

One of the questions in the survey that can be interpreted as providing some assessment of the Russian crisis’ impact on SMEs asks whether the firm’s sales, investment, and employment have changed over the past three years. As a result of the crisis, one would expect sales of SMEs to plummet and investment to take a back seat, but the result of the survey is, surprisingly, the reverse.

The number of firms that reported an increase in sales and investments over the three preceding years exceeds those that report a decrease (Figure 2). Among exporters, the number of those that report an increase is roughly the same as those that experienced a decrease in exports. Only for “employment” did more firms report a decrease, while all the other variables appear to signify that firms were not that badly affected by the Russian crisis after all.

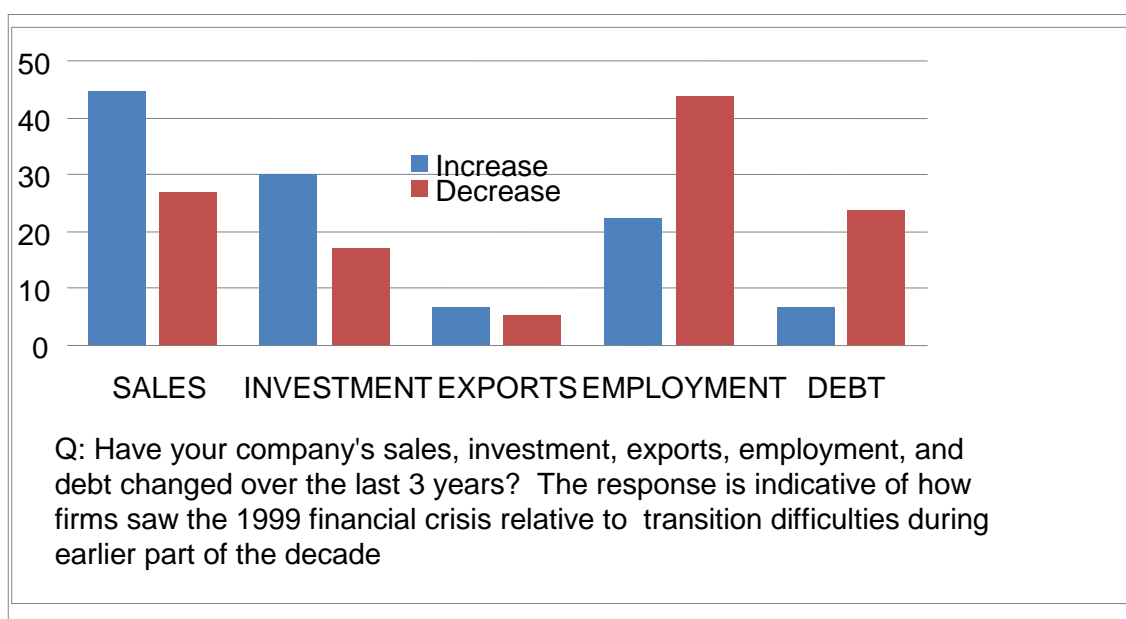
Though the question in the survey relates to the three preceding years, the answers of the enterprises in 1999 are still telling of the relatively little impact of the Russian financial crisis on Central Asian SMEs. It is as if the SME responses were saying that relative to how they were during the earlier part of the decade with all the transition difficulties brought about by the break up of the Soviet Union, the financial crisis is almost like a ‘non-event’. If the crisis had been highly significant in reversing whatever gains they have had since earlier times, many enterprises would have reported ‘decreases’ in sales, investments, and exports over the past three years. But the survey result shows more number of SMEs reporting increases. For the lack of actual data of impact on SMEs, I take this evidence to mean that the result of the Russian crisis might not have been so dire, consistent with the same findings by Kalyuzhova and Vagliasindi (2006). On the other hand, that many firms report decrease in employment may be indicative of the restructuring programs of many privatized SOEs, whereby many superfluous laborers were removed. Is there a difference in the perception between exporting and non-exporting SMEs, and importing and non-importing ones? Further

<sup>22</sup> SMEs in their study are enterprises with less than 500 employees. This definition is different from most studies e.g. by EBRD or World Bank, where SMEs are defined to be those with 250 employees and less (300 employees for World Bank studies).

<sup>23</sup> In many studies, the World Bank uses the following definition for SMEs: medium – up to 300 full time employees and annual sales up to US\$15 million; small – up to 50 employees and annual sales of up to US\$3 million; and micro—up to 10 employees and annual sales of up to US\$100,000.

classification of the respondents did not exhibit any significant difference between exporters and non-exporters, nor between importers and non-importers.

**Figure 2: Percentage Share of Reporting Firms in 1999 (in %)**

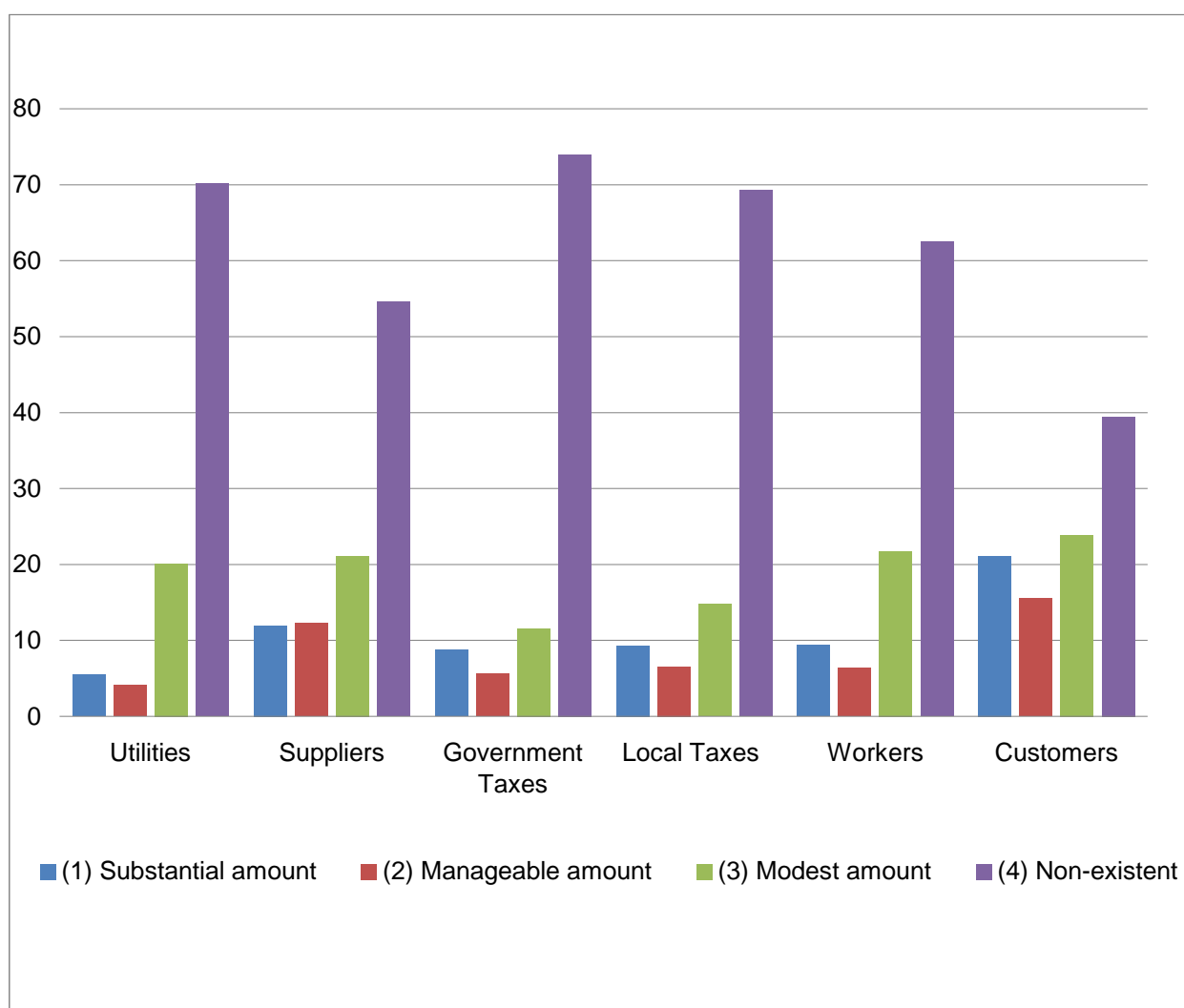


Source: BEEPS (1999)

#### 4.2.3 Arrears

Other corroborating evidence of the relatively little impact of the Russian crisis on SMEs is the number of firms in arrears on payments for taxes, utilities, salaries, and supplies. An overwhelming majority of respondents reported that they had no accounts payable in arrears (90-day overdue accounts) either to the government or suppliers or workers. Of the firms that had arrears, many more said that the amounts were modest than those that said substantial (see Figure 3). If there were significant amounts of arrears, they stemmed from late payments on accounts receivables, as customers were either unable to pay or requested to delay payments. Even then, most firms reported that the overdue accounts receivable amounts were modest. Since firms usually make use of liability payment arrears, especially tax arrears, as a cheap source of financing, this data indicates that, indeed, the SMEs did not appear to have been that badly scathed from the Russian crisis.

**Figure 3: Number of Reporting Firms (share of total in %)**



Source: BEEPS (1999).

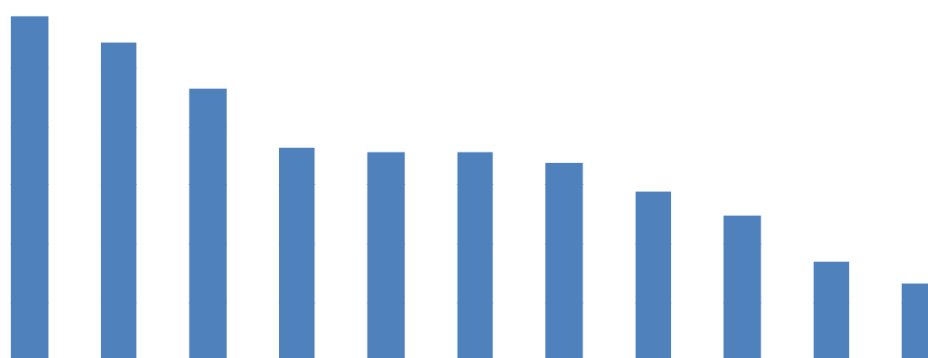
#### 4.2.4 Perception of Major Obstacles

Comparing the firms’ perception of major obstacles in 1999 and 2005, the surveys show that the SMEs’ concern during the financial crisis was over the macroeconomy (see Figures 4a and 4b). The survey asked firms to rate specific factors from 1 (not an obstacle) to 4 (major obstacle). I took the number of firms that considered the different factors as major obstacle as a share of the total sample, shown in Figure 4. More than 50% of surveyed firms considered inflation and exchange rates as major obstacles to their business, while only 46% indicated that financing was an obstacle. Other high-ranked factors are corruption, taxes, and policy/regulatory uncertainty. This result indicated how macroeconomic uncertainty posed a threat in the operations of many firms then and, by implication, financial crises exact real costs to the economy through the volatilities they create for firms. This concern over macroeconomy contrasts markedly with the result of the 2005 survey, taken at a time when the economy was generally stable. In 2005, macroeconomic considerations were not a major concern of firms. High taxes were a concern both in 1999 and 2005, but in the more stable period, it took a dominant place. Financing, too, was considered a major issue in both periods but, especially in the case of small firms, the cost of finance was a top concern in 2005. The other difference between the two surveys is that there was no single factor that was overwhelmingly considered as a major obstacle in the later survey. In 2005,

for example, the top “vote-getter” (taxes) concerned only 21% of the firms, while in 1999, macroeconomic factors received “votes” from more than half of the sample.

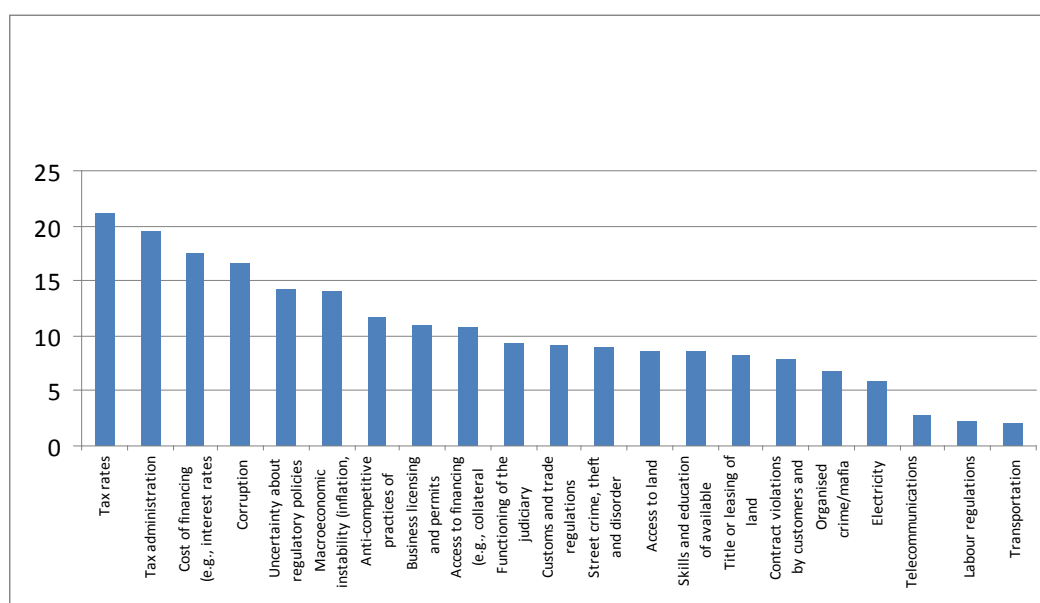
The 1999 and 2005 BEEP Surveys were not conducted on the same set of firms to make a panel data. The BEEP Surveys included a panel component of 1,500 firms from the 2002 and 2005 surveys, but not from the 1999 round. The change in perception between two groups of respondents, however, still reveals an overall shift of business sentiment even if the set of respondents may have been different, in relatively the same vein as how the random surveys that are usually carried out on various population groups are used to assess the public sentiment on any social or political issue. These random surveys of public perception are, likewise, not panel data, but rather to be considered a snapshot of the public pulse at different points in time.

**Figure 4a: Percentage of Firms Considering Factor as Major Obstacle in 1999**



Notes: (a) Refers to practices by government or private enterprises; (b) Infrastructure refers to telephone, electricity, water, roads, and land.

Source: BEEPS (1999).

**Figure 4b: Percentage of Firms Considering Factor as Major Obstacle in 2005**

Source: BEEPS (2005).

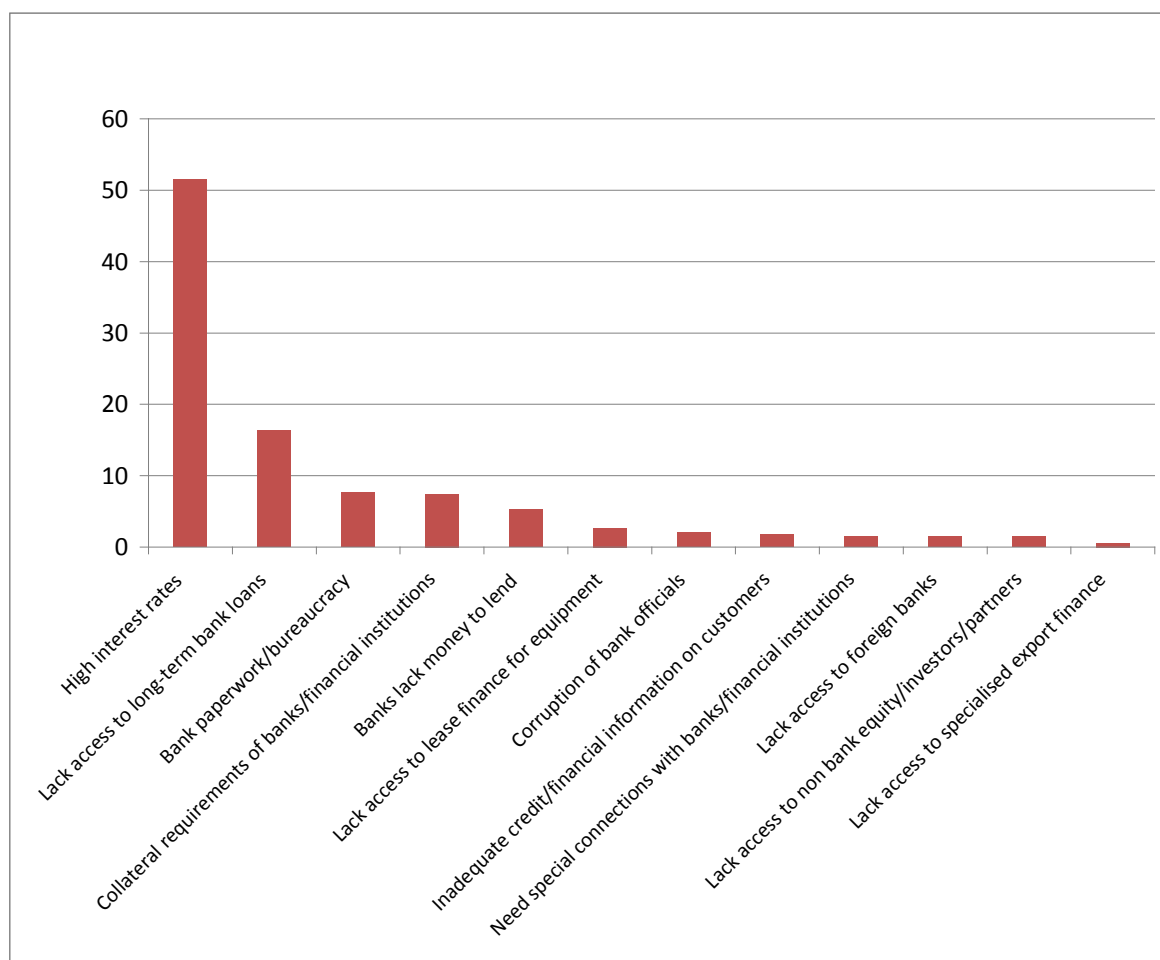
### 4.3 Effects on Trade Finance

Some questions in the BEEP Survey focused on financing obstacles. Here, more than 50% of SMEs considered high interest cost as a major obstacle and this share was the same among different groups: exporters, non-exporters, importers, and non-importers. The next three major obstacles cited in 1999 - collateral requirements, access to long-term loans, bank bureaucracy— were cited by a far lower percentage of firms that considered them as major obstacle (Figure 4). Interestingly, the ranking of these three factors permutes depending on whether the firms engaged directly in trade or not. In particular, for direct exporters and importers, collateral requirements came second, followed by access to long-term finance, and bank bureaucracy, while for non-exporters and non-importers, access to long-term finance was second, then bank bureaucracy, and collateral requirements.

Among the different formal financing arrangements that banks offer, trade finance is usually the least attractive to them, because it is typically a low-margin activity. However, it is also among the safest because they have clear, tangible collateral in the cargo that they fund. The 1999 BEEP Survey did not dwell in particular on trade finance, but Figure 5, below, indicates it must have been likely that, along with other financing, the cost of trade finance had likewise surged during the Russian financial crisis.



**Figure 5: Number of SMEs Indicating Factor as Major Obstacle to Financing in 1999 (in %)**



Source: BEEPS (1999).

#### 4.3.1 Weak Financial System

There are some factors that can explain the difficulty of access to finance, especially trade finance, of firms in Central Asia. One factor that the region shares with other transition and emerging economies is the weakness of the banking system. When the Russian financial crisis occurred, both Kazakhstan and the Kyrgyz Republic had just gone through a serious financial system crisis. The unstable financial position of the region's commercial banks, which was further aggravated by the Russian crisis, made them high risk counterparties of western banks in any trade financing deal. Various reports during the period on conditions in the CIS, of which the Central Asian countries are members, indicate that prior to the 1998 financial crisis, western banks were generally ready to confirm L/Cs issued by CIS banks.<sup>24</sup> It is likely the case that the same situation, if not worse, held true in Central Asia during the period. Since SMEs tend to get less favorable treatment from banks relative to large enterprises even during normal periods,<sup>25</sup> it can be surmised that during the Russian financial crisis, the financing situation for SMEs, could have only gotten worse.

<sup>24</sup> Various issues of the EBRD *Transition Report* discussed some of the financing problems in CIS countries. A similar situation happened to Indonesia forcing the central bank to deposit part of their foreign currency reserves in foreign banks as guarantee or collateral for the L/Cs issued by Indonesian banks.

<sup>25</sup> This is due to various factors. SME creditworthiness is hard to evaluate, and in the region, many of them are new and have no credit history.

The weakness of the banking sector does not only affect trade finance through the lack of trust from foreign counterparties; it directly affects the domestic provision of trade and working capital financing services to local exporters and importers. During a financial crisis, banks' weak condition makes them very selective in granting trade financing loans. In Central Asia, many local private banks issued L/Cs only to customers with the requisite funds on their account. This was almost equivalent to a cash collateral requirement by the issuing banks, making the financing operations of the firms more challenging.

As the region is dependent on commodities exports, Central Asia's trade financing needs are more for working capital and pre-shipment financing. Generally, without a working capital source, exporters have higher performance risk, i.e. the risk of not being able to deliver on time and according to desired quality. Hence, access to pre-shipment trade financing can help firms attract more international business. If exporters cannot deliver goods on time because of a lack of working capital, repeat business will be more difficult to obtain. But a weak banking system and a financial crisis make pre-shipment trade financing for working capital purposes more difficult and costly to obtain because the reluctance of banks to extend credit without burdensome collateral requirements is heightened during this period.

#### **4.3.2 Knowledge Deficit**

Besides the undercapitalization of Central Asian commercial banks, they also offer a limited range of services and relatively inefficient loan monitoring capacity. Particularly in the 1990s, they lacked experience in documentary trade operations as well as knowledge in other trade financing instruments such as forfaiting or factoring. Western banks often indicate that only a few banks in the region have sufficient know-how to act as an advising bank in an L/C transaction where a western bank acts as an opening (issuing) bank. In some cases, the region's banks also have standards for trade finance operations that differ from international ones. Moreover, the document-processing technology is out-of-date (UNECE 2000).

#### **4.3.3 Risk Perception and Payment Method**

The other major factor is the perception of a high risk level in Central Asia that affects conditions of payment for trade transactions. For example, the French Export Credit Agency (COFACE) classified Central Asia as a high risk area and, thereby, advised exporters to the region to negotiate on pre-payment terms if possible. In contrast, other former Communist countries like Poland and Hungary had been able to negotiate on open account<sup>26</sup> and documentary credit terms. The high risk perception, along with the lack of know-how of banks in documentary credits transactions, could be the reasons for the predominant use of the prepayment method not only in import, but also export, transactions in Central Asia and many CIS economies.

#### **4.3.4 Trade Alternative**

In Central Asia, countertrade among traditional Soviet-era partners still exist and, in fact, helped in times of financing difficulties. When access to bank financing was difficult, countertrade among CIS countries played a major role in maintaining trade volumes and supply in individual regions. Even in some countries where cash withdrawals were strictly monitored and controlled, barter activities thrived for some basic materials and consumption goods. To a certain extent, it is alleged that barter trade may actually be less costly and more convenient than cash- or credit-based trade due to high taxes, insecure property rights, imperfect credit markets, and rent-seeking behavior of financial intermediaries (UNECE 2000).

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<sup>26</sup> Open account is essentially like a trade credit given to importers by the exporter where payment may be delayed even as ownership of the exported goods had already been transferred to the importers. It takes an enormous deal of trust among parties for open account to be granted. This normally takes place, especially among vertically integrated firms or parent-subsidiary trade, where risk is extremely low and repeat business characterizes the relationship.

## 5. EFFECT OF GLOBAL FINANCIAL CRISIS

### 5.1 Transmission Channels

While the main channel for transmission of the Russian financial crisis to Central Asia was through trade links, the global crisis impacts the region directly through the financial illiquidity in the global markets. The most affected of the countries in the region is Kazakhstan which had fuelled its rapid growth through heavy private sector external borrowing from foreign capital markets. Kazakh banks balance sheets are estimated to have 50% in foreign liabilities<sup>27</sup> which, during the boom period, were plowed into the economy to finance major construction, real estate, and extractive industries. Similar to how it was in Asia (in 1990s) and in the US (recently), huge inflows of foreign finance fuelled a real estate bubble starting mid-2007. Now, when capital dried up from the global financial crisis, Kazakh banks are scrambling for new financing, both to finish off many real estate and construction activities as well as to pay off their maturing debts.

The transmission channel of the global financial crisis to the rest of Central Asia is through Kazakhstan's banking subsidiaries that operate in other Central Asian countries, particularly in the Kyrgyz Republic where nearly half of the banking system is owned by Kazakhstan banks. As the Russian and Kazakh parent banks of these subsidiaries struggled, the subsidiaries also wobbled through lack of funding, creating financial strain in other parts of the region. Thus, even countries that were not linked to the foreign financial market were caught up in the mayhem in the global markets through the troubles of the foreign-owned subsidiaries. Already, the Kyrgyz Republic had experienced a credit slowdown as a result of the banking sector difficulties in Kazakhstan.

In Kazakhstan, around 70% of bank loans are connected directly and indirectly with real estate. These loans, in turn, were funded not from domestic deposits but from foreign debt which now amount to 4.8 trillion tenge (approximately US\$39 billion.)<sup>28</sup> Now shut off from international capital markets, and facing difficulties in rolling over their external debt, Kazakh banks with high exposure to international capital markets are the most badly hit. Further, Kazakh banks' exposure to the declining Russian real estate market, along with the weakness of the Russian ruble make them susceptible to further balance sheet pressure. The increase in provisioning for the potential losses from real estate and nonperforming loans, as well as for the maturing foreign debt has created illiquidity in the lending market and tightening of lending requirements.

The other channel of contagion is the drop in remittances of migrant workers, mostly from Tajikistan and Kyrgyz Republic, working in Kazakhstan and Russia. As the economic growth in these two countries stumbles, migrant workers that benefited from the construction boom find themselves out of work and had to return home, thus contributing to the rise in domestic unemployment. In countries that have become heavily dependent on foreign remittances—Tajikistan, for example, received remittances equivalent of 50% of its 2008 GDP (IMF 2009)—the drop in this foreign financial flow is equivalent to a major external shock. The projected 30% decline in remittances in Tajikistan threatens to affect poor and vulnerable households. It will likewise have an adverse impact on the profitability of Tajik banks because of the drop in associated fees from remittances. Bank fees from remittances constitute about one third of Tajik bank income.

Although commodity prices have not reached the nadir it did in the 1990s, the weakness in commodity prices is additionally impinging on the commodity export dependent economies of Central Asia (Kazakhstan, Turkmenistan, and Uzbekistan). The lower export revenues lessen the emergency fund that they can use to boost domestic demand in the face of a

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<sup>27</sup> IMF (2009b).

<sup>28</sup> Using 122.40 tenge: 1 US\$ average exchange rate in 2008.

sluggish global market. On top of the terms of trade deterioration, weak global demand, for cotton, aluminum, and other metals (except gold), is further exacerbating growth declines in these countries, including Tajikistan.

## 5.2 Macroeconomic Effects

Macroeconomic effects, so far, have been seen mainly in Kazakhstan, the most globally linked of the Central Asian countries. In 2008, Kazakhstan grew by 3.2%, a decrease of more than five percentage points from its 2007 growth rate. For the rest of the Central Asian countries, the 2008 growth rate shed between 0.5 to 2.0 percentage points from their 2007 growth rate. In 2009, the prediction was more dire with a negative growth rate projected for Kazakhstan and very low growth expected for Tajikistan and the Kyrgyz Republic. Turkmenistan and Uzbekistan are expected to achieve real gross domestic product (GDP) growth of 7% because of favorable developments in the hydrocarbon sectors. Exchange rate depreciation, caused by asset switching in favor of safer foreign currencies, and higher food and fuel prices are expected to contribute to higher inflation. The external dimension of the crisis and weak global demand is reflected in current account projections that shift from surplus in 2008 to a small deficit in 2009. The International Monetary Fund (IMF) notes that while the energy exporters from Central Asia would see their current account surpluses evaporate due to falling commodity prices, the energy importing countries would narrow their current account deficit because of tightening financing conditions. Similarly, the fiscal position is moving from a surplus into a deficit.

**Table 7: Selected Macroeconomic Indicators (2007–2009)**

	2007	2008	2009	2007	2008	2009
	<b>GDP Growth (in %)</b>			<b>Inflation (growth in CPI in %)</b>		
Kazakhstan	8.9	3.2	-2.0	10.8	17.2	9.5
Kyrgyz Republic	8.5	7.6	0.9	10.2	24.5	12.4
Tajikistan	7.8	7.9	2.0	13.2	20.4	11.9
Turkmenistan	11.6	9.8	6.9	6.3	15.0	10.0
Uzbekistan	9.5	9.0	7.0	12.3	12.7	12.5
	<b>Exchange rate (LCU/US\$)<sup>a</sup></b>			<b>Exchange rate index (LCU/Ruble, 2007=100)</b>		
Kazakhstan	122.6	118.3	140.2	100	99.2	87.2
Kyrgyz Republic	37.3	36.5	41.7	100	100.9	85.1
Tajikistan	3.4	3.4	3.8	100	101.0	84.9
Turkmenistan	—	5,200.2	5200.2	100	102.8	76.0
Uzbekistan	—	1,314.5	1419.2	100	101.1	80.4
	<b>Current Account Balance (% GDP)</b>			<b>Fiscal Deficit (% GDP, current prices)</b>		
Kazakhstan	-7.8	5.3	-6.4	—	—	—
Kyrgyz Republic	-0.2	-6.5	-6.3	0.1	—	—
Tajikistan	-11.2	-8.8	-9.7	1.7	—	—
Turkmenistan	15.4	19.6	15.7	—	—	—
Uzbekistan	7.3	13.6	7.7	—	—	—

Note: <sup>a</sup> only first quarter 2009.

Shaded cells are projections by the IMF; CPI = Consumer Price Index; LCU= Local Currency Unit.

Sources: ADB 2008; IMF 2009a.

### 5.3 Effects on Trade Finance and SMEs

As the banking sector becomes illiquid, the story unravelling now looks similar to the previous Russian financial crisis. The financial market is characterized by deleveraging commercial banks, a sharp rise in risk aversion, and increasing numbers of bank failures. Trade finance is again among the financing facilities that show signs of tightening. An IMF survey<sup>29</sup> of banks showed that prices of lending facilities, including L/Cs, have risen, partly due to higher cost of funds and partly due to higher capital requirements and rising default risks. Banks, moreover, see the price trend continuing in 2009. The volume of trade transactions from emerging market banks had declined by an average of 6%. Emerging markets are most affected by the rising costs and increased risk perception because the products they ship tend to be low-margin products, usually as part of the global value-added supply chains. The increase in trade financing cost eats up a huge portion of their narrow margin. The survey also reported that banks had tightened guidelines for some specific countries.

#### 5.3.1 Funding Sources of SMEs

While there is scant data on the effect of the global crisis on SMEs in Central Asia, I try to assess the potential effects using the SME characteristics I obtained from the 2005 BEEP Survey.<sup>30</sup> The idea is to uncover some financing structure from this survey and derive relevant implications that can apply to the current crisis. The survey was again conducted using stratified sampling similar to the approach taken for the 1999 BEEP Survey.

Figure 6 shows the financing sources for working capital of enterprises in Central Asia. All firms show that the majority of the working capital requirements were sourced internally, while the remaining 12 to 20% were externally funded. Of the external sources, all firms relied heavily on bank borrowings, both from the government and private sector, as well as trade credits. Small enterprises, however, relied relatively less on government banks loans compared with medium enterprises. Moreover, SMEs had a heavier reliance on family loans which large enterprises did not. On the other hand, large enterprises relied more heavily on foreign bank borrowings than SMEs.

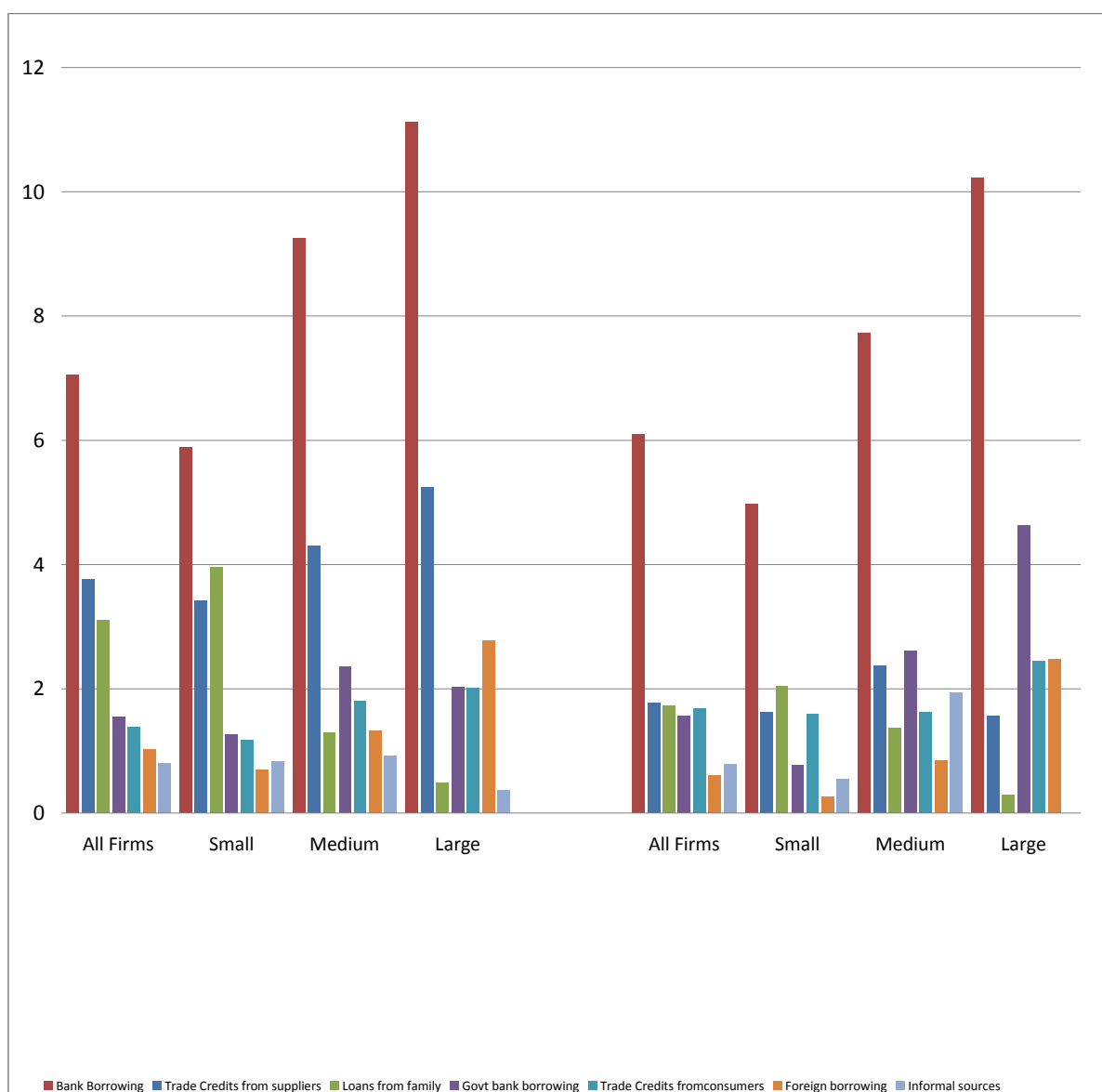
From this basic analysis, the implication is that while both SMEs and large firms would be affected by the global financial crisis through the impact on the liquidity of the banking system, large enterprises would likely be harder hit than SMEs because of their heavier reliance on foreign financing, as foreign investors and lenders are now more highly risk averse due to problems in the foreign capital markets.

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<sup>29</sup> See Dorsey (2009).

<sup>30</sup> The sample is comprised of 300 firms each for Kazakhstan and Uzbekistan, 202 for Kyrgyz Republic, and 200 for Tajikistan. Sectoral composition is as follows: 26% wholesale, retail, and repairs; 21% manufacturing; 12% construction; 9% real estate, rentals and business services; 6% transport, storage and communication; 4% hotels and restaurants; 2% mining and quarrying; and 4% other sectors.

**Figure 6: Working Capital Financing (Share of External Funding Sources in %)**



Note: The share of total working capital financing corresponds only to external sources and excludes retained earnings, hence, sum does not add up to 100%. See footnote 12 for definition of small, medium, large.

Source: BEEPS (2005).

To further analyze the differential impact of the crisis on various enterprises, I divided the groups into SME exporters and non-exporters, as well as large exporters and non-exporters. Exporters are those firms with more than 20% of their sales accounted for by direct exports.<sup>31</sup> Figure 7 shows that large exporters relied relatively more on private and government bank borrowings than SMEs. Further large exporters relied more heavily on foreign bank borrowing compared with large non-exporters. SME exporters, on the other hand, relied more on other sources of finance, like state-owned banks, family loans, supplier and consumer credits, leasing, and loans from informal sources than large exporters.

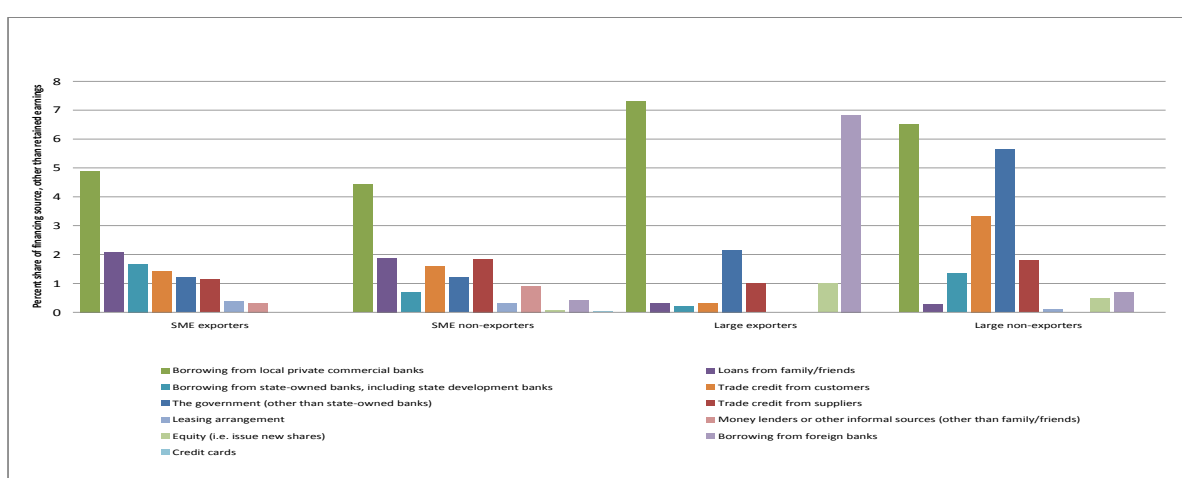
Large exporters stand to suffer from illiquidity in the global financial markets more than non-exporters because of their heavy reliance on foreign borrowing. Large exporters source

<sup>31</sup> The choice of 20% is arbitrary. The EBRD and World Bank used the 20% cut off for direct exports as a basis for the stratified sampling targets, hence I considered it, likewise, as a realistic benchmark for categorizing “exporters” from “non-exporters”.

almost 7% of their working capital requirements from foreign borrowing compared with less than 1% for large non-exporters.

Since retained earnings is a large source of working capital, the global financial crisis affects all enterprises' financing source through its effect on economic growth and sales. If sales drop, earnings will also drop, thus affecting a huge source of working capital for all enterprises. For exporters, a drop in foreign sales may be offset by the depreciation of the local currencies which increases the amount of their total revenues (in local currencies). Exporters also benefit from a more diversified market, as even if some foreign markets experience demand weakness others may compensate, compared with non-exporters that are limited to the domestic market alone. Large exporters may benefit from the rise of commodity prices because most large exporters are in the extractive industries, while SME exporters, which are usually in manufacturing and the retail/wholesale trade business, may be more directly affected by the weakness in domestic and foreign demand.

**Figure 7: External Source of Working Capital (Exporters versus Non-exporters) (in %)**



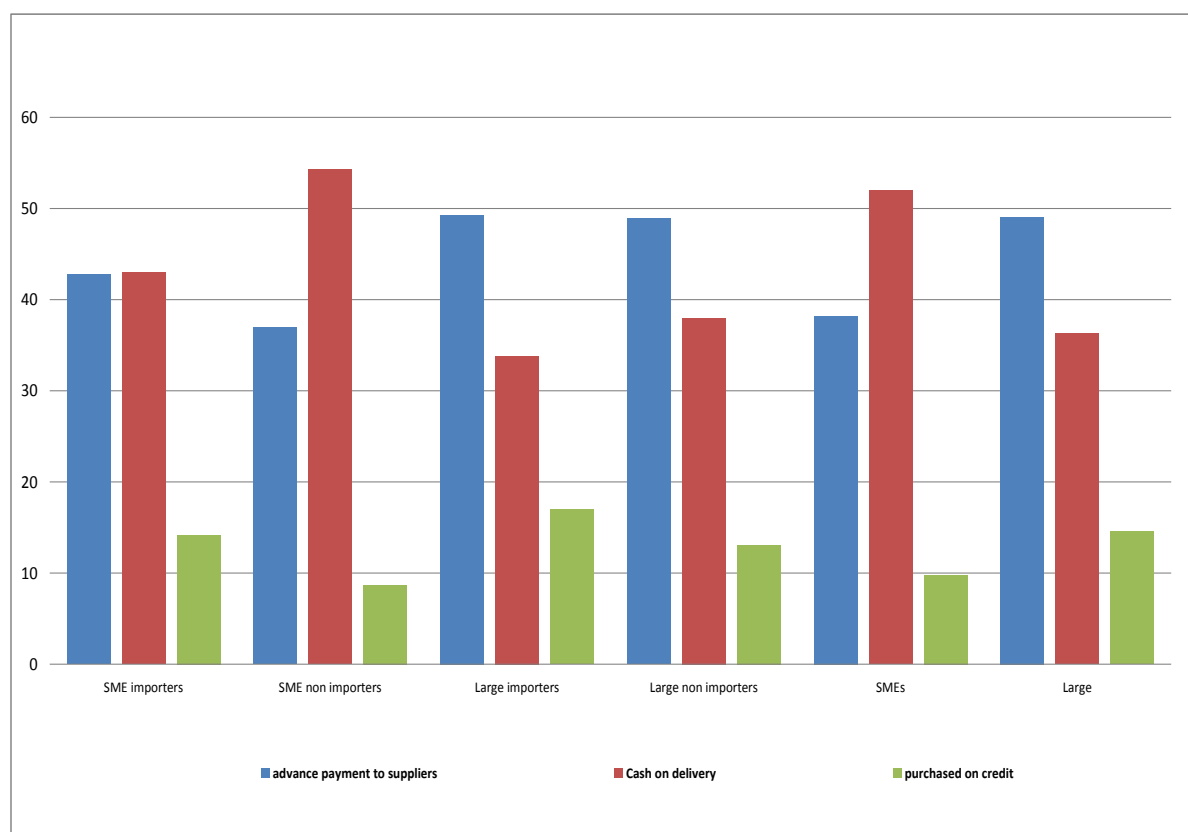
Source: BEEPS.

### 5.3.2 Nonbank Funding Sources

Firms usually use sources of finance other than the banking sector through the mode of payment to suppliers or from customers. In particular, advance payment by customers is a form of cheap credit for the producers and is a help in lessening working capital pressure. Similarly, delayed payment to suppliers is another form of credit. In this sense, how much advance payment the producers can source from customers, or how much delayed payment it can negotiate with suppliers may provide some implications on pressures that the global financial crisis can impose on firms.

Figure 8 indicates the relative share of advance payment, cash payment, and suppliers credit in the previous years input purchases of the respondents. It reveals that whether they are SMEs or large firms, enterprises in Central Asia have to transact either in cash for input purchases or provide advance payment. Supplier credits were as little as 10% of total purchases of SMEs (15% for large firms), while advance payment is close to 50% of input purchases for large firms. More than 50% of SME purchases were paid in cash. For SME importers, the advance payment requirement is even higher than the SME average.

**Figure 8: Mode of Payment for Imports (% of Input Purchases)**

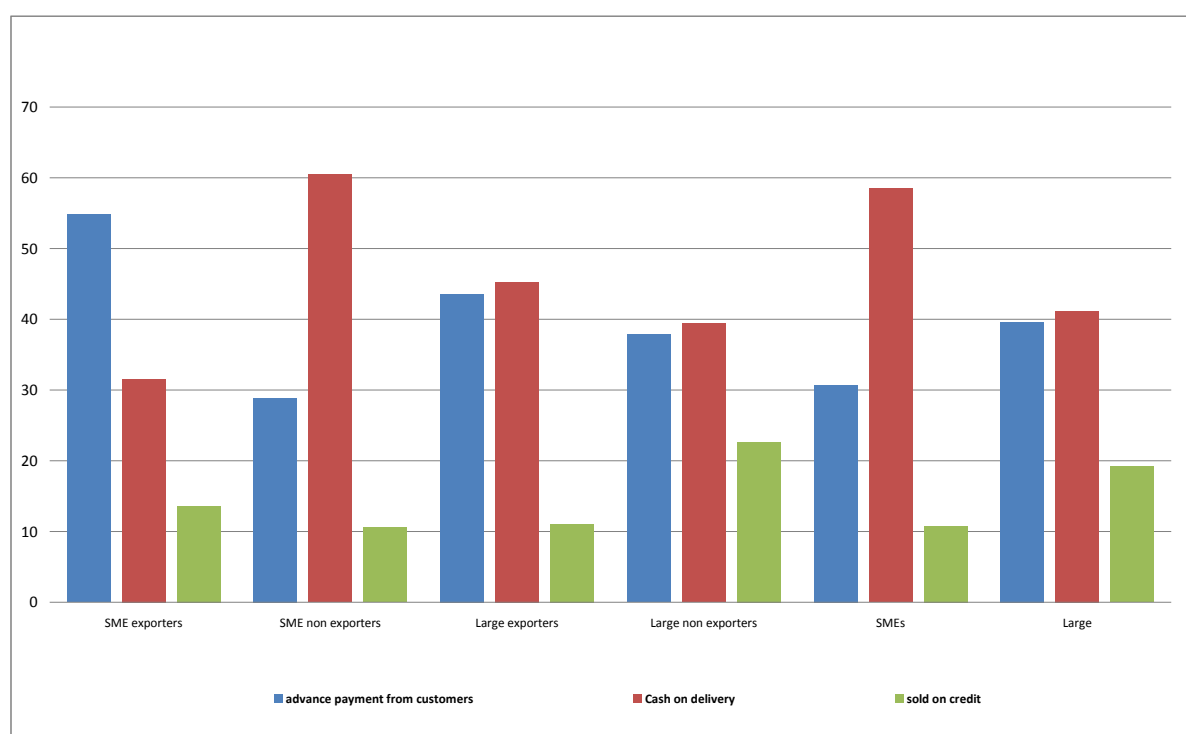


Source: BEEPS (2005).

The relative importance of prepayments and cash payments as a share of purchases implies that all enterprises would need larger working capital finance or bridge financing to be able to pay for the inputs they need for production. Either this, or input suppliers would be forced to grant more supplier credits to continue operations. However, considering the high risk associated with sales to Central Asian importers, an increase in suppliers credits from foreign suppliers may be difficult to negotiate given the current global economic situation. For SME importers, the need for advance payment may be attenuated by the existence of trade guarantees, either from the government or from international donor agencies.

The situation is relatively less stark if we look at the mode of payment by consumers (Figure 9). In this case, SMEs' financing need is decreased by the fact that a large share of their sales are paid in advance or upon delivery. This is particularly true for SME exporters, despite performance or delivery risk concerns for exporters from emerging markets generally. SME exporters get 55% of their sales paid in advance compared with 29% for non-exporting SMEs. Large firms have similar payment structures regardless of whether they export or not—receiving roughly 40% of sales through advance payments.



**Figure 9: Mode of Payment for Exports (in %)**

Source: BEEPS (2005).

The potential risk from the global financial crisis, given this payment structure on sales, is that the depressed global demand might reduce the capacity of foreign buyers to make advance payments leading them to demand more credits from exporters from Central Asia. Unlike the manufacturing trade, where alternative financing may be arranged between companies because of the vertical relationships of the exporter and importer,<sup>32</sup> trade in commodities tends to be more volatile and usually goes through organized commodities exchange markets and is, thus, highly dependent on bank-based financing. In turn, the inability of firms engaged in commodities trade to collect payments and obtain financing may have significantly contributed to their default on their own bank loans.

## 6. GOVERNMENT SUPPORT FOR SMEs

Central Asian governments recognize the importance of SME development in their countries' growth. But SMEs have yet to emerge as the real backbone of the Central Asian economies because large enterprises have historically dominated major industries like metal, oil, and gas. To assist SME growth, the countries have special programs funded by the government or foreign donor institutions. In Kazakhstan and the Kyrgyz Republic, for example, there are support infrastructures (business incubators, techno-parks), consulting and training centers, special tax regimes, outright financial support through loans and grants. Tajikistan is streamlining their SME policies to eliminate program duplication, and developing state policy and strategies to attract FDI to SMEs. Even Turkmenistan and Uzbekistan, which are the least market oriented in the region, have special financial and tax privileges in their laws for SMEs<sup>33</sup>.

In the current global financial crisis, Kazakhstan's government has set aside US\$4 billion emergency spending or approximately 20% of its GDP, out of which 117 billion tenge<sup>34</sup> (or

<sup>32</sup> For example, partner foreign firm can make advance payments to facilitate production of local firms.

<sup>33</sup> See UNECE (2003a). It provides an excellent survey of SME policies in transition economies.

<sup>34</sup> Approximately, US\$956 million using exchange rate of 122.379 tenge to one US\$.

roughly 25% of emergency spending) are allocated for SMEs. The government-owned holding company Samruk-Kazyna is managing the fund and agreed with 12 commercial banks to disburse money in February 2009 to finance SME purchases of fixed assets, operating costs, and refinancing of existing loans. The loans are capped at 750 million tenge (US\$5 million) per borrower and with a seven year tenor. The government has also lowered corporate tax rates and removed the monthly tax pre-payment to help business enterprises.

In terms of trade finance, transition economies have varying degrees of SME support through direct export financing and export credit insurance. Government-sponsored direct export finance can take the form of pre-production financing of the domestic exporter, refinancing of export credits extended by commercial banks, or interest rate subsidies. Government-owned export credit agencies usually provide trade insurance to cover various trade risks (commercial, political, etc.) of non-payment as well as guarantees for trade transactions. These guarantees are often crucial for actual access to bank finance. Unfortunately, these types of support are not as well developed in Central Asia as in other transition countries. For example, in the UNECE (2000) Conference volume, only Kazakhstan was mentioned to have a government agency providing exporters with direct financing. Likewise, only Kazakhstan and Uzbekistan have government-supported export credit and insurance schemes that seem operational. The Uzbek Export-Import Insurance Company appears to be the best capitalized and the most active export credit agency in the CIS region.

Interestingly, what the SMEs are clamoring for from the government, over and above technical and financial support such as those mentioned above, are, actually, basic market reforms in the form of transparent and consistent regulations and tax policies, less corruption, lower cost of finance, as well as better infrastructure.

## 6.1 Market Reforms

In countries like Uzbekistan and Turkmenistan, a market economy has never been fully embraced, and the global financial crisis had just reinforced their resistance to move towards greater market reform. Although these slow reform economies have legally promulgated measures to develop the private sector, they neither constitute a coherent strategy or vision for the role of the private sector in the economy nor are they fully implemented. In Uzbekistan, for example, government control remains pervasive through its direct and indirect control of state-owned joint stock companies or enterprises managed through industrial associations. Through government procurement, the state has control over important food and cash crops. For example, cotton production is controlled through a central government scheme, limiting options of farmers to plant alternative crops. The government industrial policy and involvement in the economy undermines the creation of a dynamic private sector and fair competition culture and throttles the growth of SMEs.

In Central Asia, property rights, ownership of land, and land markets are among the basic reform that could support SMEs. Thus far, only Kazakhstan and the Kyrgyz Republic have managed to amend their constitutions to allow private land ownership. Tajikistan, Turkmenistan, and Uzbekistan still have limited land tradability either de jure or de facto (Tajikistan) (see Table 8). In Uzbekistan, for example, the state grants farmers only a time-bound right to use land, not full property rights. It also heavily regulates the scale and type of activities, including controlling the amount of land devoted to particular crops. The lack of clear property rights and tradable rights in land hamper agriculture in which many individual entrepreneurs depend and severely hamper their access to finance. It undermines efficiency and discourages investments. Removing this constraint would provide a big spur for agricultural growth and productivity.<sup>35</sup>

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<sup>35</sup> In Tajikistan, the constitution still holds that the property rights to land belong to the state only. Therefore legal entities and individuals cannot own and sell the land. Land legislation allows land use

Other areas of market reform that support SMEs are in the area of institutional quality, i.e. the quality of the regulatory framework as well as the institutions that implement them. For example, addressing tax policy through a simplification of customs and tax rules and procedures and removing bureaucratic red tape, can eliminate one of the most serious constraints to business. It is, besides, a frequent source of corruption. Reform could help many SMEs that operate in the informal economy, seeking to avoid legal taxes yet also paying a high cost for avoiding the law in the form of unofficial payments to corrupt law enforcers, to emerge from the gray sector.

Central Asian countries have made significant progress in establishing a legal and regulatory framework for businesses, although better enforcement is needed. The corpus of commercial laws, e.g. transactions law or insolvency law, are generally limited in scope and thus are assessed as ranging from low quality (for Tajikistan, Turkmenistan, and Uzbekistan) to medium quality (Kyrgyz Republic and Kazakhstan) (see Table 8).

All the regulatory framework, no matter how well crafted, will be for naught without a comprehensive legal and judicial reform. An improved judiciary is critical to ensure the effective enforcement of constitutional rights and freedoms, to curb the arbitrary and predatory behavior of public administration and law enforcement agencies, to ensure better protection of property rights and contract enforcement.

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rights but does not envisage alienation (i.e. ownership or subsequent sale and resale). There is also no normative legal base duly regulating the issues of land mortgage.

**Table 8: Indicators of Market Economy Reform**

	<b>Tradability of land</b>	<b>Competition office</b>	<b>Quality of insolvency law</b>	<b>Secured transactions law</b>	<b>Quality of corporate governance law</b>	<b>Large Scale Privatization a/</b>	<b>Small Scale Privatization a/</b>	<b>Enterprise restructuring a/</b>	<b>Number of days to start a business</b>	<b>Cost of starting a business (% GNI per capita)</b>
Kazakhstan	full except foreigners	yes	medium	some defects	medium	3.00	4.00	2.00	21	5.2
Kyrgyz Republic	full except foreigners	yes	medium	modern/some defects	medium	3.67	4.00	2.00	15	7.4
Tajikistan	limited de facto	yes	very low	inefficient	very low	2.33	4.00	1.67	49	27.6
Turkmenistan	limited de jure	no	low	malfunctioning	low	1.00	2.33	1.00	—	—

Note: a/ High scores are better than low scores

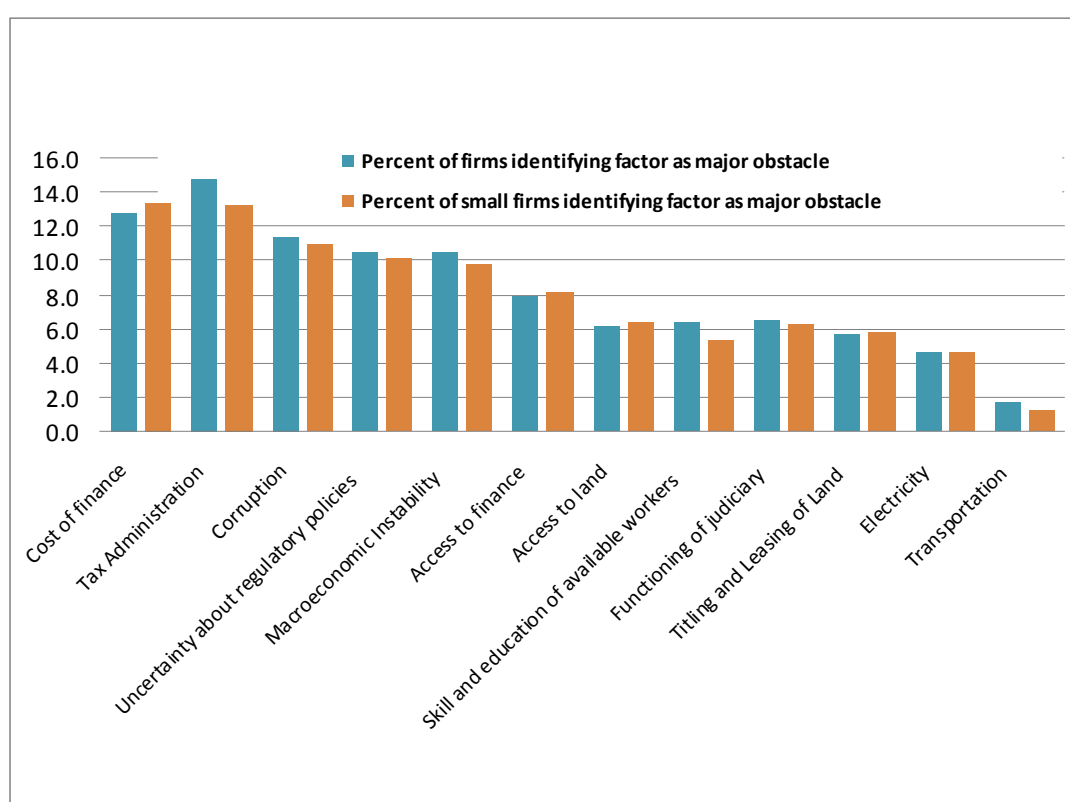
Source: EBRD database. <http://www.ebrd.com/country/sector/econo/stats/index.htm>; <http://www.doingbusiness.org/economyrankings/?excel=true>

## 6.2 SME Perceptions of Various Obstacles to Growth

I also used the 2005 BEEP Survey, once again, to assess the perception of business environment at the micro level. From this survey, I derive some implications of worthwhile government programs and support for SMEs.

Figure 10 provides a picture of what concerned firms, including SMEs, the most. The survey asked how problematic the different factors were for the growth and operation of the enterprise with options from 1 (no obstacle) to 4 (major obstacle). The graph shows the percentage of firms in Central Asia that consider the different factors as a major obstacle to their growth (i.e. rated them as 4). Among small firms, the cost of finance was chosen by most, followed by tax administration and corruption. Access to finance is somewhere in the middle of all the factors identified. For all firms, tax administration appears to have posed a greater concern than the cost of finance.

**Figure 10: Major Obstacles Identified by Firms (in %)**



Source: BEEPS (2005).

Various other reports add further qualitative assessments to the survey results. For example, a United Nations (UN) Economic Commission for Europe (UNECE) study<sup>36</sup> stated that in some Central Asian countries, firms cannot deduct some production expenses, e.g. credit for value added tax (VAT) on capital imports, including plant, machinery or building, from their taxable amount, even though it is the international accounting practice. This puts firms operating in these economies at a competitive disadvantage because they have to pay higher taxes. Other complaints are about the low state of executive discipline and the large number of inspectors that hinder entrepreneurial activities, the high level of corruption and growth of the shadow economy, time-consuming and bureaucratic licensing procedures, poor information dissemination for SMEs, or frequent changes of legislation. In Turkmenistan, the complaints center on the lack of commitment towards entrepreneurial

<sup>36</sup> UNECE (2003a).

activities. Government reforms of these basic regulatory issues would go a long way to facilitate growth of entrepreneurship.

### 6.2.1 Perceptions of Obstacles by Size of Firm

Are different sized firms affected differently? Are their perceptions significantly different from each other? To answer whether firms of different size differ in their perceptions of obstacles, I divided the respondent into SME (below 250 employees) versus large firms (more than 250 employees). I computed the respective rating averages from each group for each factor, then tested for significance of the mean difference. The result is reported in Table 9a. I also divided the firms into micro and small firms (below 50 employees) vis-à-vis medium and large (more than 50 employees). The latter result is in Table 9b.

The result in Table 9a shows that for Central Asia as a whole, there is no difference in the perceived problem of the cost of finance across firm size, but in terms of access, SMEs find it relatively more problematic than large firms. However, when it comes to customs and trade regulations, large enterprises find it more a problem than SMEs do. The highest rating for both SMEs and large enterprises are the tax rates and tax administration.

In the Kyrgyz Republic, SMEs find electricity a greater concern than large enterprises do, but the reverse takes place for customs and trade regulations, labor regulations, and quality of labor. In Kazakhstan, Uzbekistan, and Tajikistan, the perceptions of all firms of the various obstacles to growth are not significantly different from each other, except for customs and trade regulation (Kazakhstan: with large firms showing a greater emphasis), street crime (Uzbekistan: SME firms reported higher scores), and corruption (Tajikistan: SME emphasis was greater).

Table 9b shows a slightly different result. For Central Asia, the two groups' average perception of the obstacles diverged for electricity, customs and trade regulations, tax administration, labor regulations, and skills and available workforce. They did not, however, vary significantly in their perception of financing. In the individual countries, too, there were more significant divergences than in the previous table. For example, in Kazakhstan, small firms found access to finance, cost of finance, electricity, and transport, more of a concern than did medium and large enterprises, while the latter found customs and trade regulations more problematic than other types of firms.

One possible explanation for these two different results is that medium and large firms are not too dissimilar in their perception of obstacles and constraints to growth. Hence, when medium firms were put along the same group as micro and small enterprises, the group average of SMEs moved closer to that of large enterprises. But when medium firms were removed from the group, the constraints cited by micro and small enterprises came to the fore in a more obvious manner. This finding could be useful in designing policies for SMEs as a group.

Table 9a: Perceptions of Obstacles, by Size of Firm 2005

	Central Asia			Kazakhstan			Uzbekistan			Tajikistan			Kyrgyz Republic		
	SME Mean	Large Firms Mean	SMEs vs Large Firms	SME Mean	Large Firms Mean	SMEs vs Large Firms	SME Mean	Large Firms Mean	SMEs vs Large Firms	SME Mean	Large Firms Mean	SMEs vs Large Firms	SME Mean	Large Firms Mean	SMEs vs Large Firms
<b>Finance</b>															
Access to Finance	2.0	1.8	*	2.0	1.8	-	2.0	1.8	-	1.9	1.7	-	2.1	2	-
Cost of Finance	2.3	2.2	-	2.4	2.2	-	2.0	2.1	-	2	2	-	2.6	2.5	-
<b>Infrastructure</b>															
Telecommunications	1.3	1.2	-	1.3	1.2	-	1.3	1.3	-	1.5	1.4	-	1.2	1.1	-
Electricity	1.6	1.4	-	1.4	1.3	-	1.6	1.7	-	2	1.8	-	1.5	1.1	*
Transport	1.4	1.4	-	1.4	1.3	-	1.4	1.7	-	1.5	1.6	-	1.4	1.2	-
Access to Land	1.6	1.5	-	1.7	1.5	-	1.3	1.2	-	1.7	1.6	-	1.7	1.5	-
<b>Business Regulation</b>															
Title or leasing of land	1.6	1.5	-	1.7	1.5	-	1.4	1.4	-	1.7	1.6	-	1.7	1.3	-
Customs and trade regulations	1.8	2.1	*	1.8	1.9	*	1.8	1.9	-	1.8	1.8	-	1.8	2.6	*
Business licensing and permits	2.0	1.9	-	1.9	1.9	-	1.9	1.7	-	2.2	2	-	1.9	2.2	-
Regulatory policy uncertainty	2.1	2.1	-	2.0	1.9	-	2.1	2.0	-	1.9	1.6	-	2.9	3.3	-
<b>Taxation</b>															
Tax rates	2.5	2.3	-	2.4	2.0	-	2.4	2.4	-	2.6	2.3	-	2.8	2.5	-
Tax administration	2.5	2.4	-	2.3	2.1	-	2.3	2.4	-	2.6	2.3	-	2.9	2.7	-
<b>Labor</b>															
Labor regulations	1.4	1.5	-	1.4	1.4	-	1.3	1.5	-	1.4	1.3	-	1.5	1.9	*
Skills and available workforce	1.8	1.9	-	1.9	2.0	-	1.5	1.4	-	1.7	1.6	-	2	2.8	*
<b>Macroeconomic Instability (inflation, exchange rate)</b>															
	2.1	2.2	-	2.1	2.0	-	2.1	2.0	-	2.1	1.8	-	2.6	3	-
<b>Institution's property rights</b>															
Judiciary	1.8	1.7	-	1.8	1.7	-	1.6	1.4	-	1.8	1.5	-	2	2.2	-
Corruption	2.0	1.9	-	1.9	1.8	-	1.6	1.4	-	2.1	1.4	*	2.7	2.8	-
Street crime	1.7	1.7	-	1.8	1.6	-	1.6	1.2	*	1.6	1.4	-	2.2	2.4	-
Organized crime	1.5	1.6	-	1.5	1.4	-	1.4	1.2	-	1.6	1.4	-	1.7	2.1	-

Note: \* signifies statistical difference between the two group means at 95% confidence level.

Source: BEEPS (2005) and author's computations.

**Table 10: Perception of Obstacles, by Size of Firm**

	Central Asia			Kazakhstan			Uzbekistan			Tajikistan			Kyrgyz Republic		
	Micro/ Small Mean	Medium / Large Mean	Micro/ Small firms vs Medium /Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium / Large Mean	Micro/ Small firms vs Medium /Large Firms
<b>Finance</b>															
Access to Finance	2.0	1.9	-	2.1	1.7	*	1.9	2.1	-	1.9	1.9	-	2.1	2.1	-
Cost of Finance	2.3	2.2	-	2.5	2.2	*	2.0	2.2	-	1.9	2	-	2.7	2.4	-
<b>Infrastructure</b>				1.4											
Telecommunications	1.3	1.3	-	1.4	1.1	*	1.3	1.3	-	1.5	1.4	-	1.2	1.2	-
Electricity	1.6	1.5	*	1.4	1.2	*	1.6	1.7	-	2.1	1.8	-	1.5	1.4	-
Transport	1.4	1.5	-	1.4	1.3	-	1.4	1.6	*	1.4	1.6	-	1.3	1.4	-
Access to Land	1.6	1.5	-	1.8	1.4	-	1.3	1.3	-	1.8	1.6	-	1.7	1.7	-
<b>Business Regulation</b>															
Title or leasing of land	1.6	1.5	-	1.8	1.5	-	1.4	1.4	-	1.7	1.7	-	1.7	1.5	-
Customs and trade regulations	1.7	2	*	1.7	1.9	*	1.8	2	-	1.8	1.8	-	1.7	2.3	*
Business licensing and permits	1.9	2	-	1.9	1.9	-	1.9	2	-	2.1	2.2	-	1.9	2.1	-
Regulatory policy uncertainty	2.2	2.3	-	2.0	1.9	-	2.1	2.1	-	1.9	1.9	-	2.8	3.1	*
<b>Taxation</b>															
Tax rates	2.5	2.6	-	2.4	2.3	-	2.4	2.7	*	2.5	2.6	-	2.8	2.8	-
Tax administration	2.4	2.6	*	2.3	2.3	-	2.2	2.6	*	2.5	2.6	-	2.9	2.9	-
<b>Labour</b>															
Labor regulations	1.3	1.6	*	1.4	1.5	-	1.3	1.6	*	1.3	1.5	*	1.4	1.7	*
Skills and available workforce	1.7	2.0	*	1.8	2	-	1.4	1.7	*	1.6	1.8	-	1.9	2.4	*
<b>Macroeconomic Instability (inflation, exchange rate)</b>															
Institution's property rights	2.2	2.2	-	2.1	1.8	-	2.0	2.2	-	2.0	2.1	-	2.6	2.8	-



	Central Asia			Kazakhstan			Uzbekistan			Tajikistan			Kyrgyz Republic		
	Micro/ Small Mean	Medium / Large Mean	Micro/ Small firms vs Medium /Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium/ Large Mean	Micro/ Small firms vs Medium/ Large Firms	Micro/ Small Mean	Medium / Large Mean	Micro/ Small firms vs Medium /Large Firms
Judiciary	1.8	1.8	-	1.8	1.8	-	1.6	1.5	-	1.7	1.9	-	1.9	2.1	-
Corruption	2.0	2.0	-	2.0	1.9	-	1.6	1.6	-	1.9	2	-	2.7	2.7	-
Street crime	1.8	1.8	-	1.8	1.7	-	1.7	1.3	*	1.5	1.7	-	2.1	2.4	-
Organized crime	1.5	1.6	-	1.5	1.5	-	1.4	1.2	-	1.5	1.6	-	1.6	1.9	-

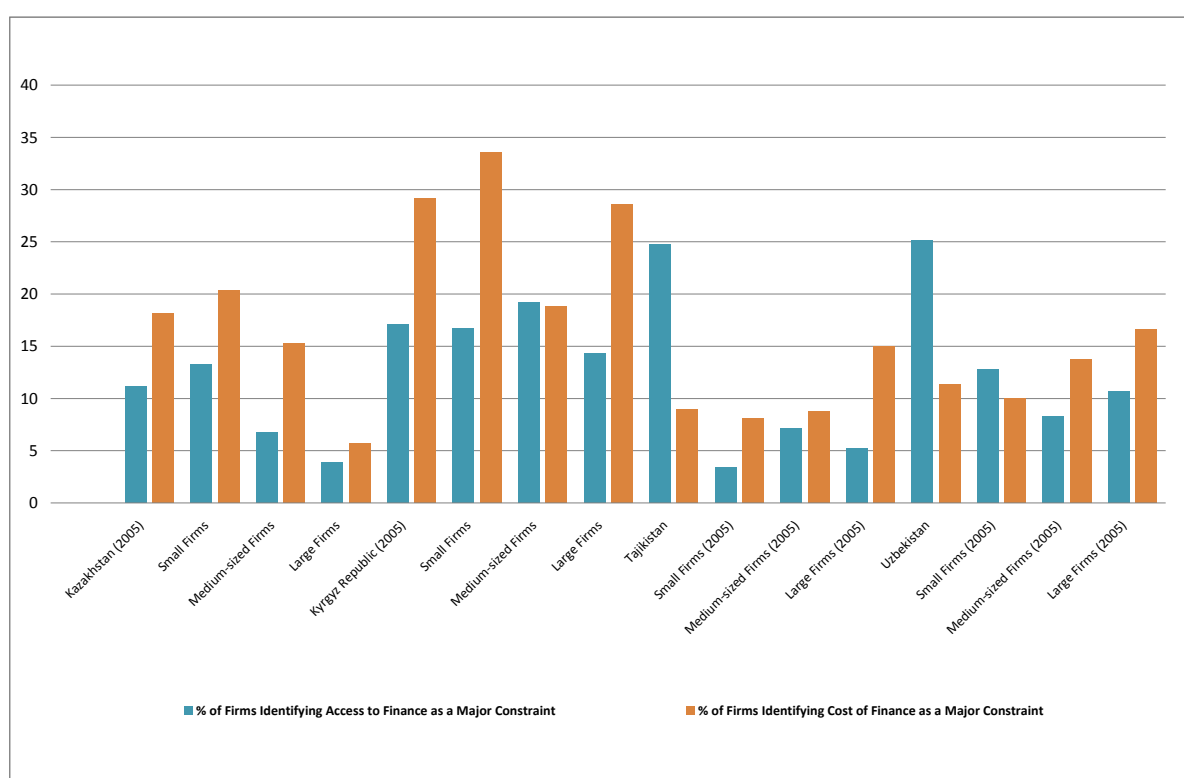
Note: \* signifies statistical difference between the two group means at 95% confidence level

Source: BEEPS (2005) and author's computations.

### 6.3 Cost and Access to Finance

Since the financing problem figures prominently among the major concerns of all firms, I take a closer examination of this factor by dividing the survey response by firm size. Figure 11 shows the percentage of firms which indicated that cost and access to finance were major obstacles, by size of firms and by country. The result shows that in Kazakhstan and the Kyrgyz Republic, the cost of finance was indeed a major constraint, even more for small firms than medium and large firms. But in the Kyrgyz Republic, many large firms also appeared to be constrained by cost more than access to finance, with almost the same percentage of large firms and small firms indicating this factor as a major obstacle. The picture is rather different for Tajikistan and Uzbekistan, where access to finance took ascendancy over cost as an obstacle. This is perhaps because these countries have more backward property rights arrangements, making it difficult for firms to provide the required collateral in order to obtain loans from financial institutions. As small firms were typically unable to access finance, cost was not as much of a constraint to small firms as for large firms.

**Figure 11: Cost and Access to Finance (in %)**



Source: BEEPS (2005) and author's calculations.

The implication of these results is that the best form of government support is again basic market reform—state provision of stable property rights is fundamental to financial access for enterprises. In other Central Asian countries that already have these basic conditions, reasons for the high finance costs, nevertheless, need to be probed. If this is due to high risk perception of SMEs by banks, then more and sustained special government funded low-cost loans may be of assistance to further promote SME growth.

### 6.4 Characteristics of Bank Loans

Looking closely at bank loans in Central Asia, the average cost (annual interest rate on loans) for all firms was 18%, 400 basis points higher than the average for all transition

economies (Figure 12 a–12c). Of the Central Asian countries, only Kazakhstan was right on the average for transition countries while the other three<sup>37</sup> have considerably higher cost, with Tajikistan having the highest (24%). As expected, small and medium firms borrow at much higher costs than large firms, almost 200–300 basis points above the rates for large firms.

The average loan maturity in Central Asia was also shorter by four months than the transition countries' average. In Central Asia, only large firms were able to borrow loans with 30 months tenor. Kazakhstan, again, was on the mark with the average for all transition economies, while Tajikistan and Uzbekistan, had considerably shorter loan maturities. The processing of loans also takes longer in Central Asia than the transition economy average, by an average of four days.

The value of required collateral is, surprisingly, lower in Central Asia than the average transition economy. Transition countries' average collateral value is 159% over the value of the loan, but Central Asia's average is 156%. This is because Kazakhstan and Uzbekistan had lower collateral value requirements compared with Tajikistan and Kyrgyz Republic. Interestingly, the range of required collateral values varied for SME and large firms. For SMEs, the maximum collateral value requirement went as high as 600% of the loan value, while for large firms, the maximum was 450%.

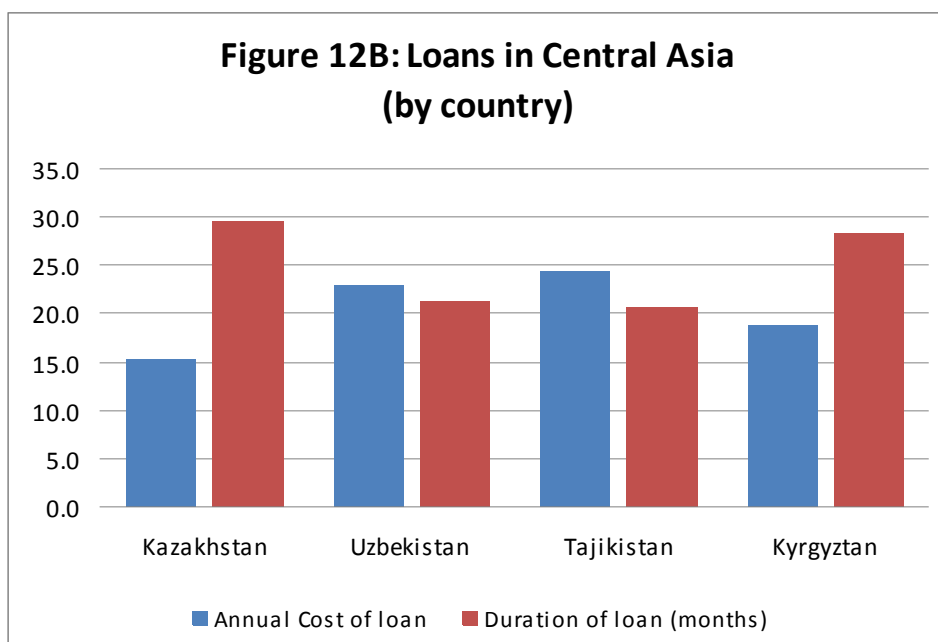
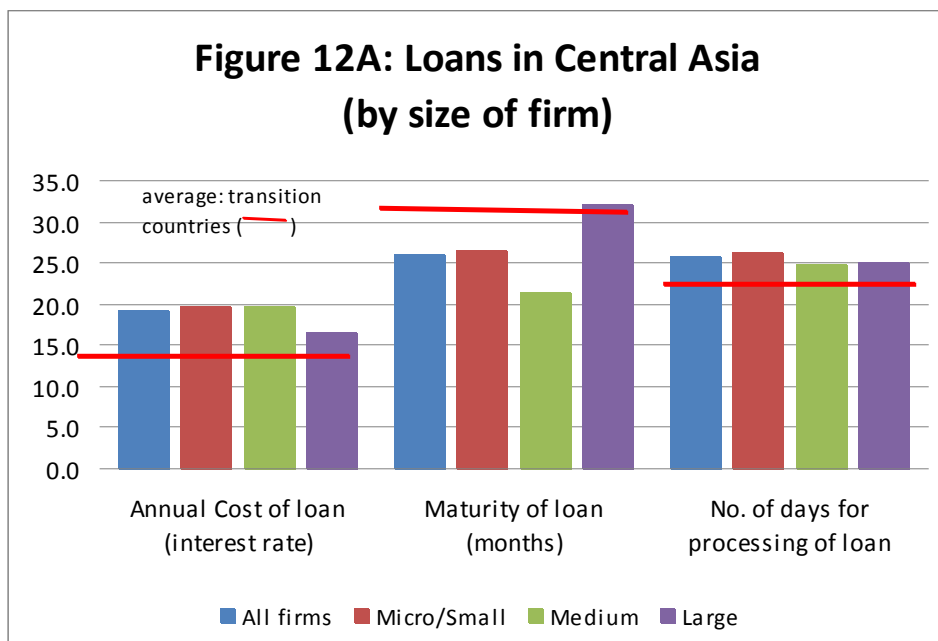
The collateral required was mostly composed of buildings, machinery, and equipment. Large firms had access to more sophisticated inventory and accounts receivables financing, while small firms had to use personal property as collateral.

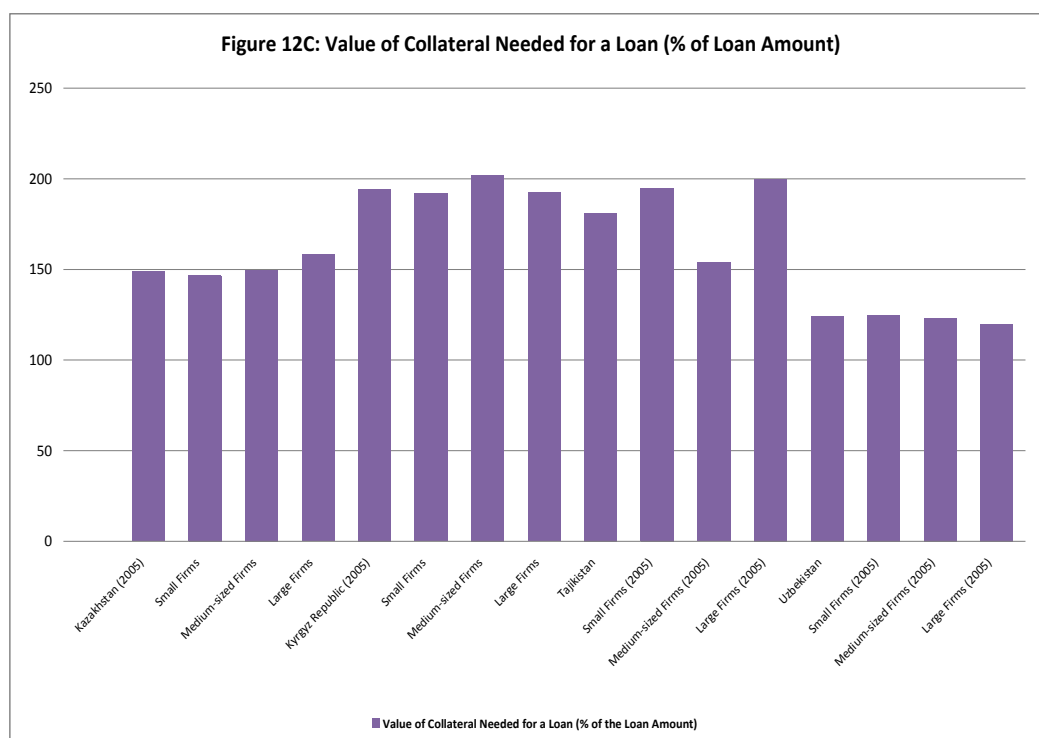
On the issue of cost, as previously stated, low-cost government funded facilities or international donor grants for SMEs might be the best way to provide access to affordable financing and relatively longer-term financing for SMEs. The exceedingly high collateral requirements in some cases might also be linked to stringent bank regulations or excessive risk aversion, which the government could help reduce to more moderate levels.

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<sup>37</sup> There is no corresponding data for Turkmenistan.

**Figure 12: Loans in Central Asia:  
By Size of Firm (12A), By Country (12B), and by Collateral Required (12C) (in %)**





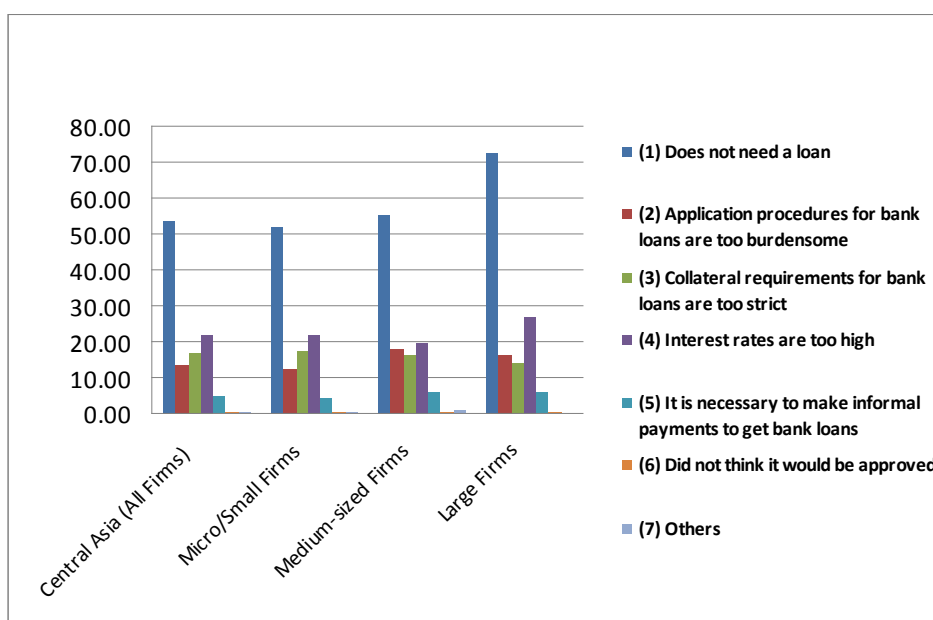
Source: BEEPS (2005) and author's calculations.

## 6.5 Bank Loan Usage by SMEs

Thirty-eight percent of the Central Asian firms surveyed had a bank loan, while 62% did not have loans. Of these, 95% did not apply for a loan while 4% had their application turned down, and the remaining few have a pending application. If these percentages held steady for the entire Central Asian economy and if a similar structure existed in the 1990s, these might help explain why, based on the survey, the 1999 Russian financial crisis appeared to have a minimal impact on SMEs. For, if small and medium businesses did not avail themselves of loans from the banking system, then financial system disruption would, indeed, affect them little.

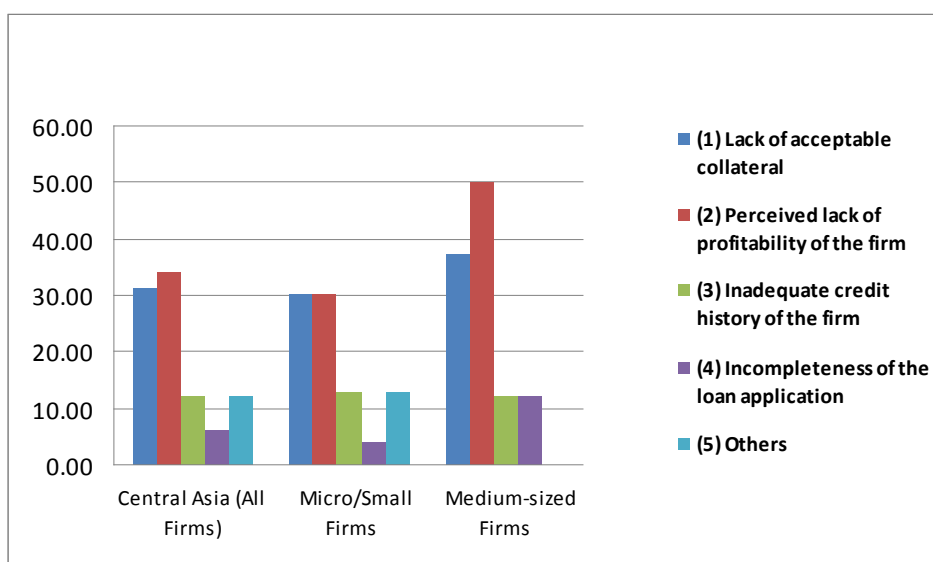
Asked for reasons for not using loans, most firms said they had no need for it, which perhaps implies that many enterprises are not yet so well versed with dealing with the market economy and financial systems. The other major reasons cited are: high cost of borrowing, problems with collateral, and burdensome application procedures (see Figure 13). Firms with rejected loans attributed the rejection to their lack of acceptable collateral, the financial institution perceived a lack of profitability in their enterprise, and the lack of a credit history (Figure 14).

**Figure 13: Reasons for Not Applying for a Loan (in %)**



Source: BEEPS (2005) and author's calculations.

**Figure 14: Reasons for Rejecting Loan (in %)**



Source: BEEPS (2005).

## 7. SUMMARY AND POLICY RECOMMENDATIONS

SMEs are the backbone of many economies, but in Central Asia, SMEs reaching their full potential still lies in the future. They are still new to the workings of the market, many just started in the 1990s, while the business and economic environment in which SMEs operated, though markedly improved since the beginning of the transition process, remain lacking in transparency and regulatory clarity. Yet, although SMEs have operated for only a short span of time, many studies already put their contribution to the economy anywhere between 31% and 45%, and their contribution to employment somewhere between 25% and 60%. There are an estimated 11 to 28 SMEs per 1,000 people in Central Asia, more than a third of the firms engaged in trade. Almost all small enterprises and more than 80% of

medium-sized firms in Central Asia have been started from scratch rather than from privatized state-owned enterprises.

The paper discussed the effect of the Russian and the current global financial crisis on Central Asia. While the route which spread the contagion resulting from the 1999 Russian financial crisis to Central Asia was primarily through trade links, the current crisis is reaching the region directly through financial links, through the global financial illiquidity that is adversely affecting Russian and Kazakhstan banks with high foreign indebtedness, and through their subsidiaries in Central Asia, the rest of the region. For the first crisis, the paper presented some econometric as well as indirect survey data that appear to show that the impact of the crisis on SMEs might not have been so dire, compared with their previous condition after the Soviet breakup, because their production structure is more flexible than large SOEs or large enterprises that are partially owned by the government. In the current financial crisis, financing costs for enterprises have increased, including trade finance. But the paper conjectures that large firms are going to be harder hit than SMEs because of the former's heavier reliance on foreign bank borrowing and global capital markets. The possible adverse impact on SMEs would include weakness in demand, both domestic and foreign, which can affect their sales and profits, and thus their capacity to raise financing which, the surveys show, SMEs rely upon heavily.

On government support for SMEs, while government programs designed to promote the growth of SMEs are available, including special financial support during the crisis (in the case of Kazakhstan), what enterprises most clamor for, according to the survey, are basic market reforms. These include transparent and clear regulatory rules, stable property rights, lower taxation through the use of international accounting standards, less corruption, and better infrastructure. The paper shows slight differences in these concerns across countries as well as between large, small, and medium enterprises. The high cost of finance, a top concern especially among SMEs, is caused by SMEs being perceived as high risk and by their lack of required collateral. The paper derived implication for the need for government- or international donor-funded financing facilities that could provide cheap, longer term financing to SMEs. Just relying on market solutions will always result in very high financing costs for SMEs (because that is based on the rational decision taken by private financial providers, given the risk of lending to SMEs) and could, thereby, stunt the growth of many SMEs. Government assistance is needed to provide the affordable finance that SMEs need to grow.

Government financial assistance to SMEs, however, requires a stable financial system that can efficiently funnel government funds to the targeted sector. Here, there is enormous work that needs to be done. In some countries, like Uzbekistan and Tajikistan, the intermediation role of banks is still not yet fully appreciated. In these countries, banks still maintain their old communist era function as government agents—enforcing monetary and fiscal policy through the control of the supply of cash and liquidity, monitoring financial transactions, and automatically deducting taxes from depositors' account on behalf of the tax authorities. In addition, in Uzbekistan, the government restriction on cash withdrawals from banks has led many SMEs to conduct the bulk of their operations in cash, illegally, rather than go through the banking system where they cannot withdraw money from their own accounts, unless it is for purposes (within specific categories) allowed by the government.<sup>38</sup>

Even in a country like Kazakhstan, which has more advanced banking systems and regulations, there is also a need to more efficiently attract domestic deposits to fund various business ventures. Efforts to promote the growth of a domestic pool of funds from local deposits have taken a back seat due to the availability of easy money that used to be raised

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<sup>38</sup> In some cases, this restriction has driven some SMEs out of business. For example, when a small sewing company needed to import fabric from abroad, it requested the large factory that ordered it to make an advance payment of Som600,000, which was duly deposited in its bank account. But the sewing company was unable to withdraw that cash to make the purchase, leading it to default on its contract.

from abroad. The painful lesson from the global crisis is that the financial system needs to rely a lot more on local deposits and domestic savings and lessen the dependence on foreign financing.

More SME financing may also be obtained from non-traditional sources, such as private equity funds. While in the past, this group of financing institutions could not enter the markets sufficiently due to government ownership restrictions or reluctance to sell SOEs, the global crisis has provided an opportunity for new ways of thinking. In particular, financing from private equity holds promise in that they have the long-term money necessary to grow and develop a business, provided that they are afforded appropriate exit strategies either through initial public offerings (IPOs) or sales to a strategic investor of the businesses they have developed.

For trade financing, considering that prepayment is most often required of importers from Central Asia, there is a large scope for government or private sector guarantees to create liquidity in international transactions. Hence, there is a need to develop functioning export credit agencies in Central Asian countries, where few are yet operational. Other steps that can be done, especially for Kazakhstan and the Kyrgyz Republic where the financial sector is relatively stable and more advanced, is to allow more trade finance instruments, other than L/Cs, such as factoring, receivables-backed financing, warehouse/inventory receipt financing, or supply chain financing, to be used in the country. Whether the government's existing regulatory framework allows for these other types of trade financing is an area that should be looked into.



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