Supporting SMEs for more productive countries

IMPACTO CAF
OUR CONTRIBUTION TO DEVELOPMENT

CAF DEVELOPMENT BANK OF LATIN AMERICA AND THE CARIBBEAN

Supporting SMEs for more productive countries

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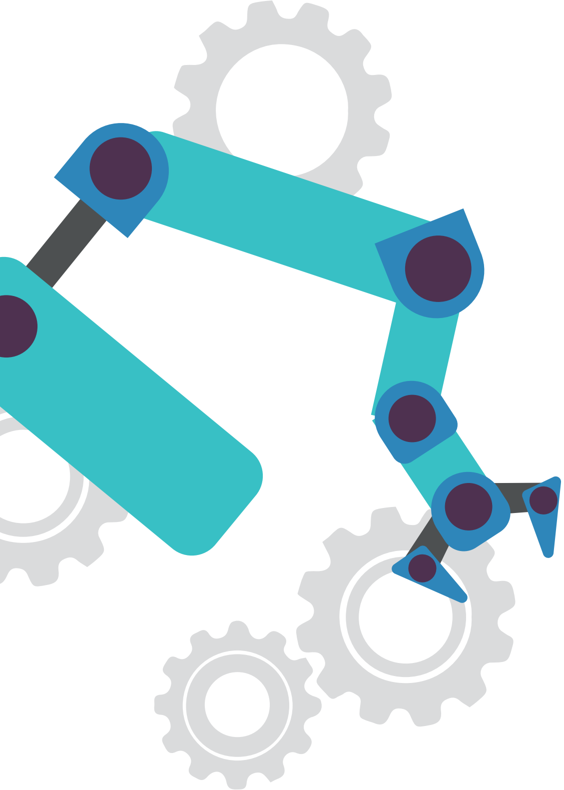


Supporting SMEs for more productive countries

Small and medium-sized enterprises are very important to the region's economies:[1]

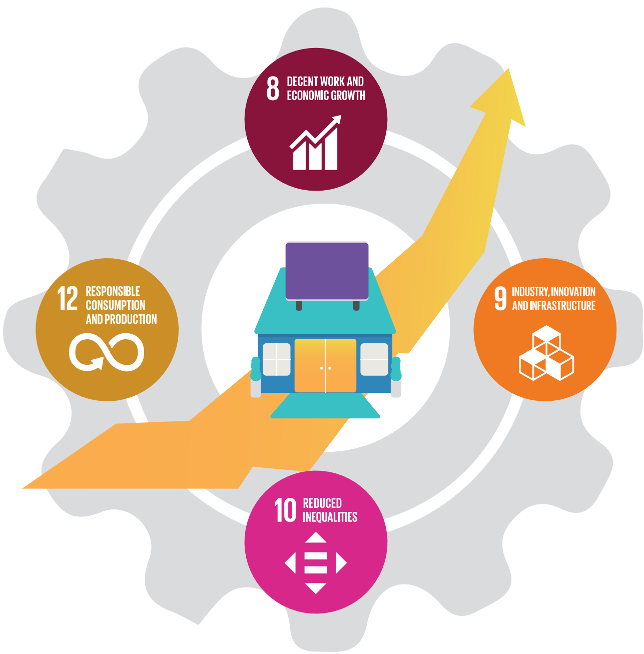
11%	share in the total number of formal companies in Latin America
34%	contribution to total employment
21%	contribution to regional production value

The universe of SMEs is very heterogeneous, with very different companies, in terms of size—measured by the number of employees or revenue/sales—as well as age, technology adoption, and technical capacity. As a result, their needs are as diverse as the support and financing efforts required to meet them.

In today's globalized and competitive world, companies need to seek business financing that will enable them to come into existence, remain in the market, grow, and expand. Financing is essential because it has the potential to help companies increase their levels of production, employment, and sales, as well as boost investment in fixed assets and technological innovation, even allowing them to achieve greater productivity.

As part of efforts to promote the development and sustainability of SMEs in the region, CAF—through various instruments—has sought to reduce financing gaps, improve their technical capacities, and, ultimately, boost countries' productivity.

The above-mentioned actions aim to achieve the Sustainable Development Goals (SDGs) outlined in the United Nations 2030 Agenda, and foster:



Current issues

The financing problem, in figures

Lack of access to financing, or access under disadvantageous conditions, is one of the main problems faced by SMEs in Latin America and the Caribbean.

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Domestic credit to the private sector as a percentage of Gross Domestic Product (GDP) barely reaches 50% in most countries in the region, far below the European Union (92%) and the United States (186%).[2] In fact, one out of every three SMEs in the region reports constraints in accessing credit, either because they applied for credit at a financial institution and did not get it, or because they were discouraged from applying for it due to disadvantageous conditions such as high interest rates, insufficient amounts and reduced terms, and/or restrictive loan contract terms such as collateral and guarantee requirements. In addition, these constraints tend to be greater for younger SMEs, which in general lack collateral and credit history and, therefore, are riskier, and in SMEs owned or led by women.[3]

Information asymmetries represent one of the main problems contributing to the credit access constraints that an SME must face. While the SME (or any other borrower, regardless of size) has all the information about the value of the project it wants to carry out and its intention to repay the loan, the lending bank does not have all this information and is therefore forced to evaluate the SME using market averages, to the detriment of projects with positive value but without capital or collateral to prove their ability to repay the loan. As a result, interest rates are raised and loan amounts reduced, excluding from the market a portion of SMEs with valuable projects.

Limited access to financing is particularly relevant due to its negative implications for growth and productivity. About one-fifth of SMEs in Latin America and the Caribbean say that lack of access to financing is the main constraint to their growth.[4] In addition, SMEs in the region are very unproductive not only compared to large companies[a] but also compared to SMEs in developed regions: average labor productivity, i.e., the amount of goods and/or services that a worker produces in a period of time, is only 30% of the level in the United States. Despite improvements since 1970, when relative productivity was 25%, a significant productivity gap still persists. And this gap is one of the main reasons for the lag in per capita income and, therefore, in the standard of living of Latin American countries.[5]

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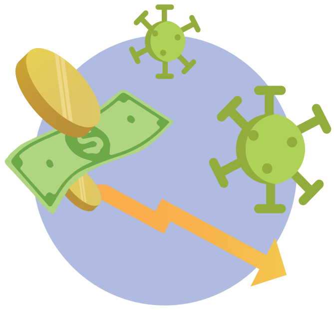
How does the lack of financing impact the development of SMEs?

When entrepreneurs face a lack of access to credit, it prevents them from starting a business that could be profitable in the long term. In the case of SMEs in operation, when a business owner's access to credit is restricted, they cannot invest in profitable activities or projects that would make their business grow, increase their profits and improve their workers' salaries. As a result, companies tend to be smaller than optimal.[6] In addition, the lack of financial resources prevents business owners from investing in employee training and capacity building, which would enable better matching of their skills and tasks, thus boosting productivity.[7]

In addition, lack of access to credit limits SMEs' ability to react to unexpected external events that affect the economy. SMEs in the region typically operate with very limited financial protection, very low levels of liquidity—compared to large companies—and are highly dependent on sales volume. This was crucial during the COVID-19 pandemic as it severely limited their ability to grapple with the economic crisis that ensued.[8] Business owners had to cope not only with a drop in demand due to reduced consumption but also with a decline in supply due to supply chain disruptions that impacted production levels. This led to reductions in cash flow which, in turn, hindered

a The lower relative contribution of SMEs to regional production with respect to their share of employment suggests that the productivity lag of the region's SMEs is relatively greater than that of large companies, which also lag behind, albeit less so.

the payment of salaries and generated delays in the payment of suppliers. The affected context in which SMEs develop their businesses, combined with the lack of access to financing, strongly compromised their growth and survival.



CAF’s contribution and its impact

Credit lines

To close the gaps in access to financing in the region, CAF acts as a second-tier bank, granting credit lines to development financial institutions and private commercial banks, so that they can then provide financing to SMEs. This increased supply of credit makes it possible to rise the availability of funds for SMEs that already have access to credit, as well as to alleviate financing constraints for SMEs that are currently unable to obtain credit when combined with credit guarantees.

A **credit line** is a financial tool given to customers, up to a certain amount and term limit, which allows them to request funding for various similar and independent projects during the term thereof. Credit line terms can be short (1 year), medium (1 to 5 years), or long (more than 5 years).

In 2022, outstanding credit lines amounted to approximately **USD 5.81 billion.**

CAF'S ACTIONS IN THE LAST 5 YEARS (2018-2022):

USD 24.58 billion
disbursed in credit lines

12 countries benefited
Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Panama, Paraguay, Peru and Uruguay.

148,440 loans
for SMEs in Latin America and the Caribbean

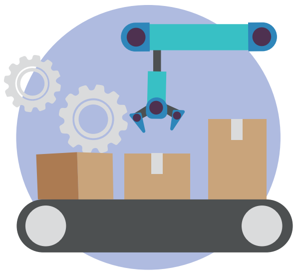
Short-term loans would increase the use of inputs, production, employment, sales and exports of SMEs.

These lines of credit for SMEs were mainly used to finance **short-term operations**, especially working capital and foreign trade operations. With regard to working capital, access to credit allows SMEs to have the money or liquidity necessary to cover their day-to-day obligations, such as paying employees and service and input suppliers. The financing of foreign trade operations facilitates the access and insertion of SME exporters and importers into foreign markets. For example, through the prefinancing of production and the packaging of goods before they are exported, or the deferral of the payment of inputs until payment for the sale of goods abroad is received.

It is estimated that each SME benefiting from the CAF credit line generated 13 new jobs.

According to the available evidence, this type of financing helps SMEs to use more inputs (+14%) and produce more (+6%).[9] It also increases employment (between 4% and 24%),[10] even sometime after receiving the loan[11]. It is estimated that each SME benefiting from the CAF credit line generated 13 new jobs.[b]

In addition, the increased liquidity has favorable effects on SME performance. Not only do they produce more, but they also sell[12] and export more (+40%).[13] Moreover, some non-exporting SMEs are starting to export.[14]



CAF also offers, although to a lesser extent, credit lines to finance **medium and long-term operations**. These loans are for investment projects and the acquisition of capital goods, such as machinery and equipment. This investment allows SMEs to increase production, as well as to develop productive reconversion and modernization processes in order to enter new market segments.

Long-term loans would increase investment in fixed assets, production, employment, innovation and, potentially, productivity.

Scientific evidence shows that these long-term loans can increase investment in fixed assets by up to 30%,[15] and employment and production by 4% and 5%, respectively. These impacts last several years after receiving the loan. [16]

According to one study, this type of SME financing has positive effects on productivity and wages, representing an increase of around 10% in the medium and long term.[17] However, few studies analyze improvements in these variables: given the limited time

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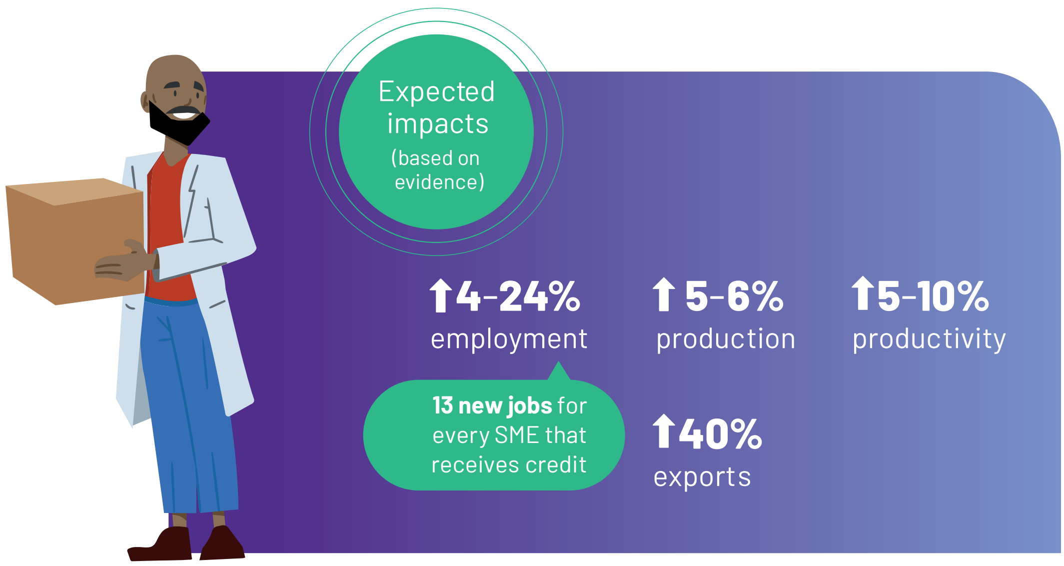
b According to the study by Eslava et al. 2017, the average employment of SMEs benefiting from Bancóldex credit is 117, prior to receiving such credit, and the impact coefficient is 0.11. Multiplying these two figures we obtain that the impact in number of jobs generated per SME is 13.

horizon in which they have been carried out, more time may be needed, since the organizational and technological changes necessary to improve productivity take time to produce the intended effect.

The medium and long-term credit lines are also aimed at investing in innovation activities in the development of new products and/or processes or improving existing products and/or processes. In fact, evidence shows that SMEs use these resources to innovate.[18] In addition, a big part of these resources are used to finance the internationalization of Latin American SMEs, which consists of developing activities or processes in a country or group of countries other than the company's country of origin, either to hire qualified employees, access raw materials, or produce or sell abroad.

Regardless of the type of operations financed, access to these loans makes it easier for SMEs in general, but especially for young ones, to develop a relationship with the lending bank. In the future, these ties could lead to better credit conditions, for larger amounts and longer terms. It also increases the probability of accessing financing from other financial institutions and, in particular, the long-term financing required to improve productivity.[19] At the same time, better SME performance leads to greater access to financing and/or more investment, generating a virtuous cycle of growth.



Granting of partial guarantees

In addition to credit lines, CAF has developed a partial guarantee product for SMEs, aimed at financial intermediaries, through which it takes part of the risk associated with a loan granted to an SME.

This instrument complements the offerings of national guarantee funds and systems in the countries of the region. In the past, CAF has also supported national guarantee funds and systems through counter-guarantees, retro-guarantees, co-guarantees, and equity strengthening. In this regard, two emblematic support initiatives stand out: the creation of the National Guarantee Fund of Ecuador and the Guarantee Fund of Paraguay.

By reducing credit risk, guarantees allow private financing sources to offer better overall credit conditions to SMEs in the region, including terms and amounts. Available studies show that access to these partial guarantees increases the probability of SMEs being granted a loan,[20] the amount of the loan (17%), research and development expenditures (8%), investment in fixed assets (6%),[21] production (6%),[22] employment (4%-17%) and even total factor productivity (5%). The increases in production and employment would last over time. In addition, while short-term financing for working capital accounts for the effects on production and employment, the impacts on productivity can be attributed to long-term financing for research and development and investment in fixed assets.[23]

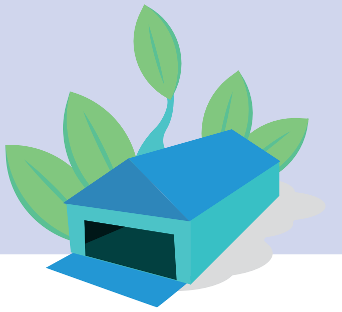
Partial guarantees, by reducing credit risk, enable SMEs to access better financing conditions.

Credits with a gender and environmental sustainability approach

Regarding its credit lines, CAF adopts a vision that pays attention to the debates of this century, encouraging the financing of operations with a gender approach and that promote climate adaptation, mitigation, and environmental sustainability.

A financing operation that exemplifies **a gender approach to CAF's lending** is a loan approved in 2021 for the Corporación Nacional de Finanzas Populares y Solidarias (CONAFIPS) in Ecuador to finance micro, small, and medium-sized enterprises associated with organizations in the popular and solidarity sector, known as savings and credit cooperatives. The primary objective of this loan is to achieve financial inclusion and reduce gender gaps in terms of access, use, and quality of the supply of financing. A total of 2,428 business owners, mainly micro-business owners, 61% of whom are women, have benefited from the credits provided with this facility.

With respect to **financing operations related to the environment**, an important milestone in 2021 was the approval of the Regional Program for Local Financial Institutions (LFIs), in co-financing with the Green Climate Fund, for USD 150 million. This program seeks to provide financing, accompanied by technical support, to encourage investments by SMEs in Chile, Ecuador, Panama, and Peru in the renewable energy, energy efficiency, sustainable agriculture, and forestry sectors. The program will promote the mitigation of the environmental impacts of SMEs, reducing carbon dioxide emissions as a result.



Other measures adopted

In addition to traditional credit lines, CAF provides other financial products and services that favor economic and social reactivation and increased SME productivity in the region.

Support to mitigate the economic consequences of COVID-19

CAF granted a regional facility for USD 1.6 billion to national or subnational development banks.

The objective was to facilitate the process of reactivating economic activity, supporting micro, small, and medium-sized enterprises (MSMEs) and other companies in critical sectors related to the coronavirus, such as health, food, transportation, and logistics. The purpose of this countercyclical productive financing was to prevent companies with growth potential from exiting a market or industry and thus preserve the jobs they generate.

Support for technical capacity building

CAF also provides specific non-financial support through technical cooperation funds. The objective is to help SMEs improve processes, products, and services by supporting them through knowledge services and skills development. This is mainly non-reimbursable financing aimed at complementing the countries' technical capacities.

In the case of SMEs, the following actions stand out:

Initiatives to improve the knowledge of workers and employers

» 2 free online courses to improve knowledge of digital and innovation tools.

220 people trained

» Training in agroclimatic risk management in Colombia.

2,800 farmers trained
↳ **50%** women

Technological and tax management solutions

» Implementation of the Agricultural Risk Management Information System (SIGRA) in Colombia, to improve land use and production systems.

2,800 farmers benefited

» Implementation of an online tax payment system in Trinidad and Tobago.

16,547 MSMEs benefited

Specific advisory services for innovation, export, and financial inclusion of SMEs

» Innovation Week, an innovation training and advisory program, which benefited companies in Argentina, Bolivia, Colombia, Ecuador, Mexico, Panama, Peru, and Uruguay (2017-2022).

340 companies benefited

» Innovation training program under the Triz method (2022), which benefited manufacturing SMEs in Argentina, Colombia, Mexico, and Uruguay.

36 SME benefited

» Entrepreneurial Exporting Excellence Program (3E) to improve its model for exporting non-traditional goods and services, which supported exporting firms in Colombia and Ecuador (2013-2022).

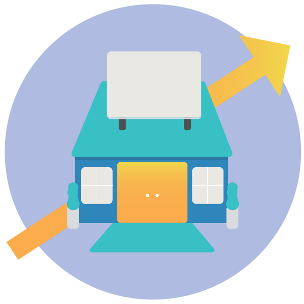
161 companies benefited

» Financial Inclusion Laboratory (LIF, for its acronym in Spanish), which, through technical assistance to Fintech companies with high growth and innovation potential, enables the development of innovative technological solutions that will have a favorable impact on the financial inclusion of MSMEs in the region.

440,460 MSMEs benefited

CAF provides training and advisory services for SMEs in topics such as management and job skills skills, financial inclusion financial inclusion, digital transformation digital transformation and exports.

According to available research, linking individual and group training and advisory services to financial, marketing, and human resources management practices in SMEs, for example, has a positive effect on employment,[24] sales, profits,[25] and productivity[26] in the short term.



Considerations for improving the quality of the design of SME financing programs.

The design of multilateral bank financing programs is key to addressing the credit access constraints faced by SMEs.

In this regard, a good design should seek to finance viable SMEs with the capacity to repay, and those that, although they meet these conditions, cannot access private credit.

Also, financing programs aimed at the SME sector, which are specifically focused on the size of companies, should not generate disincentives to grow.

A good design of multilateral bank financing programs should seek to finance viable SMEs with the capacity to repay, and those that, although they meet these conditions, cannot access private credit.

In addition, and to the extent possible, the generation and dissemination of information on SMEs that are potentially good credit subjects should be facilitated so that banks can obtain an estimate of SME risk that is closer to reality, thus improving the credit supply and its conditions for this segment.

Finally, it is important that credit use be conditioned to where there are more spillover effects and more market failures, that is, to segment the product portfolio according to the needs of the different types of SMEs.

In summary

Small and medium-sized enterprises (SMEs) are important contributors to regional production and employment generation. Despite their role in local economies, they face credit access constraints that affect their productivity and make them vulnerable to economic crises, such as the event triggered by the COVID-19 pandemic.

CAF has developed and continues to develop actions to reduce the financing gaps of the region's SMEs and improve their technical capacities to increase their productivity.

Credit lines granted to development financial institutions and private commercial banks, as well as guarantees and technical cooperation funds, have a significant impact on SME employment and production. The ultimate objective of SME support is to increase their productivity and, therefore, regional productivity.

Reference notes

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