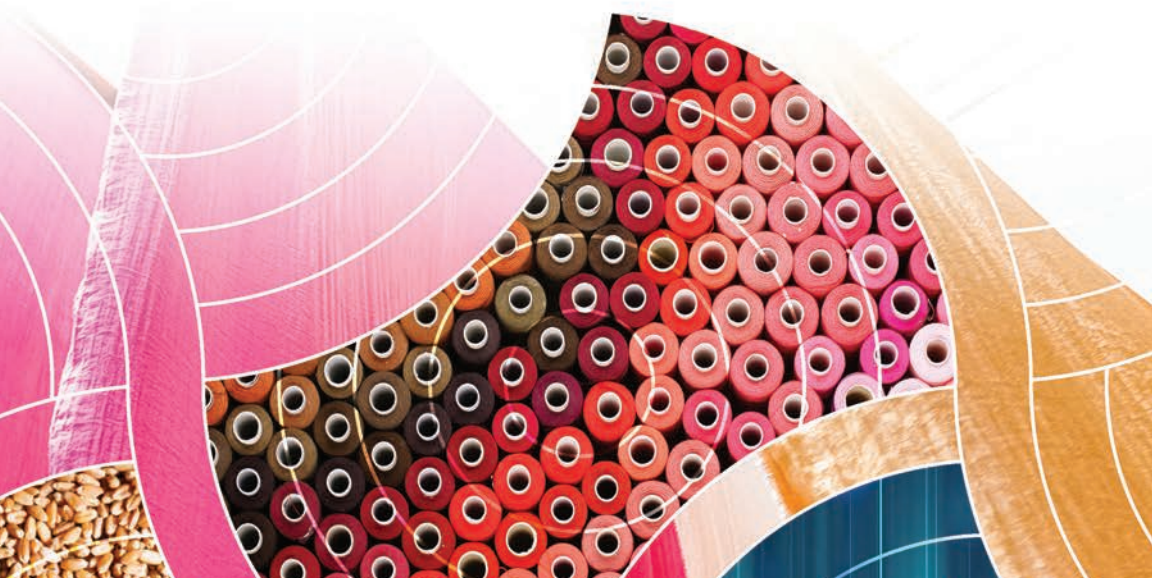


# LEVERAGING SME FINANCE THROUGH VALUE CHAINS IN CAREC LANDLOCKED COUNTRIES



Edited by Peter J. Morgan and Naoyuki Yoshino



ASIAN DEVELOPMENT BANK INSTITUTE



# **LEVERAGING SME FINANCE THROUGH VALUE CHAINS IN CAREC LANDLOCKED COUNTRIES**

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# Preface

Small and medium-sized enterprises (SMEs) are the workhorses of Asian economies, and form a critical transmission belt for promoting inclusive and sustainable economic growth and social development in the region. However, SMEs typically find it difficult to access finance for growth due to problems such as information asymmetry and lack of collateral. Even when SMEs can access finance, they typically face more severe constraints and more stringent conditions than larger businesses, including higher interest rates and greater collateral requirements. SMEs in the Central Asia Regional Economic Cooperation (CAREC) countries, especially those countries that were formerly in the Soviet Union, face particular challenges where the private sector is still in an early stage of development, market-related institutions are still weak, and painful after-effects of the breakup of the Soviet Union and the transition to market-led economies still linger.

Studies show that participation in international trade can be a powerful engine for growth through mechanisms such as technology transfer, training, and quality control. However, SMEs typically face greater challenges than large firms in entering export markets due to lack of scale, capital, technology, and managerial capacity. SMEs in landlocked CAREC countries face additional constraints due to lack of direct access to seaports, generally inadequate transportation and logistics infrastructure, high trading costs, diverse non-tariff barriers and underdeveloped financial systems. It is necessary to break the vicious cycle between low productivity, lack of competitiveness, and inadequate access to finance.

The development of global value chains (GVCs) in Asia and the Pacific has great promise to expand the potential for SMEs to participate in international trade. Besides directly being involved in export activity, they can obtain skills, technology, and know-how by partnering with competitive international firms. Meeting the quality standards of the partnering firms can contribute substantially to raising both product quality and productivity. Not least, such partnerships can help improve SME's access to finance, either from the firms themselves or from other financial institutions.

In turn, a stronger SME sector can help foster private enterprise, innovation, market development, employment, and economic diversification, and induce more efficient allocation of scarce resources. By joining GVCs, SMEs can contribute to economic

development in the CAREC landlocked economies by helping to diversify their production base, create employment opportunities, alleviate poverty, and ensure regional food security. In particular, linking regional agriculture value chains in sparsely populated cities to distant markets can raise the output and profitability of farmers and small producers in rural areas.

The objective of this study is to take stock of the challenges faced by SMEs in the CAREC landlocked economies in terms of their access to finance in view of the above-mentioned constraints. This includes identifying cultural, procedural, institutional, and regulatory incentives, disincentives, and barriers faced by SMEs to access finance, and the reasons for the lack of such access. The study also assesses opportunities for SMEs to link with both domestic and global value chains and the potential impact of this on their access to finance.

Finally, it proposes policy recommendations to improve SMEs' access to finance and trade finance, especially in the agri-business sector. The recommendations address effective regulatory frameworks, access to finance (banks, capital markets, start-up finance, non-traditional microlending or community lending, risk capital), special programs funded by foreign donor institutions, guarantee schemes, improving skills (entrepreneurial training), encouraging networking among SMEs, and use of information and communication technology.

By comparing country experiences in different areas, circumstances, and levels of income, the aim is to identify lessons regarding best practices and important innovations that would be useful for other countries. Such lessons include the importance of crafting a national strategy that includes all major stakeholders; the need for a coordinated approach that includes financial education, consumer protection and regulation and/or supervision to build trust as well as knowledge; the need to promote financial access in ways that are aligned with economic returns and with consistent regulation; the desirability of regulating microfinance entities "proportionately" in line with financial system risk; the need to promote new delivery technologies and credit databases; and the need for national financial literacy data and financial education strategies.

Existing financial supervisory and regulatory frameworks have largely been shaped by the environment of traditional commercial banking, and this environment has not necessarily proved to be conducive for increasing financial inclusion. Efforts and policies to expand financial access have often involved innovations in areas such as the types of financial institutions (microfinance, crowd financing), borrowing regimes (mutual responsibility loans), collateral requirements, service

access (mini-branches), new types of products (microcredit, microdeposits, micro-insurance), new delivery channels (mobile phone banking, e-banking, representative banking), and new technologies to meet identity requirements (biometric ID).

All of these developments require that regulatory and supervisory frameworks be reviewed, extended, and adapted to cover them. Supporting institutions also need to be developed or deepened, such as nationwide credit databases and credit rating agencies for households and SMEs. Because trust is essential to encourage financial participation, consumer protection frameworks also need to be expanded to cover these developments.

Levels of financial literacy among SME entrepreneurs are generally low. Governments increasingly recognize the need to develop policies to promote financial education, but such efforts to date have been fragmented and inadequate. Financial education efforts confront numerous hurdles, such as the lack of digital literacy, inadequate access in rural areas, the lack of coordination among relevant ministries institutions, and the lack of basic data about the level of financial education. Separate programs need to be developed to target different groups, including schoolchildren of various ages, those in rural areas, women, the poor, and the elderly.

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# Abbreviations

AAFF	Azerbaijan Agricultural Finance Facility
ADB	Asian Development Bank
AKDN	Aga Khan Development Network
AKF	Aga Khan Foundation
APMA	Agricultural Project's Management Agency
BEEPS	Banking Environment and Enterprise Performance Survey
BEPS	Banking Environment and Performance Survey
BRI	Belt and Road Initiative
CAREC	Central Asia Regional Economic Cooperation
CBAR	Central Bank of the Republic of Azerbaijan
CBU	Central Bank of Uzbekistan
CCR	Centralized Credit Registry
CGF	Credit Guarantee Fund
CIAC	Credit Information Analytical Center
CIBT	Credit Information Bureau Tajikistan
CIT	corporate income tax
CMPI	Centre for Media and Public Initiatives
CRIF	international credit rating agency
EBRD	European Bank for Reconstruction and Development
EDF	Entrepreneurship Development Fund
EEU	Eurasian Economic Union
ENPARD	European Neighborhood Program for Agriculture and Rural Development
FAO	Food and Agricultural Organization of the United Nations
FDI	foreign direct investment
FIMSA	Financial Markets Supervision Authority
GDP	gross domestic product
GIZ	German Enterprise for International Cooperation
GVC	global value chain
ICT	information and communication technology



IFAD	International Fund of Agricultural Development
IFC	International Finance Corporation
IFI	international financial institution
IMF	International Monetary Fund
INFE	International Network on Financial Education
KASE	Kazakhstan Stock Exchange
KCM	Kazyna Capital Management
MCI	monthly calculated indicator
MFI	microfinance institution
MFO	microfinance organization
MSME	micro, small, and medium-sized enterprise
NBFI	nonbank financial institution
NBT	National Bank of Tajikistan
NDS	National Development Strategy
NPL	nonperforming loan
NSC	National Statistical Committee
NSO	National Statistical Office
OECD	Organisation for Economic Co-operation and Development
P2P	peer-to-peer
PRC	People's Republic of China
QRCC	QABUS Research and Consulting Company
SCD	Systematic Country Diagnostic
SME	small and medium-sized enterprise
SOE	state-owned enterprise
SPS	sanitary and phytosanitary
SWOT	strengths, weaknesses, opportunities, and threats
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
USAID	United States Agency for International Development
VAT	value-added tax
WTO	World Trade Organization

# Leveraging SME Finance through Value Chains in Landlocked CAREC Countries: Overview

Peter J. Morgan, Akerke Nurgaliyeva, and Dossym Kydyrbayev

## 1.1 Introduction

Small and medium-sized enterprises (SMEs) are the backbone of economic activity in Asia and the Pacific, and are critical to sustain inclusive economic growth and social development. More than 96% of total enterprises in the region are SMEs, which together account for about 42% of total gross domestic product (GDP) and employ 62% of the workforce (ADB 2015b). However, SMEs typically find it difficult to access finance for growth due to the well-known problems they face of information asymmetry and lack of collateral. Even when SMEs can access finance, they often face more severe constraints than larger businesses and, even when financing is secured, it often is under more stringent conditions, including higher interest rates and greater collateral requirements. Moreover, SMEs in the Central Asia Regional Economic Cooperation (CAREC) countries, especially in those states that were formerly in the Soviet Union, face particular challenges where the private sector is still in an early stage of development and market-related institutions are still weak.

Participation in international trade can be a powerful engine for growth through mechanisms such as technology transfer, training, and quality control, but SMEs typically face greater challenges than large firms in entering export markets due to lack of scale, capital, technology, and managerial capacity. SMEs in landlocked CAREC countries face additional constraints due to lack of direct access to seaports, generally inadequate transportation and logistics infrastructure, high trading costs, and underdeveloped financial systems, which often do not provide a diverse range of financial products at an affordable rate to support the risky ventures required to promote the growth of SMEs.

The development of global value chains (GVCs) in the Asia and the Pacific region has expanded the potential for SMEs' participation in international trade, including the participation of those in landlocked CAREC countries. The maxim that the "countries that embrace [GVCs] grow faster, import skills and technology, and boost employment" (World Bank 2019b: 1) is a fundamental motivation for exploring ways that SMEs in the landlocked economies of the CAREC region can participate in GVCs. Linking SMEs with domestic and global value chains can improve their business portfolio and opportunities for access to finance. In order to raise SMEs' share in economic activity, contribution to trade, and links to GVCs, SMEs need more resources, skill sets, market access, access to finance, and regulatory support to thrive and be competitive.

In turn, stronger SMEs can foster private enterprise, innovation, market development, employment, and economic diversification, and induce efficient allocation of scarce resources. By joining GVCs, SMEs can contribute to economic development in the CAREC landlocked economies by helping to diversify their production base, create employment opportunities, alleviate poverty, and ensure regional food security. In particular, linking regional agriculture value chains in sparsely populated cities to distant markets can not only raise the output and profitability of SMEs, but also offer better opportunities for access to finance.

The objective of this book is to take stock of the challenges faced by SMEs in the CAREC landlocked economies in terms of their access to finance in view of the above-mentioned constraints. This includes identifying cultural, procedural, institutional, and regulatory incentives, disincentives, and barriers faced by SMEs to access finance, and the reasons for the lack of such access. The study also assesses opportunities for SMEs to link with both domestic and global value chains and the potential impact of this on their access to finance. Finally, the study proposes policy recommendations to improve SMEs' access to finance and trade finance, especially in the agri-business sector, in light of best global practices, including the People's Republic of China's (PRC) program to nurture and support SMEs. The recommendations address effective regulatory frameworks, access to finance (banks, capital markets, start-up finance, non-traditional micro-lending or community lending, risk capital), special programs funded by foreign donor institutions, guarantee schemes, improving skills (entrepreneurial training), encouraging networking among SMEs, and use of information and communication technology.

In terms of financial inclusion and development, the economies in the CAREC area—Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan<sup>1</sup>—have generally lagged other Asian economies, partly due to the disruptions and instabilities that followed the breakup of the Soviet Union in 1991 (Yoshino and Morgan 2017). Since gaining independence from the Soviet Union, many CAREC countries have experienced similar economic events. Their populations distrusted financial institutions, and they were unprepared to go through difficult procedures to avail themselves of the services offered by such institutions. Moreover, a number of financial crises have challenged the CAREC countries and their banking sectors. The global financial crisis had a spillover effect on all of these economies. In Tajikistan, the remittances of labor migrants fell from \$3.7 billion in 2013 to \$1.9 billion in 2016, leading to a major devaluation of the Tajik somoni. The fall in oil prices inflicted negative shocks on oil-exporting economies, leading to currency devaluations in Kazakhstan and Azerbaijan, and indirectly affected other economies dependent on remittance flows from those countries. Policies aimed at promoting financial inclusion and financial literacy, especially for SMEs, have not generally been pursued as actively in this region as elsewhere in Asia.

Table 1.1 summarizes the major macroeconomic data of these countries. Clearly, they vary widely in various dimensions. The per capita GDP ranged from only \$801 in Tajikistan to \$9,030 in Kazakhstan, as of 2017. This largely reflects differences in resource endowments, especially fossil fuels. The level of financial development also varies substantially, with the ratio of credit to the domestic private sector ranging from 14% in Tajikistan to 63% in Georgia. However, all of them share the legacy of Soviet-style economic systems and the vicissitudes associated with a transition to a market economy.

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<sup>1</sup> Afghanistan is not included in this study. Georgia is not landlocked, but is included because it is also a CAREC member and formerly a part of the Soviet Union.

**Table 1.1: Major Macroeconomic Characteristics of CAREC Countries in the Study, 2017**

Country	GDP (\$ billion)*	Population*	Land area (sq. km)*	GDP per capita (\$)*	Domestic Currency per \$*	CPI inflation rate (%)**	Domestic credit to the private sector, % of GDP*
Azerbaijan	40.7	9,862,429	82,670	4,131.6	1.70	13.0	22.2
Georgia	15.1	3,717,100	69,490	4,057.3	2.53	6.0	62.5
Kazakhstan	162.9	18,037,646	2,699,700	9,030.4	344.70	7.4	29.9
Kyrgyz Rep.	7.6	6,201,500	191,800	1,219.8	68.80	0.4	21.8
Mongolia	11.4	3,075,647	1,553,560	3,717.5	2,472.50	0.5	53.0
Tajikistan	7.1	8,921,343	138,790	801.1	9.15	7.3	13.7
Uzbekistan	49.7	32,387,200	425,400	1,533.9	8,069.60	12.5	NA

CAREC = Central Asia Regional Economic Cooperation, CPI = consumer price index, GDP = gross domestic product, NA = not available, sq. km = square kilometer.

Sources:

\* indicates data from World Bank World Development Indicators Database (2017).

# indicates data from IMF International Financial Statistics Database. <http://data.imf.org/regular.aspx?key=61545850> (accessed 21 February 2019), 2018 average.

\*\* indicates data from IMF World Economic Outlook October 2018, 2017, but 2016 for the Kyrgyz Republic and Mongolia.

## 1.2 Definitions of SMEs, Global Value Chains, and Value Chain Finance

This section reviews the definitions of SMEs, GVCs, and supply chain finance which underlie the analysis in this book.

### 1.2.1 | Definition of SMEs

During the last decade, the development of small and medium-sized businesses became a priority for the governments of CAREC countries, as well as an important factor for economic growth. However, as shown in Table 1.2, there is no standard definition of SMEs across the region, which complicates comparative analysis.

The maximum size of small enterprises varies from 30 employees in Tajikistan to 100 employees in Kazakhstan and Uzbekistan (depending on the sector), while the maximum size of medium-sized firms varies from 50 employees in the Kyrgyz Republic to 250 employees in Georgia, Kazakhstan, and Uzbekistan (depending on the sector). In addition to SMEs, only the Kyrgyz Republic and Uzbekistan have definitions of micro enterprises.

**Table 1.2: SME Definitions in the CAREC Landlocked Countries**

Countries	Micro	Small	Medium
Azerbaijan	<11 employees	11–50 employees	51–250 employees
Georgia	NA	<50 employees	50–250 employees
Kazakhstan	<11 employees	15–100 employees	101–250 employees
Kyrgyz Republic	<7 employees (trade, transport, communication, education, healthcare, finance) <15 (agriculture, energy, construction, mining, processing)	7–15 employees (trade, transport, communication, education, healthcare, finance) 15–50 employees (agriculture, energy, construction, mining, processing)	16–50 employees (trade, transport, communication, education, healthcare, finance) 51–200 (agriculture, energy, construction, mining, processing)
Mongolia	NA	<20 employees (all sectors) <50 employees (services)	20–149 employees (wholesale) 50–199 employees (retail, manufacturing)
Tajikistan	NA	<31 employees	31–200 employees
Uzbekistan	<26 employees	26–100 employees	101–250 employees

CAREC = Central Asia Regional Economic Cooperation, NA = not available, SME = small and medium-sized enterprise.

Note: The figures for Uzbekistan are draft proposals.

Sources: Aliyev (Chapter 2), Boojoo (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

A key issue is that the definition of SMEs in these countries typically only applies to registered firms, and hence does not cover most individual entrepreneurs or peasant farmers. As a result, the share of SMEs in agriculture in these countries is typically small, 5% or less. Moreover, it means that entities not classified as SMEs typically do not qualify for special programs available to SMEs.

### 1.2.2 | Definition of Global Value Chains

The definition of value chains also varies. The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) defines a GVC as follows:

A global value chain refers to the full range of cross-border, value-added business activities that are required to bring a product or service from the conception, design, sourcing raw materials, and intermediate inputs stages to production, marketing, distribution, and supplying the final consumer (UNESCAP 2007).

GVCs are another way of describing global production networks or supply chains:

The phenomenon of production networks or value chains is also known as cross-border production sharing or fragmentation of production (ADB 2015b: 6).

GVCs have grown rapidly in the last 2 decades, aided by developments in communications, the internet, and transportation. However, GVCs vary significantly according to the degree of value-added involved. Gereffi, Humphrey, and Sturgeon (2005) and UNESCAP (2007) identify three major types of GVC:

- (i) International supply markets, where transactions are made based on arm's length relationships between buyers and sellers across borders, requiring minimal coordination and cooperation (e.g., commodity markets).
- (ii) Producer-driven networks, where the lead firm has a central role in controlling the activities of the international network of subsidiaries, affiliates, and suppliers.
- (iii) Buyer-driven networks, where large retailers, marketers, and brand manufacturers obtain finished goods from an international network of suppliers.

Perhaps the key issue in terms of economic development is whether GVCs contribute to the development of production quality and expertise in developing-country firms belonging to the GVC. In the case of commodity markets (type i), there seems to be little scope for the transmission of such expertise to upstream firms in the value chain, since they produce for commoditized markets with little or no direct interaction with downstream buyers. On the other hand, types ii and iii provide much more scope for the transfer of quality standards and know-how, since the downstream firms depend on the quality, consistency, and cost-efficiency of the products involved in order to preserve their brand identities and product differentiation benefits. Therefore, the lead firms have a strong incentive to have a more direct influence on the production activities of upstream suppliers.

This situation is described by the World Bank as follows:

Through GVCs, countries trade more than products; they trade know-how, and make things together. Imports of goods and services matter as much as exports to successful GVCs.

GVCs integrate the know-how of lead firms and suppliers of key components along stages of production and in multiple offshore locations. The international, inter-firm flow of know-how is the key distinguishing feature of GVCs (World Bank 2019b: 1).

However, as will be described in this book, there are relatively few examples of types ii and iii in CAREC countries, especially in agriculture. This is a major barrier in terms of the potential for SMEs to upgrade themselves by participating in GVCs.

### **1.2.3 | Definition of Supply Chain Finance**

A firm's participation in GVCs can enhance its ability to obtain finance by various means. This is generally referred to as supply chain finance, although there is not yet a standardized definition of this:

... supply chain finance can be expressed as a combination of trade finance and a technological platform that connects trading partners and financial institutions, and provides various services related to supply chain events, as defined by the International Factors Group (IFG). Various combinations of financing instruments and services can be arranged under supply chain finance (ADB 2015b: 70).

The key question for the purpose of this study is the extent to which participation in value chains (global or otherwise) can improve the ability of SMEs to access finance. As suggested by the above definition, supply chain finance can include a number of different types of financing mechanisms, including trade finance and financing support from the lead firm in the supply chain. It also requires expertise on the part of banks and other financial institutions to evaluate the risk-reduction and growth-enhancing effects of an SME belonging to a supply chain and its needs for investment to upgrade its product quality to a level that qualifies that firm to belong to a supply chain.



## 1.3 Rationale for SME Participation in Global Value Chains

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SMEs can benefit directly from participation in GVCs, and such participation can also have indirect benefits for the economy as a whole. Yuhua and Bayhaqi (2013) argue that, at the micro level, the benefits of SME participation in GVCs include:

- (i) increased technical capacity;
- (ii) increased demand for existing products and services, greater utilization of operational capacity, and an improvement in production efficiency;
- (iii) cooperating with enterprises, both upstream and downstream, in global production networks can create prestige and credibility for SMEs, making it easier to access finance, and attract foreign investors and human resources; and
- (iv) providing SMEs with a gradual and sustainable direction toward internationalization (ADB 2015b: 12).

As mentioned in the previous subsection, the degree of value-added involved in the GVC will determine the extent to which the above factors apply, especially (i) and (iii), and particularly the latter, which relates directly to financial access. This underlines the importance of emphasizing GVCs with higher value-added, e.g., types ii and iii mentioned in section 1.2.2.

At the macro level, SME participation in global production networks can bring a number of benefits (Yuhua and Bayhaqi 2013):

- (i) A stronger SME sector is positively associated with economic growth.
- (ii) SME participation in global production networks can increase employment in local economies.
- (iii) Global production networks can allow domestic SMEs to expand their exports and thereby facilitate the country's accumulation of foreign reserves, which can be critical for the stable and sustainable growth of developing economies.
- (iv) Participation in GVCs can provide a vehicle for the transformation and upgrading of local economies and businesses, thereby providing another channel to promote sustainable economic growth and development (ADB 2015b: 12).

In light of these benefits, what factors can help to promote SME participation in GVCs? Yuhua (2014) found that the potential factors supporting SMEs' participation in GVCs include: (i) product quality, (ii) product delivery, (iii) financial stability, (iv) production capacity, (v) flexibility and adaptability, (vi) standards and certificates, (vii) the ICT level of business operation, (viii) innovation capacity, (ix) the business environment, and (x) physical and informational infrastructure. Yuhua (2014) also identified several additional key factors enabling SMEs in developing countries to enter GVCs, including: (i) product price, (ii) geographic location, and (iii) innovative capacity. SMEs need to have a good understanding of global markets and the business needs of GVCs in order to produce goods with the appropriate quality, competitive price, and capacity for delivery (Yuhua 2014; Yuhua and Bayhaqi 2013). Similarly, the United Nations Conference on Trade and Development (UNCTAD 2010) identified productive capability, labor productivity, technology, human capital, and business practices as important factors influencing SME participation in GVCs (ADB 2015b: 13).

## 1.4 Role of SMEs in Landlocked CAREC Countries

The SME sectors in the landlocked CAREC countries have been developing at different paces. In some countries, SMEs' role is critical in sectors like agriculture, trade, and construction, while in others—resource-rich countries, like Kazakhstan—SMEs are also present in services and manufacturing related to extraction industries. Table 1.3 summarizes the share of SMEs in GDP, the number of firms, and total employment. SMEs typically account for more than 90% of registered firms, but the shares of GDP and employment are much lower. This is because small farmers and self-employed workers are typically excluded from the definition of SMEs. This creates considerable difficulties for this study, since a key focus is agricultural value chains, but most entities involved in agriculture are not included in the SME definition. In all countries except the Kyrgyz Republic, the share of GDP is lower than that of employment, reflecting relatively low productivity in the SME sector. This is particularly the case in resource-rich countries such as Azerbaijan, Kazakhstan, and Mongolia.

In Azerbaijan, SMEs account for only 18.5% of employment. One reason is that agriculture comprises only 1.1% of total SMEs, due to the Law on Family Farming, which excludes family farms from the SME definition because they are not considered as entrepreneurs (Aliyev Chapter 2). Georgian SMEs play a significant role in job creation, with a 67% share of total private sector employment (Khishtovani, Saghareishvili, and Basilidze Chapter 3). In Kazakhstan, SMEs contributed 26% of GDP in 2017.

In Tajikistan, SMEs account for 35% of total employment and 30% of GDP. However, SMEs play a relatively important role in job creation. In 2017, 78% of jobs were provided by SMEs, compared to 50% in 2000 (Mirzoev and Sobirzoda Chapter 7). SMEs' contribution to GDP in Uzbekistan increased to 54.9% in 2017 from 38.2% in 2005. They are mostly active in services (retail and catering) and the agricultural sector. In Uzbekistan, SME development is driven by micro-enterprises, which employ eight people on average, rather than small enterprises. This is explained by the underdeveloped business environment. Almost 80% of agriculture's contribution to GDP is accounted for by small entrepreneurs (Tadjibaeva Chapter 8).

**Table 1.3: Role of SMEs in CAREC Economies**

Country	% of GDP	% of Firms	% of Employment
Azerbaijan	6.4	95.0	18.5
Georgia	61.6	–	67.0
Kazakhstan	26.0	96.0	33.0
Kyrgyz Republic	39.0	–	21.2
Mongolia	17.8	86.0	70.0
Tajikistan	30.0	–	35.0
Uzbekistan	54.9	90.0	78.0

– = not available.

Sources: National Statistics Offices, Aliyev (Chapter 2), Boojoo (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

## 1.5 Status of Financial Inclusion for Individuals and Small and Medium-Sized Enterprises in Landlocked CAREC Countries

Table 1.4 provides an overall picture of the status of financial inclusion in landlocked CAREC countries by listing several main indicators from the World Bank and International Monetary Fund (IMF) surveys related to financial inclusion. This shows that there is great variation in terms of the development of financial inclusion in the region, even though levels of financial inclusion are generally low.

Secondly, levels of financial inclusion for individuals and firms are not necessarily at similar stages of development. For example, compared with the other CAREC countries, Mongolia scores highest in all but one of the categories in Table 1.4. Kazakhstan has a relatively high share of adults with formal accounts, but a relatively low share of firms with a line of credit from banks, especially SMEs. Overall, the share of SMEs with a bank loan or line of credit is 30% or less in all countries except Mongolia. Use of digital financial services (fintech) such as e-money or mobile phones is generally low, but is increasing rapidly in several countries.

**Table 1.4: Main Financial Inclusion Indicators for CAREC Countries**

		Azerbaijan	Georgia	Kazakhstan	Kyrgyz Republic
Commercial bank branches per 100,000 adults <sup>a</sup>		6.6 <sup>d</sup>	32.7	3.0	8.4
ATMs per 100,000 adults <sup>a</sup>		32.7	74.3	74.0	31.2
Share of adults with formal account (% age 15+) <sup>b</sup>	All adults	28.6	61.2	58.7	39.9
	Women	27.7	63.6	60.3	38.9
	Adults belonging to the poorest 40%	18.1	46.1	48.8	35.7
	Young adults (% aged 15–24)	12.6	30.7	36.9	27.0
	Adults living in rural areas	20.2	55.1	56.7	39.1
Saved at a financial institution (% age 15+) <sup>b</sup>		4.5	4.6	13.9	3.0
Loan from a financial institution in the past year (% age 15+) <sup>b</sup>		13.1	23.7	20.0	9.4
Firms with a bank loan or line of credit (%) <sup>c</sup>		15.8	35.8	19.2	29.1
Small firms with a bank loan or line of credit (%) <sup>c</sup>		15.6	30.4	15.0	24.6
Firms using banks to finance investments (%) <sup>c</sup>		27.1	22.1	16.3	18.4
Firms using banks to finance working capital (%) <sup>c</sup>		17.6	27.6	13.0	23.3
Electronic payments used to make payments (% age 15+) <sup>b</sup>		12.9	29.6	38.2	28.6
Mobile phone used to pay bills (% age 15+) <sup>b</sup>		1.3	2.3	8.6	0.5
Mobile phone used to send money (% age 15+) <sup>b</sup>		9.8	6.9	16.4	17.6

*continued on next page*

**Table 1.4: Continued**

		Mongolia	Tajikistan	Uzbekistan
Commercial bank branches per 100,000 adults <sup>a</sup>		70.4	NA	36.1
ATMs per 100,000 adults <sup>a</sup>		88.6	NA	21.6
Share of adults with formal account (% age 15+) <sup>b</sup>	All adults	47.0	37.1	58.7
	Women	42.1	36.0	60.3
	Adults belonging to the poorest 40%	38.5	29.7	48.8
	Young adults (% aged 15–24)	49.3	20.9	36.9
	Adults living in rural areas	46.3	34.4	56.7
Saved at a financial institution (% age 15+) <sup>b</sup>		19.3	11.3	2.3
Loan from a financial institution in the past year (% age 15+) <sup>b</sup>		28.9	14.7	2.1
Firms with a bank loan or line of credit (%) <sup>c</sup>		48.1	14.6	26.4
Small firms with a bank loan or line of credit (%) <sup>c</sup>		42.2	15.1	26.4
Firms using banks to finance investments (%) <sup>c</sup>		22.7	13.2	16.1
Firms using banks to finance working capital (%) <sup>c</sup>		44.4	19.2	13.1
Electronic payments used to make payments (% age 15+) <sup>b</sup>		79.4	40.3	33.6
Mobile phone used to pay bills (% age 15+) <sup>b</sup>		10.7	2.3	2.5
Mobile phone used to send money (% age 15+) <sup>b</sup>		35.6	19.5	5.4

ATM = automated teller machine, CAREC = Central Asia Regional Economic Cooperation, NA = not available.

Sources:

<sup>a</sup> IMF. Financial Access Survey 2017 (2013 Tajikistan data).

<sup>b</sup> World Bank Global Findex Survey 2017.

<sup>c</sup> World Bank Global Financial Development Database 2018 (2013 data).

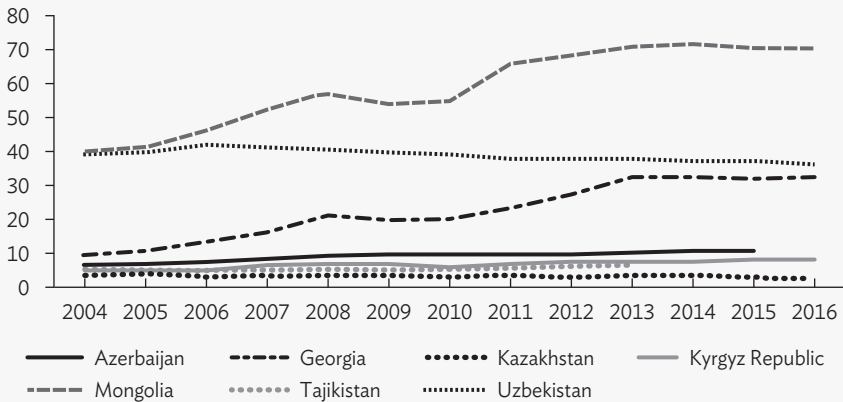
<sup>d</sup> Azerbaijan Financial Market Supervisory Authority (FIMSA) and Azerbaijan State Statistics Committee.

## 1.5.1 | Banking Services

### Banking Network

Figure 1.1 shows the penetration of bank branches in the seven landlocked CAREC economies since 2004. Aside from Uzbekistan and Kazakhstan, the other five countries in this region have seen gradual increases in the level of bank penetration, although this remains very low in Azerbaijan, the Kyrgyz Republic, and Tajikistan.

**Figure 1.1: Bank Branch Penetration per 100,000 Adults**



Source: IMF Financial Access Survey. <http://data.imf.org/?sk=E5DCAB7E-A5CA-4892-A6EA-598B5463A34C> (accessed 17 July 2018).

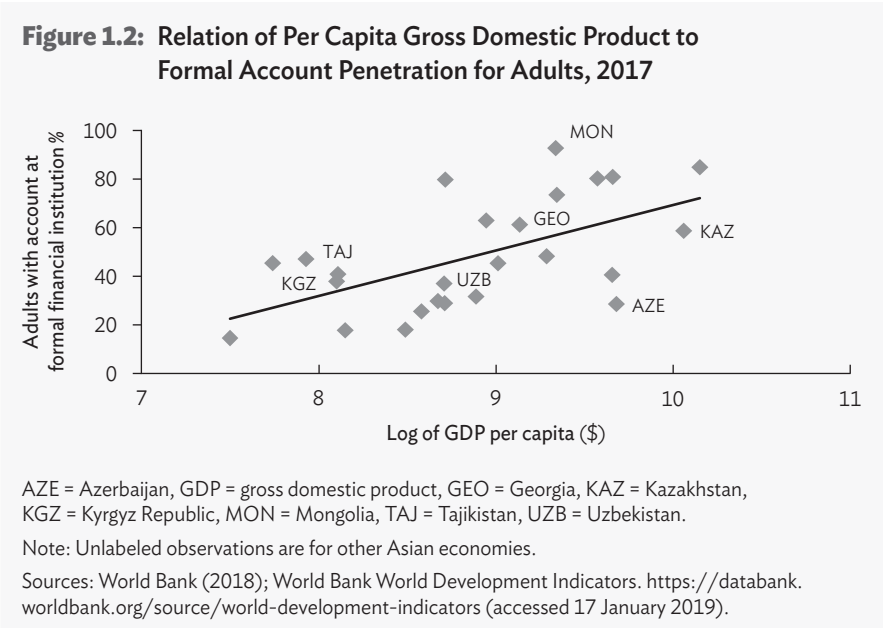
Overall, the number of bank branches has increased since 2004, especially in Georgia and Mongolia, and in 2015 Georgia, Mongolia, and Uzbekistan surpassed the world average of 12 branches per 100,000 adults. The declining trend in Kazakhstan and Uzbekistan reflects the very slow rate of increase in the number of branches relative to population growth.

The situation with the distribution of ATMs is somewhat different, with Georgia, Kazakhstan, and Mongolia having significantly higher levels of penetration than the other four countries (Table 1.4). ATM penetration has been growing relatively rapidly in all of the landlocked CAREC economies, although from a very low base in some cases. The main issue is the extent to which the ATMs are concentrated in major cities instead of being distributed more evenly throughout the country. In Georgia and the Kyrgyz Republic, well over half of all ATMs are located in the three largest cities, while the share for Kazakhstan is about 30% (IMF 2018).

## Accounts

Figure 1.2 shows that households' financial access in Asia in terms of the percentage of adults with an account at a formal financial institution tends to rise in line with per capita GDP. Most landlocked CAREC economies lie relatively close to the trend line, except Mongolia, which is well above the line, and Azerbaijan, which falls far below the trend. However, there is still huge variation across countries in

the CAREC region, implying that other factors besides income (including overall financial development and regulatory, institutional, social, and geographic factors) play important roles. For example, Georgia has a much higher level of deposit penetration than Uzbekistan, even though the per capita income levels of these two countries are similar. Moreover, all the CAREC economies except Georgia and Mongolia have penetration shares below 60%.

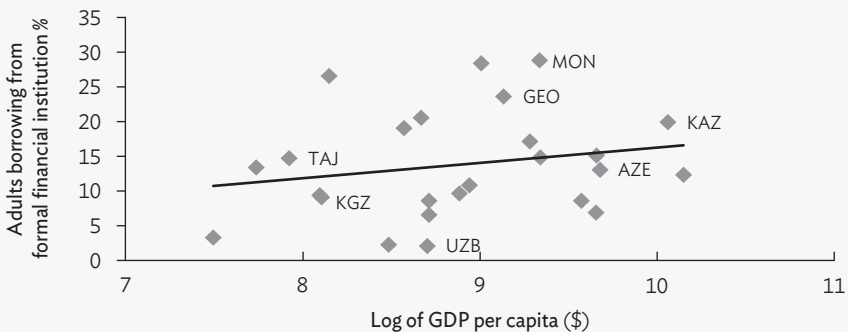


The fact that Azerbaijan has the lowest level of account penetration among adults (29%) despite having relatively high per capita income stands out as a puzzle. One possible reason for this is the country’s very low level of bank branch penetration, which is much lower than in Georgia, Mongolia, and Uzbekistan (Figure 1.1). However, this cannot be the only explanation, as Kazakhstan, the Kyrgyz Republic, and Tajikistan have even lower levels of bank branch penetration. Table 1.3 shows that Azerbaijan has by far the lowest level of account penetration in the region, with among the poorest 40% of the population, young adults, and the rural population. This points to a great disparity in account access among the population, suggesting that bank penetration in rural areas is very weak. Kazakhstan’s low level of account penetration relative to income may reflect the high share of national income from natural resource production there.

## Credit

Based on data from Asian countries, Figure 1.3 shows that the relationship between per capita GDP and the share of adults obtaining loans from formal financial institutions is positively sloped; however, this relationship is weaker than that observed with accounts. Once again, large variations can be seen in the CAREC region. In terms of borrowing rates, Kazakhstan, Azerbaijan, and the Kyrgyz Republic fall fairly close to the trend line; Mongolia and Georgia are ranked much higher; and Uzbekistan falls well below the trend. Uzbekistan's ranking appears mainly to reflect cultural and religious factors: the 2017 Global Findex survey found that 30% of adults cite religious reasons for not using financial services (World Bank 2018).

**Figure 1.3: Relationship between Per Capita Gross Domestic Product and Loan Penetration for Adults, 2017**



AZE = Azerbaijan, GDP = gross domestic product, GEO = Georgia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, MON = Mongolia, TAJ = Tajikistan, UZB = Uzbekistan.

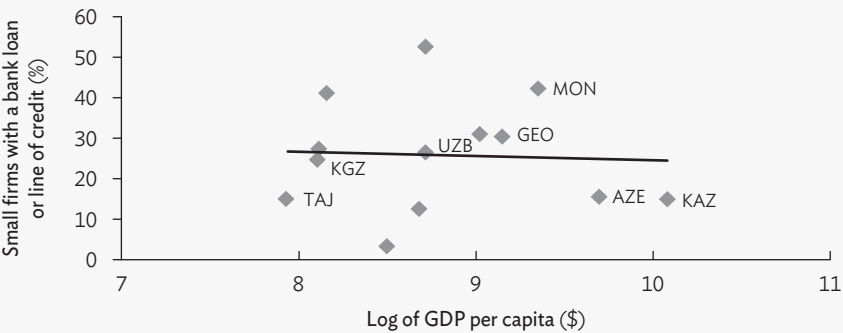
Note: Unlabeled observations are for other Asian economies.

Sources: World Bank (2018); World Bank World Development Indicators. <https://databank.worldbank.org/source/world-development-indicators> (accessed 17 January 2019).

Figure 1.4 shows a relatively flat but negative overall relationship between per capita GDP and the share of small firms with a line of credit. Once again, the CAREC economies show a high degree of variation. Data are available for considerably fewer countries than for household financial access. Borrowing rates for Azerbaijan, Kazakhstan, and Tajikistan are well below average; that of Mongolia is above average; and those for the other three economies are close to the average. The low levels for Azerbaijan, Kazakhstan, and Tajikistan appear well-correlated with the low levels of bank branch penetration shown in Figure 1.1.



**Figure 1.4: Share of Small Firms with a Bank Loan or Credit Line, 2013**



AZE = Azerbaijan, GDP = gross domestic product, GEO = Georgia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, MON = Mongolia, TAJ = Tajikistan, UZB = Uzbekistan.

Note: Unlabeled observations are for other Asian economies.

Sources: IMF (2018); World Bank World Development Indicators. <https://databank.worldbank.org/source/world-development-indicators> (accessed 17 January 2019).

1.5.2 | Insurance

The use of insurance services remains very low in most CAREC countries. Most of the country studies find that their insurance markets are small and at a nascent stage. This is mainly due to a lack of information about most insurance products, a lack of trust in insurance companies, insufficient types of compulsory insurance, and a lack of control mechanisms for the sale of existing mandatory insurance products. In the life insurance market, apart from some increases in Azerbaijan, Georgia, and Kazakhstan, the ratio of premiums to GDP is very low. Life insurance premiums are growing rapidly in Azerbaijan, but have fallen significantly from their earlier peak in Kazakhstan. The ratio in other economies is quite small, lower than 0.06% in all cases. Tajikistan’s insurance sector is one of the least developed in Central Asia. Insurance claims by SMEs are rare and usually unattended, which significantly undermines trust in the insurance sector (Mirzoev and Sobirzoda Chapter 7).

The nonlife insurance market is similarly small. The ratio for all countries is less than 0.6%, although Kazakhstan previously had ratios of more than 1%. The recent trend in nonlife insurance premiums in most countries is low and flat, except for the Kyrgyz Republic, which shows a big drop.

### 1.5.3 | Kinds of Financial Institution Involved

Commercial banks are still the workhorse of SME financing, but their role is supplemented by various nonbank financial institutions. Inclusion-oriented financial institutions include microfinance institutions (MFIs), state-owned banks, post offices offering financial services, credit cooperatives, and international and community organizations. State-owned banks and governments often take the lead in initiating financial inclusion strategies and governing financial inclusion-related institutions. For example, the Government of Azerbaijan provides three different plans for SME financing (see Table 1.5, column 1).

**Table 1.5: Elements of Financial Inclusion Strategies**

Country	Inclusive Financial Institutions	Subsidized Funding	Innovative Financial Products and Services	Innovative Delivery Technologies	Innovative Systems to Enhance Credit Access
Azerbaijan	NBCIs, including Azerpost, credit unions, MFIs	Subsidized loans provided by National Fund for Support of Entrepreneurship, Azerbaijan Mortgage and Credit Guarantee Fund, Azerbaijani Investment Company, State Agency for Agricultural Credits	Various insurance products	Mobile banking, electronic payments through national payment terminals such as e-Manat and Million	Azerbaijan Mortgage and Credit Guarantee Fund, 2017 Law on Encumbrance of Movable Property allowed movable property to be used as collateral
Georgia	Credit unions, MFIs		Supplementary pension-saving system, P2P lending, and crowdfunding	Digital banking enabling e-payments, receiving deposits, and transfers	Private credit bureau CreditInfo Georgia, public credit database, Credit Guarantee Mechanism
Kazakhstan	The number of MFIs is increasing rapidly, but the level of loans remains small	Interest rate subsidies and guaranteed loans	Microfinance	Electronic payments available with fairly wide use	
Kyrgyz Republic	MFIs, credit unions, microcredit unions	State mortgage companies providing subsidized rates for public employees and farmers	Microloans, collateral-free loans	Internet and mobile banking available but not widely used	Credit bureau, State Guarantee Fund, new law on warehouse receipts

*continued on next page*

**Table 1.5: Continued**

Country	Inclusive Financial Institutions	Subsidized Funding	Innovative Financial Products and Services	Innovative Delivery Technologies	Innovative Systems to Enhance Credit Access
Mongolia	Credit unions (does not mention MFIs specifically)	Tax exemptions, credit guarantees, subsidies for leasing and insurance		Internet and mobile banking	Credit Guarantee Fund, Integrated Mineral Resources Initiative
Tajikistan	MFIs, credit unions	Entrepreneurship Support Fund		Electronic payments and mobile banking available but not widely used, increasing payment card use with POS terminals	Credit guarantee fund, private credit guarantee facility
Uzbekistan	Microkreditbank, MFIs	Subsidized loans offered by government-controlled banks for specific sectors and investment purposes		Electronic payments, mobile banking, internet banking	Credit registries and public and private credit bureaus

MFI = microfinance institution, NBCI = nonbank credit institution, P2P = peer-to-peer, POS = point of sale.

Sources: Aliyev (Chapter 2), Boojoo (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

Table 1.6 shows the breakdown of loans by type of financial institution as a percentage of GDP in the seven CAREC economies. It shows that the lending landscape is clearly dominated by commercial banks and other depository institutions, mainly public sector banks.

## Commercial Banks

The banking sector has faced difficult operating conditions in a number of countries, which have squeezed SMEs' financial access opportunities. In Azerbaijan, total bank assets fell from 64% of GDP in 2015 to 40% of GDP in 2017, reflecting nonperforming loan (NPL) write-offs and bank closures (Aliyev Chapter 2). In Tajikistan, the NPL ratio rose to more than 50% of total assets by early 2017, while the capital adequacy ratio declined to 11.5% in March 2016, driven by the largest banks (Mirzoev and Sobirzoda Chapter 7). This greatly constrained the ability of banks to lend to SMEs.

**Table 1.6: Outstanding Loans by Type of Financial Institution, 2017 (% of GDP)**

Type of Institution	AZE	GEO	KAZ	KGZ	MON	TAJ	UZB
Commercial banks	16.2	57.7	26.4	20.8	51.7	15.2	44.4
Subtotal for SMEs	–	8.3	9.7	–	8.9	–	8.0
Credit unions and financial cooperatives	–	0.0	–	0.2	0.3	–	–
MFIs	<1.0	4.4	0.2	2.2	–	3.1	1.7
Other financial intermediaries	0.6	–	3.3	–	1.8	–	–
Total	16.8	62.1	29.9	23.2	53.8	18.2	46.1

– = not available, AZE = Azerbaijan, GDP = gross domestic product, GEO = Georgia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, MFI = microfinance institution, MON = Mongolia, SMEs = small and medium-sized enterprises, TAJ = Tajikistan, UZB = Uzbekistan.

Sources: Authors' calculations. Data from IMF (2018), except Mongolia (2016) and Tajikistan (2013), GDP data from the World Bank World Development Indicators Database, SME data for Kazakhstan from Kapparov (Chapter 4), Mongolia data for SMEs from Boojoo (Chapter 6), Tajikistan data from the National Bank of Tajikistan, and Uzbekistan data for SMEs from Tadjibaeva (Chapter 8).

In Kazakhstan, SMEs are the main borrowers from banks and account for over 80% of their business loans portfolio. This reflects the ability of large companies to borrow more cheaply elsewhere. Nonetheless, SMEs still face many difficulties getting access to credit from banks (Kapparov Chapter 4).

Banking in Uzbekistan continues to be dominated by a handful of state-owned banks (86% of total assets) and lacks competition and transparency. Government-controlled banks still support the government's economic priorities through subsidized loans offered to specific sectors and for specific investment purposes. Small business loans amount to only about 17.7% of total loans and 8% of GDP (Tadjibaeva Chapter 8).

### Microfinance Institutions

Levels of development with respect to MFIs vary greatly. In Kazakhstan, the number of registered MFIs has grown very quickly, from 136 at the beginning of 2017 to 160 in September 2017. In the first 6 months of 2017, the MFI loan portfolio increased by 30% to reach \$0.4 billion, although this is still a tiny fraction of the total amount of SME and retail bank loans (\$26 billion). One reason for their remarkable loan growth is that the MFI regulations are not as stringent as those for commercial banks.

For example, licensing is not required for those MFIs that do not take deposits (Kapparov 2018). In Georgia, the number of registered microfinance organizations has increased dramatically, from two in 2004 to 81 in 2016, while MFIs' total assets as a share of GDP grew from 0.02% in 2006 to 8% in 2016. Similarly, MFI loans reached 4.4% of GDP in 2016, the highest in the region (Babych, Grigolia, and Keshelava 2018). In the Kyrgyz Republic, the number of MFIs and credit unions reached a peak of 651 units, and loans amounted to 8% of GDP by 2011 (Hasanova 2018). However, this share shrank to less than 3% of GDP by 2016 as a result of regulatory tightening and the conversion of some MFIs to bank status. In Tajikistan, MFI loans have grown rapidly, accounting for 17.7% of all loans (the highest relative share in the region), reflecting in part the country's relatively low level of financial development. However, MFI credit growth may be limited by the borrowing capacity of their clients (Mirzoev and Sobirzoda Chapter 7). On the other hand, as highlighted by the World Bank Group (2016), the nonbank credit sector in Azerbaijan is underdeveloped and offers limited credit opportunities for SMEs, with total loans accounting for less than 1% of GDP (Ibadoghlu 2018).

In Uzbekistan, MFI loans are limited, only accounting for 3.6% of total loans and 1.6% of GDP, although they make up 20% of all loans to SMEs and have been growing rapidly. Microkreditbank, established in 2006, provides preferential loans to SMEs at interest rates of only 5%, well below the inflation rate of 14.4% in 2017. The losses are covered by the state (Tadjibaeva Chapter 8).

### **Multilateral Banks and International Donor Organizations**

Multilateral banks and international donor organizations also provide funding for SMEs through a wide variety of programs. There are significant programs in Georgia, where international financial institutions such as the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the World Bank, the International Finance Corporation (IFC), and the German state-owned development bank, KfW, have been actively supporting the provision of credit lines to SMEs, as well as more targeted business groups such as women's businesses and horticultural farms in Uzbekistan. ADB has been actively involved in governments' efforts for SME development. In particular, ADB in 2011 provided a \$500 million loan to the Damu Fund under the Kazakhstan government's guarantees. Given the high interest rate environment, significant unmet demand for SME finance, and limited government subsidy programs, funding from international financial institutions plays an important role in Uzbekistan (Tadjibaeva Chapter 8).

## Leasing

Leasing is another source of finance for SMEs. Costs are higher than bank lending, but fewer guarantees are required. In Uzbekistan, it is rather limited, accounting for only 0.6% of GDP. One problem is the lack of understanding of the service among potential customers (Tadjibaeva Chapter 8).

## Private Equity Funds

The first public venture fund in Kazakhstan was created in 2004 and is now named the National Agency on Technological Development. Another equity management fund is Kazyna Capital Management, which invests as a limited partner in different equity funds in various sectors (Kapparov Chapter 4).

### 1.5.4 | Inclusion-related Financial Products and Services

To promote financial inclusion, governments and credit organizations provide various specialized and innovative products and services, including microproducts such as no-frills bank deposits, microcredit and microinsurance, agent banking, and microbranches. In Azerbaijan, agriculture-related financing products are provided, such as harvest insurance, index-based weather insurance, and index-based livestock mortality insurance. These products and services allow farm households to smooth fluctuations in household income due to seasonality and mitigate external risks associated with farming.

Most MFIs in the Kyrgyz Republic practice group lending. Over half (53%–71%) of MFIs' credit portfolios consist of group, collateral-free loans. Since women have restricted access to collateral, they have become the majority of MFI borrowers (70% during 2006–2016, on average). The accessibility of loans, simplified procedures for obtaining them, and branches in rural areas have made microfinance attractive to the low-income rural population. Relatively liberal laws have inspired the establishment of over 650 MFIs, and MFI loans accounted for almost half of the country's total credit portfolio in 2011 (Hasanova 2018). In Uzbekistan, MFIs can offer three products: microcredit, microloans, and microleasing.

### 1.5.5 | Innovative Delivery Technologies

Innovative delivery technologies, such as mobile phones, e-money, and internet banking, can also help bridge distances and save time. Digital banking services are developing rapidly in the region, albeit from a very low base (Table 1.4).

A national electronic payment system introduced in Azerbaijan has led to a large increase in utilization, and recent regulatory changes in Uzbekistan have created an upsurge in mobile phone banking (Ahunov 2018).

In Georgia, the most commonly used technologies include internet banking, telephone banking, mobile banking, and text message banking. Georgians actively use electronic payments to pay public utilities and purchase goods (Babych, Grigolia, and Keshelava 2018). In Mongolia, the number of mobile phone users is growing fast, which is driving steady growth of internet banking, especially mobile banking users. The number of internet banking users almost tripled and the number of mobile banking users doubled from 2015 to 2017 (Boojoo Chapter 6). According to a 2014 survey by the International Finance Corporation in Tajikistan, very few banking services are currently available online, as the software used by banks and MFIs does not allow some operations to be implemented (Mogilevskii and Asadov 2018). Several large banks and MFIs provide mobile banking services, but penetration rates are still low. The national payment system Korti Milli, as well as international payment systems such as Visa, Mastercard, and UnionPay, are widely used in the financial system. Several MFIs in Tajikistan have started using payment service provider terminals for loan repayment (Mirzoev and Sobirzoda Chapter 7).

Peer-to-peer lending and crowdfunding are not yet available in Kazakhstan. They play only a very limited role in Azerbaijan and Uzbekistan, since the regulatory environments are not supportive.

## 1.6 Financial Knowledge and Skills of Small and Medium-Sized Enterprise Entrepreneurs

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In the aftermath of the global financial crisis, financial literacy and financial education have received increasing attention. The crisis yielded sobering lessons, such as how the mis-selling of financial products directly contributed to the severity of the crisis, both in developed economies and in Asia. To a certain extent, this can be attributed to inadequate financial knowledge on the part of individual borrowers and investors.

Financial literacy has gained an important position on the policy agenda of many countries, and the importance of collecting informative, reliable data on financial literacy levels across the adult population has been widely recognized.

At the Los Cabos Summit in 2012, the Group of 20 (G20) leaders endorsed the High-Level Principles on National Strategies for Financial Education developed by the Organisation for Economic Co-operation and Development (OECD) and the International Network on Financial Education (INFE), thereby acknowledging the importance of coordinated policy approaches to financial education (G20 2012). At the same time, surveys consistently show that financial literacy is relatively low, even in advanced economies (OECD/INFE 2016). As individuals are increasingly required to manage their own retirement savings and pensions, mainly due to the trend of switching from defined-benefit to defined-contribution pension plans, the need for high levels of financial literacy is rising.

Lusardi and Mitchell (2014: 6) define financial literacy as “peoples’ ability to process economic information and make informed decisions about financial planning, wealth accumulation, debt, and pensions.” OECD/INFE (2016: 47) defines financial literacy as “[a] combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and ultimately achieve individual financial wellbeing.” Thus, this concept of financial literacy is multidimensional, reflecting not only knowledge, but also skills, attitudes, and actual behavior.

Financial education can be viewed as a capacity-building process over an individual’s lifetime, which results in improved financial literacy and well-being. Financial education is also necessary to prepare for old age.

Financial education for SMEs is also important. Japan and Thailand have begun to collect SME databases; as a result, SMEs have started keeping their books, becoming more aware of their daily revenues and expenses in the process. Some SMEs have also started to think long-term. Therefore, collecting an SME database can be a good source of financial education for SMEs. At the same time, asset management has become vital for SMEs. SMEs must prepare pension contributions for their employees, leading to an accumulation of pension assets. Therefore, SMEs need to know how to manage their pension reserve assets.

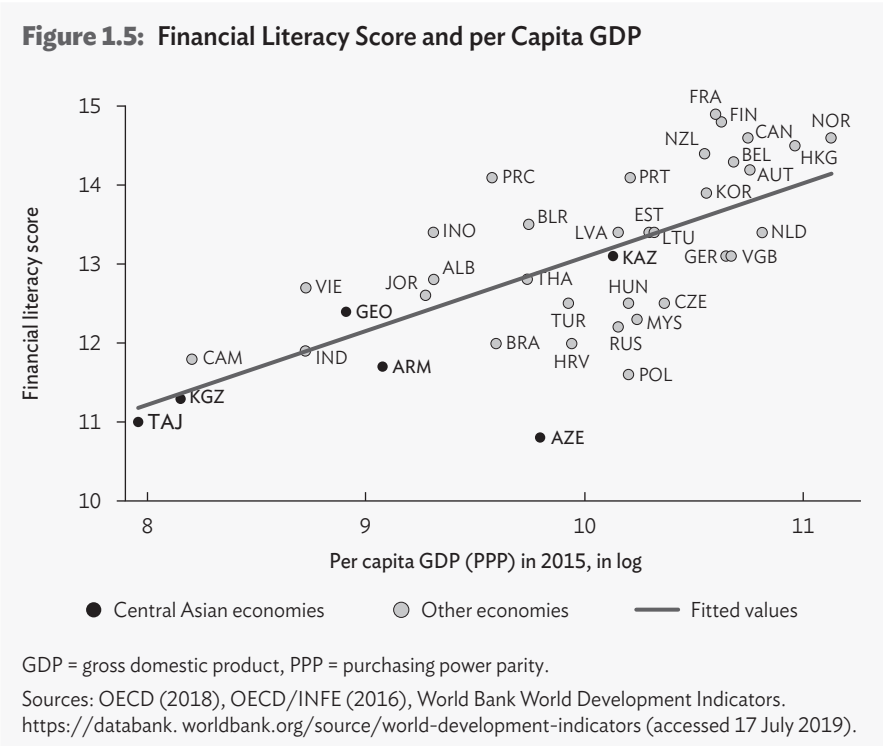
### **1.6.1 | Status of Financial Literacy**

Mapping the current status of financial literacy (or financial capability) in Asia presents challenges to researchers and policy makers alike: this is a new area with limited data, the coverage of available surveys is relatively uneven, and methodologies and results are inconsistent. Only a limited number of Asian economies and target groups within them have been surveyed so far, and their results vary widely. Although there is some relationship between financial literacy and per capita income, rankings differ significantly across different studies.



Greater coverage of target groups (e.g., students, seniors, SMEs, and the self-employed) is needed. It is desirable that international organizations, such as the OECD, the World Bank, and ADB, sponsor surveys using similar survey questionnaires and methodologies to establish a meaningful basis for international comparisons.

The OECD/INFE survey of adult financial literacy has been conducted in five CAREC economies—Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, and Tajikistan. Figure 1.5 shows that there is a significant correlation between the average financial literacy score and average per capita GDP, although there is also significant dispersion around the trend line. The survey does not specifically address SMEs, but probably gives a good indication of the relative status of financial literacy in each country. Four of the five CAREC countries lie close to the trend line, but Azerbaijan lies well below it, and in fact has the lowest score of any country.



It is not clear what the reasons for this are. Azerbaijan has the lowest or very low scores for both the financial knowledge and financial behavior subcomponents of the financial literacy score. According to the results of Standard & Poor's 2014 Global Financial Literacy Survey, 41% of adults in Mongolia were found to be financially literate, slightly above the global average, but in Uzbekistan only 21% of adults were financially literate, putting it in the lower quintile of countries (Klapper, Lusardi, and van Oudheusden 2015).

## 1.6.2 | Financial Education Strategy

There are still many policy gaps in CAREC economies in the areas of financial literacy and financial education. A variety of programs exist, as summarized in Table 1.7, which shows national strategies; the roles of central banks, regulators, and private programs; and the channels and coverage of such programs.

**Table 1.7: Financial Education Programs and Strategies**

Country	National	Central Bank	Other Regulators
Azerbaijan	National Financial Literacy Strategy (since 2016)	Financial Literacy Project 2010	Financial Literacy Project of the Ministry of Education, Financial Market Supervisory Authority, Ministry of Economy, Small and Medium Business Development Agency
Georgia	National Strategy for Financial Education (since 2016), SME Development Strategy of Georgia 2016–2020	National Bank of Georgia is the leading authority in the National Strategy	Ministry of Economy and Sustainable Development, Entrepreneurship Development Agency (Enterprise Georgia), Innovation and Technology Agency (GITA)
Kazakhstan	State Program for Enhancing the Investment Culture (2007–2011) (only for initial public offerings)	Program to improve the population's financial literacy for 2016–2018, key performance indicators not directly linked to financial inclusion measures	

*continued on next page*

**Table 1.7: Continued**

Country	National	Central Bank	Other Regulators
Kyrgyz Republic	Program to Improve Financial Literacy 2016–2020	Key partner to the government's Financial Literacy Program, program for training of population by MFIs	
Mongolia	National mid-term program 2016–2021	Participating in national mid-term program	Ministry of Finance, Ministry of Education, Culture and Sport and Financial Regulatory Commission
Tajikistan	No comprehensive national financial education program. The Strategic Priorities of NBT on Development of Mechanisms on Protection of the Rights of Consumers of Financial Services in the Republic of Tajikistan for 2017–2019 have a goal to enhance financial literacy	Expected: annual international financial literacy weeks, distribution of financial products booklets	Financial infrastructure development program initiated by the IFC 2015, activities by international donors in coordination with national agencies
Uzbekistan	Financial literacy addressed in Strategy for Action 2017–2021	Financial literacy program jointly held with the IFC, Association of Banks, Chamber of Commerce (2017), support from AFI and World Bank to draft financial literacy strategy	
Country	Private Sector/MDB	Coverage/Targets	Channels
Azerbaijan	Azerbaijan Banks Association partnership with the CBAR, joint training for commercial banks, Azerbaijan Microfinance Association programs	Students, broad public, economic journalists, CBAR employees, commercial bank employees	Awareness-raising programs; schools, seminars, training
Georgia	Stakeholders of the National Strategy	Youth, the rural population, the unemployed, others in need	Training, awareness promotion campaigns, incorporation in school curricula (math and civil education), brochures, videos, mass media

*continued on next page*

**Table 1.7: Continued**

Country	Private Sector/MDB	Coverage/Targets	Channels
Kazakhstan	Some financial education activities by commercial banks and microfinance institutions	Schoolchildren, students, the general population	Mass media, school curricula, meetings, public lectures, National Bank of Kazakhstan's specialized website for financial inclusion, other activities
Kyrgyz Republic	Several fragmented consultations, training, and books by financial institutions with limited coverage; financial literacy programs by international organizations	Schoolchildren, youths, adults, entrepreneurs, general citizens	New education curricula, training, consultation, media, a specialized website for financial inclusion
Mongolia	Mongolian Banks Association, Mongolian Insurers Association, Savings Insurance Corporation, etc.	Schoolchildren, youths, rural residents, adults	Cooperate with school/university curricula and modules, initiatives with private sector institutions and NGOs, targeted training for rural residents
Tajikistan	Partnership with the IFC in the 2015 program, National Association of Medium and Small Business, National Association of Business Women in Tajikistan, Association of Innovative Technology in Entrepreneurship, Association of Banks of Tajikistan, Trade and Commerce Chamber	Youths, students, teachers, the wider citizenry	Workshops, training, mass media, social media, booklet distribution
Uzbekistan	Financial literacy program by the National Association of Microfinance Institutions, Microfinance Centre, ADB project to increase MSME loans to women, NORMA Center capacity building programs, Chamber of Commerce	Students and youths, SME owners, women, migrant workers, small farmers, low-income groups, remote communities	Training programs

AFI = Alliance for Financial Inclusion, CBAR = Central Bank of Azerbaijan Republic, IFC = International Finance Corporation, MDB = multilateral development bank, MSME = micro, small, and medium-sized enterprises, NGO = nongovernment organization, NSFE = National Strategy for Financial Education, SME = small and medium-sized enterprises.

Sources: Aliyev (Chapter 2), Boojoo (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

In 2014, the Central Bank of Azerbaijan implemented its National Financial Literacy Strategy. The Strategic Road Map for Production of Consumer Goods at the Level of Small and Medium Entrepreneurship in the Republic of Azerbaijan shows the Ministry of Economy, the Ministry of Education, the Financial Market Supervisory Authority, and the Small and Medium Business Development Agency as the main implementers of the financial literacy strategy in 2017–2020. However, currently, there are no special programs to promote financial literacy among SMEs (Aliyev Chapter 2). In 2016, Georgia implemented its National Strategy for Financial Education with the goal of improving consumer wellbeing and consumer protection. There is no specific national financial education strategy for SMEs, but the National Bank of Georgia has implemented two programs to increase SMEs' level of financial literacy (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

In Kazakhstan, the 2014 Concept for the Financial Sector Development of the Republic of Kazakhstan until 2030 (2030 Concept) states that work to increase the level of financial education should be continuous; however, this has not yet been implemented. There is no strategy that focuses on the financial literacy of SMEs and entrepreneurs. Financial education of SMEs is conducted mainly by financial institutions (banks, insurance companies, the Damu Fund, etc.) (Kapparov Chapter 4). The Kyrgyz Republic adopted a program to improve financial literacy for 2016–2020, including the first centralized initiatives to provide financial education in the school curriculum, but there are no specific programs for SMEs, although there are programs targeting bank customers. Mongolia, with the technical support of the World Bank, initiated a National Program on Financial Literacy for 2016–2021.<sup>2</sup> No national strategies for promoting financial literacy have yet been implemented in Tajikistan or Uzbekistan. In Tajikistan, however, since 2010, the IFC, the German Enterprise for International Cooperation (GIZ), the Aga Khan Foundation (AKF), and other multilaterals have piloted financial counseling services to consumers: they have demonstrated that counseling significantly improves financial planning, savings, and even incomes of entrepreneurs in rural areas (although it had a negligible impact on arrears). However, training by SMEs in the area of capacity-building has been limited (Mirzoev and Sobirzoda Chapter 7). In Uzbekistan, several initiatives were supported by international organizations jointly with nongovernment organizations and commercial banks to enhance the financial literacy of various groups, including students and youth, women, migrant families, small farm holders, communities in remote areas, and vulnerable groups.

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<sup>2</sup> National Program for Financial Literacy. [https://www.mongolbank.mn/documents/regulation/2016-2020sanhuu\\_eng.pdf](https://www.mongolbank.mn/documents/regulation/2016-2020sanhuu_eng.pdf).

The Alliance for Financial Inclusion and the World Bank are supporting the Central Bank of Uzbekistan to draft a financial inclusion strategy, including a strategy for financial literacy (Tadjibaeva Chapter 8).

## **Institutions Involved**

Both public and private institutions are involved in organizing financial literacy programs. Public institutions include the central banks, ministries of education, ministries of finance, international organizations (e.g., the World Bank and the OECD), and schools. Private institutions include associations of banks and MFIs. In Azerbaijan, the banks' association established a Financial Literacy Council as a platform for discussing ideas, information, and experiences in this sector. In 2010, the Central Bank of Azerbaijan Republic and Azerbaijan Microfinance Association launched the Financial Literacy Project. In Kazakhstan, financial education is implemented by the National Bank of Kazakhstan and some commercial banks and MFIs. In the Kyrgyz Republic, although centralized financial education is relatively new, commercial banks and MFIs are also involved in financial education programs. In Mongolia, the Ministry of Finance; the Bank of Mongolia; the Ministry of Education, Culture, and Sport, the Financial Regulatory Commission; the Mongolian Banks Association; the Mongolian Insurers Association; the Savings Insurance Corporation; non-state organizations operating in the financial sector; relevant associations; and universities developed a program with the technical support of the World Bank's National Mid-Term Program 2016–2021 for financial literacy. In Tajikistan, the IFC, GLZ, AKF, and other multilaterals are involved. In the past decade, the Aga Khan Development Network and 55 Group have separately set up their own enterprise growth accelerators and an enterprise investment fund. In Uzbekistan, the central bank, the IFC, the Association of Banks of Uzbekistan, and the Chamber of Commerce of Uzbekistan have implemented programs on financial literacy.

## **Target Groups and Programs**

Column 6 of Table 1.7 summarizes the targets of financial literacy programs, including students, the general population, youth, central bank and commercial bank employees, economic journalists, SME owners, the rural population, the unemployed working force, teachers, and low-income groups. Countries with programs focusing on SMEs and entrepreneurs include the Kyrgyz Republic and Uzbekistan.

## **Types of Program**

Financial literacy programs are conducted via several different channels. The first is training and workshops, which are being carried out in Azerbaijan, Georgia, the Kyrgyz Republic, Tajikistan, and Uzbekistan.

The second channel is social media. Examples are found in Georgia, Kazakhstan, the Kyrgyz Republic, and Tajikistan. Mass media tools such as videos are used to raise the awareness of the general population, especially youth and students.

The third channel is consultations, which private financial institutions usually provide to their clients. For example, in the Kyrgyz Republic, commercial banks and MFIs periodically inform their clients about financial products by providing consultations and trainings, and disseminating informational materials. In Mongolia, the Bank of Mongolia recently concluded a 3-month campaign on financial literacy with an emphasis on improving personal and household financial habits.<sup>3</sup>

## General Financial Education

Financial education has not yet been implemented in general school curricula, but some CAREC countries are now in the process of introducing it. For example, in the Kyrgyz Republic, a new curriculum for school education will be introduced to inculcate responsible financial behavior from a young age. Some related subjects will also be strengthened (Tilekeyev Chapter 5). Georgia is planning to integrate financial literacy topics into the national school curriculum (in mathematics and civil education classes). The pilot program, SchoolBank, is already in action, and the National Bank of Georgia is delivering training for pupils, as well as training for teachers in 11 public schools.

## 1.7 Barriers to Financial Inclusion

Barriers to financial inclusion can be classified as supply-side, demand-side, institutional and environmental, and cultural aspects. Supply-side barriers reflect limitations in the capacity or willingness of the financial sector to extend financial services to poorer households or SMEs. These can be further subdivided into three categories: market-driven factors, regulatory factors, and infrastructure limitations.

### 1.7.1 | Business Environment

Table 1.8 summarizes a variety of measures of the business environment and situation of competitiveness in CAREC landlocked countries that may affect the performance of SMEs. The first part of Table 1.8 shows the Doing Business scores

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<sup>3</sup> <https://montsame.mn/en/read/133041>.

from the World Bank survey. There is considerable variation in the overall Doing Business rankings, ranging from 6th for Georgia to 126th for Tajikistan. Interestingly, the rankings for obtaining credit are generally higher than the overall rankings, except for Georgia and Kazakhstan. Rankings are generally poorer for trading across borders and resolving insolvency: the former is a problem for developing GVCs, while the latter is likely to weigh on banks' decisions on lending to SMEs. The second and third parts show rankings from the World Bank Enterprise Survey and the World Economic Forum Global Competitiveness Report 2017–2018, respectively. Both surveys rank problems with obtaining finance, although the results are only moderately consistent. Azerbaijan has the highest share of respondents citing finance as a problem in both surveys and Mongolia the lowest, but the results for other countries are less consistent. Overall global competitiveness rankings range from 35th for Azerbaijan to 102nd for the Kyrgyz Republic, with Mongolia just ahead of that. The rankings for financial market development are lower than for the overall index in most, but not all, cases.

### 1.7.2 | Supply-Side Factors

**Market-driven factors.** Market-driven factors include aspects such as relatively high maintenance costs associated with small deposits or loans, high costs associated with providing financial services in small towns in rural areas, a lack of credit data or usable collateral, and a lack of convenient access points. Interest rates for SMEs are typically high, and government interest subsidy programs often create distortions and do not reach those firms most in need of support. The provision of financial services in rural areas in particular can pose problems in countries with geographically difficult-to-reach rural areas, leading to a high cost of financial services. In Georgia, for example, the cost of providing services outside major cities is high, particularly for MFIs whose clients are mainly lower-income households. In Kazakhstan, financing of the SME sector is limited due to the inactivity of the banking sector in the wake of tightened regulation after the financial crisis of 2007. Nonetheless, only about 10% of firms report it to be their major problem, focusing more on corruption, workforce quality, and taxes (Kapparov Chapter 4). In Uzbekistan, lack of ICT infrastructure for banking services and associated high transportation costs are cited as key obstacles, especially for women entrepreneurs (Tadjibaeva Chapter 8).

Collateral requirements are generally high, and collateral is typically restricted to land and immovable assets. This is cited as an issue in all countries in the region. In Uzbekistan, firms cite collateral requirements as the third most important reason for avoiding formal finance (Tadjibaeva Chapter 8). Table 1.8 shows that collateral requirements are high in Azerbaijan, Georgia, and Mongolia, but the requirements for the other countries are actually below the global average of 208.



**Table 1.8: Indicators of Business Climate and Competitiveness in CAREC Countries**

Country	Azerbaijan	Georgia	Kazakhstan	Kyrgyz Rep.
Doing Business score (rank)				
Overall	78.6 (25)	83.3 (6)	77.9 (28)	68.3 (70)
Getting credit	80.0 (22)	85.0 (12)	65.0 (60)	75.0 (32)
Trading across borders	77.0 (84)	90.0 (43)	70.3 (102)	80.7 (70)
Resolving insolvency	63.8 (40)	56.0 (60)	67.8 (37)	47.6 (82)
Business Environment				
Firms choosing access to finance as biggest obstacle (rank)	31.3 (1)	20.9 (2)	10.6 (5)	4.6 (6)
Value of collateral needed (% of loan)	247.0	223.0	196.0	188.0
Female participation in ownership (%)	4.5	33.9	28.3	49.4
Global Competitiveness ranking				
Overall	35	67	57	102
Financial market development	79	63	114	86
Access to financing (ranking as problem)	16.5 (1)	12.0 (2)	14.5 (1)	8.0 (4)
Country	Mongolia	Tajikistan	Uzbekistan	
Doing Business score (rank)				
Overall	67.7 (74)	57.1 (126)	67.4 (76)	
Getting credit	80.0 (22)	40.0 (124)	65.0 (60)	
Trading across borders	66.9 (117)	59.1 (148)	49.8 (165)	
Resolving insolvency	29.4 (152)	30.9 (146)	45.2 (91)	
Business Environment				
Firms choosing access to finance as biggest obstacle (rank)	20.6 (1)	19.2 (1)	6.7 (4)	
Value of collateral needed (% of loan)	225.0	165.0	176.0	
Female participation in ownership (%)	37.8	32.7	29.2	
Global Competitiveness ranking				
Overall	101	79	N/A	
Financial market development	129	105	N/A	
Access to financing (ranking as problem)	7.7 (7)	14.4 (4)	N/A	

CAREC = Central Asia Regional Economic Cooperation.

Sources: World Bank (2019a); World Bank Enterprise Surveys 2013 data; World Economic Forum Global Competitiveness Index 2017–2019.

In Georgia, the lack of competition in the banking sector, which is dominated by two banks, also tends to raise borrowing costs. According to the World Bank Enterprise Survey, interest rates are one of the main factors leading Georgian SMEs not to apply for loans (Khishtovani, Saghareishvili, and Basilidze Chapter 3). The lack of competition among banks is also cited as a problem in Mongolia. In Tajikistan, virtually no credit is available to start-ups because default and currency risks are far too high. In Uzbekistan, the banking sector's high share of state-owned banks and limited capacity for financial intermediation remains a key barrier to development of the private sector, and in particular the provision of finance to SMEs. The Central Bank of Uzbekistan actively regulates interest rates on loans and "recommends" interest rates on deposits, which often leaves bank interest rates below the inflation rate. Nonetheless, 80% of entrepreneurs interviewed indicated high loan rates as a main problem for SME development (Tadjibaeva Chapter 8).

The lack of credit data and reliable financial records also worsens the problem of information asymmetry, which discourages banks from lending to poorer households and SMEs. This leads to the expansion of the informal credit sector. In the Kyrgyz Republic, the shadow economy is estimated at 40% of GDP, and many entrepreneurs operate in the quasi-formal sector (Hasanova 2018). The absence of transparent accounts and activities prevents entrepreneurs from accessing a sufficient level of finance, while persons receiving informal wages cannot prove their creditworthiness and must borrow from pawnshops or relatives.

**Regulatory factors.** Regulatory factors include capital adequacy and supervisory rules that may limit the attractiveness of small deposits, loans, or other financial products for financial institutions. For instance, in Mongolia, investors report that the business registration process is efficient and clear, but the main issue is the non-transparent legal, regulatory, and accounting practices (see Boojoo Chapter 6). Strict requirements regarding the opening of branches or ATMs may also restrict the attractiveness of doing so in remote areas. Although identification and other documentation requirements are important, both with respect to know-your-client requirements and the monitoring of possible money laundering and terrorist-financing activities, these can pose problems for poor households in countries that do not have universal individual identification systems. Regulatory requirements such as restrictions on foreign ownership and inspection requirements can also restrict the entry of MFIs. Regulatory requirements should be calibrated to be commensurate with the systemic financial risks posed by various financial institutions and the trade-off between financial stability and greater financial inclusion. In Tajikistan, for example, regulators tend to be slow to understand market evolution and are therefore reluctant to experiment with new technology-based

financial products (Mogilevskii and Asadov 2018). In Uzbekistan, a major constraint on developing innovative banking services is excessive government intervention in banks' activities and an overregulated banking system (Tadjibaeva Chapter 8).

Regulatory barriers also include inadequate systems for collateral and insolvency procedures. In Azerbaijan, the complexity of the collateral mechanisms leads banks to apply harsh conditions to their customers to insure themselves against losses. Recently, measures to extend collateral to movable assets have been adopted, but not yet implemented (Aliyev Chapter 2). In Georgia, land fragmentation is a problematic issue for SMEs who apply for government programs, because some programs have minimum requirements for the size of the area. Also, unregistered land cannot be taken as collateral; therefore, ongoing problems in land registration also hinder SMEs' access to finance. According to the new state constitution, foreigners cannot own agricultural land in Georgia, which is expected to have a negative effect on agricultural development, foreign direct investment in agriculture, and the price of agricultural land, thereby reducing collateral values (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

In Georgia, in the agricultural sector, the majority of farmers are not registered as legal entities and, when demanding finance, they apply for retail loans. As their businesses are not registered, they are not able to declare their income, making it difficult for them to get financing. Lack of information on the part of SME managers about government finance programs has also been cited as a barrier in Georgia.

There is no credit registry in the Kyrgyz Republic, although there are credit bureaus (Tilekeyev Chapter 5). In Mongolia, only land with immovable property can be used as collateral at commercial banks, since it is the only asset that is properly registered in the credit registry managed by the Bank of Mongolia (Boojoo Chapter 6).

**Infrastructure limitations.** Infrastructure-related barriers include a lack of access to secure and reliable payments and settlement systems, limited availability of either fixed or mobile telephone communications, and limited availability of convenient transport to bank branches or ATMs. Numerous studies have identified a lack of convenient transport as an important barrier to financial access (see, for example, Tambunlertchai 2017). This makes it difficult to reach people living in rural and low-income areas, particularly in Kazakhstan and Tajikistan, where rural-urban disparities are large.

### 1.7.3 | Demand-Side Factors

Demand-side factors across all of the subject countries include a lack of funds, lack of knowledge of financial products (i.e., financial literacy), low management skills, and lack of trust. Lack of trust can be a significant problem when countries do not have well-functioning supervision or regulation of financial institutions, or programs of consumer protection that require adequate disclosure, regulation of collection procedures, and systems of dispute resolution. For example, in the Kyrgyz Republic, state institutions regulating the financial sector are widely distrusted, second only to police services (see Hasanova 2018). This lack of trust is partly associated with the collapse of the Soviet Union, which resulted in a widescale loss of household savings in Soviet-era banks. Confidence in Tajikistan's banking sector remains low following the recent financial crisis, not least due to liquidity problems, insolvency of several large banks, and deposit withdrawal issues from these banks (Mirzoev and Sobirzoda Chapter 7). In Uzbekistan, surveys showed SMEs lacked awareness of business development services, nongovernment organizations, and business associations, and had low trust of banks.

### 1.7.4 | Institutional and Environmental Barriers

Institutional and environmental barriers include inefficient bankruptcy laws and weak credit assessment systems, which contribute to high interest rates and collateral requirements, as well as more general factors that contribute to the overall business environment. For example, Azerbaijan's bankruptcy law does not function efficiently and is seldom used. Moreover, due to the absence of a collateral registry system for movable collateral (other than vehicles), most lenders require real estate as collateral for a significant portion of the loan value, and several only accept real estate collateral in practice (Ibadoghlu 2018). The Bankruptcy Law of Mongolia defines bankruptcy as a civil matter. The bankruptcy process is too vague, onerous, and time-consuming. According to the World Bank's Doing Business Report, it takes 4 years to become bankrupt (Boojoo Chapter 6). Other negative factors include obsolete provision of primary legislation for property rights, inadequate regulatory frameworks for commercial activity, high corruption, weak rule of law, and low regulatory quality (Tadjibaeva Chapter 8). As shown in Table 1.8, the Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan have low scores for insolvency resolution.

General competitiveness issues are also important. While Azerbaijan was ranked 15th out of 183 countries in 2010, this figure had fallen to 122nd place among 190 countries in 2018 (Aliyev Chapter 2). The World Economic Forum's Global Competitiveness Index lists access to finance as the second most problematic factor with regard to doing business in Georgia (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

In Kazakhstan, state-owned enterprises (SOEs) in many sectors are competing with private companies, thereby introducing distortions to the market economy.

Mandatory social payments in Mongolia are relatively high. The basic corporate income tax rate is 10% for income up to \$1.14 million, and the portion of income exceeding that amount is subject to 25% corporate income tax (Boojoo Chapter 6).

### 1.7.5 | Cultural Factors

Cultural factors include religious and gender-related issues. Although Azerbaijan is a Moslem country, the existing banking legislation does not support Islamic banking, which means that entrepreneurs susceptible to religious demands cannot obtain bank loans. Another cultural aspect is a negative attitude of the society toward women's engagement in entrepreneurship (Aliyev Chapter 2). In Kazakhstan, gender barriers are most prevalent in rural areas, where women lack access to financial services because they do not have regular employment, pension accounts, bank accounts, credit history, financial education, or business knowledge and skills (Kapparov Chapter 4).

In the Kyrgyz Republic and Uzbekistan, most household assets are registered under the names of the male members, which means that, effectively, women have limited access to credit due to their limited asset holdings (Tadjibaeva Chapter 8; Tilekeyev Chapter 5). Related obstacles in Uzbekistan include negative prejudice from lenders and lack of access to business networks. Table 1.8 shows that there is considerable variation in the share of firms with partial ownership by women, with a share of only 4.5% for Azerbaijan, much lower than for the other countries.

## 1.8 Status of Domestic and Global Value Chains

Value chains in the countries in this study are present only in traditional sectors, primarily agriculture and resources, not in new economy ones. Each of the countries in this study has its own strategy for value chain development. However, the current stage does not allow them to integrate significantly into global markets. CAREC landlocked countries face similar obstacles to value chain participation, such as low productivity in agriculture and low quality of services, logistics, and access to markets for producers in rural areas. The very low level of equipment technology, labor intensity, and integration with GVCs greatly hinders the increase in productivity and profitability in these sectors.

For example, ADB's research on SMEs in Kazakhstan (ADB 2015b) identified the following obstacles to SMEs' participation in GVCs:

- Inability to meet international product or quality standards
- Difficulties in the business environment
- Difficulties in finding skilled workers and professionals in service sectors
- Weak institutional support
- Disadvantages faced by younger firms

### 1.8.1 | Agriculture

Agriculture constitutes a large share of GDP in the Kyrgyz Republic, Tajikistan, and Uzbekistan. The Kyrgyz Republic mainly exports dairy products, fruit, and vegetables. In the case of dairy products, value chains include farmers, agents, factories, and exporters. Although there are more than 10,000 milk farmers in the Kyrgyz Republic, they are the weakest part in this chain, due to limited access to finance and the lack of financial literacy, while factories provide high quality final products. The value chain for kidney beans consists of farmers, agents, exporters, and transport companies (Tilekeyev Chapter 5).

Due to good environmental factors, Uzbekistan is the main producer and supplier of horticultural products in the region, placing it among the world's top 10 exporters in several categories of fruits, vegetables, and nuts. However, key problems for the development of horticultural and other agricultural value chains include the very slow progress of changes in policies for the sector, such as the lack of market mechanisms and the absence of efficient reforms of the sanitary and phytosanitary system (Tadjibaeva Chapter 8). In Azerbaijan, the main producers of agricultural products are small firms, including family businesses. In 2017, over 54% of the aggregate output came from cattle breeding and around 45% from plant growing. However, the export capacity of the food industry is very low, implying that there is little potential to create value chains there. The role of SMEs in processing industries is insignificant.

Tajikistan faces the challenge of putting in place basic pre-conditions for integration into GVCs, including diversification of production and trade; increased private investment; skills development; financial system development; transport and communications infrastructure; and business regulation. Agriculture has been identified as the most promising sector for GVC development, especially the meat/beef and dairy value chains. However, the lack of access to machinery, know-how, financial resources, skilled labor, and non-labor inputs explains why agribusiness in Tajikistan is lagging its neighbors (Mirzoev and Sobirzoda Chapter 7).

Agricultural exports in Georgia are focused on hazelnuts, wine, and water, and these products have the biggest shares in agricultural value chains. Georgian SMEs participate in the global hazelnut GVC, one of the best examples of such participation in the region. However, due to the low level of local suppliers, farmers have to sell their products at the local market while they are still fresh because of the lack of storage services. Value chain participants are connected mainly informally. Other agricultural products, such as fruits and vegetables, have the potential to enter the global market, but value chain development requires strengthening processing facilities, improving the quality of the workforce, better coordination between the value chain participants, and improved motivation of farmers (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

In Kazakhstan, SMEs mainly act as intermediaries in the commodity trade; hence SME exports are mainly concentrated in oil- and grain-producing regions. The Kazakhstan government aims to attract transnational corporations to increase the competitiveness of intermediate product exports, especially in the agricultural sector. In addition, successful companies involved in the processing sector receive support in promoting their products in domestic and global markets. The results of these strategies can be assessed in 3 to 5 years. However, it is not clear how much SMEs will benefit from these developments in agriculture.

### 1.8.2 | Manufacturing

Kazakhstan's government highlights the importance of diversifying the economy. The state program of industrial-innovative development for 2015–2019 was focused on stimulating the competitiveness of the manufacturing industry, aimed at increasing labor productivity and exporting processed goods. The new program for 2020–2024 aims to create conditions for encouraging the manufacturing sector to enter both the regional and domestic markets.

The Kyrgyz Republic's manufacturing sector has significant potential to join GVCs, especially in apparel manufacturing, where the final product is exported to the Russian Federation and other neighboring countries. Positive factors include low tax rates; a large pool of workers in the industry, including engineers, technicians, and designers; good knowledge of tastes and preferences of Russian Federation and Kazakh consumers; and an industry structure that allows fast diversification (Tilekeyev Chapter 5).

Mongolia is the second largest producer of cashmere in the world, producing about 6,000 tons per year, which makes up 28% of the world's production and over a third of domestic employment. The cashmere industry has received extensive funds, incentives, and technical assistance from the government and international donor organizations. The cashmere industry is dominated by one large company, which makes it a good candidate for GVC finance, although it weakens the competitive position of SMEs in the industry.

### 1.8.3 | Services

In the service sector, tourism in Azerbaijan has the capacity for further development at both the domestic and international levels. However, for SMEs in Azerbaijan to compete internationally in tourism, in an environment where natural conditions are better in other countries, the government should create a supportive infrastructure and introduce simplified visa procedures (Aliyev Chapter 2). The tourism sector in the Kyrgyz Republic has potential due to the natural beauty of the mountainous areas, but the insufficient levels of service quality and staff skills are a critical constraint for growth (Tilekeyev Chapter 5). In Mongolia, tourism also has the potential for GVC development, although it faces many challenges (Boojoo Chapter 6).

### 1.8.4 | Regional Cooperation

Regional cooperation between CAREC countries, partnerships with the Russian Federation and the PRC, and integration in GVCs with transnational corporations will benefit all countries involved, and develop other markets. Such regional cooperation can be achieved with better infrastructure and logistics conditions, and a win-win market environment. For example, introducing mutual visa recognition and product standardization systems will promote increased demand.

In 2015, the PRC announced its transfer of 51 industrial production sites to Kazakhstan. As of 2017, 12 sites, mainly in the processing industry, have been transferred. In addition, five agreements were signed, aimed at creating cluster cooperation zones in transport infrastructure, trade, processing industries, construction, agriculture, and other areas (Vakulchuk and Overland 2019: 119). However, most of the progress so far has been in transport infrastructure, with agriculture being the sector with the highest potential for development. Direct involvement of SMEs in these projects is likely to be slight, but they can benefit from improvements in transport infrastructure that promote regional connectivity (Kapparov Chapter 4).



## 1.9 Value Chain Financing Analysis

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In some CAREC countries, value chain participants receive financial support through the programs implemented by the government, donor organizations, and financial institutions. The Georgian government provides financial and technical assistance to small farmers and agro-cooperatives through programs such as Plant the Future, the Program of Agroproduction Promotion, and Co-financing of Agro Processing and Storage Enterprises. The government program Produce in Georgia supports new entrepreneurs, providing credits up to GEL5 million (approximately \$1.8 million). Other programs entail cofinancing SMEs in agroprocessing and storage. Through the Agroinsurance program, beneficiaries can insure agricultural land of up to 5 hectares, and up to 30 hectares in the case of cereals. There is also substantial participation in finance at various stages of value chains by international donor organizations. However, internal value chain financing is not yet developed in Georgia, as SMEs involved in value chains mainly have informal relationships with their partners (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

Azerbaijan's SMEs have very limited access to finance. In 2017, bank loans allocated to them amounted to 10.2% of banks' aggregate loan portfolio. The high levels of collateral requirements and interest rates are the main factors that discourage SMEs from borrowing: 40.4% of farmers self-finance their businesses, establishing credit unions, and 59 credit unions are operating in Azerbaijan today. In addition, SMEs get support from international institutions through joint projects such as the Agricultural Competitiveness Improvement Project (ACIP) and the Azerbaijan Agricultural Finance Facility. Qualified banks can finance agribusiness value chains at any stage. However, commercial banks prefer to allocate loans to the final stages, such as wholesale, retail, and export (Aliyev Chapter 2).

Access to finance in Kazakhstan is largely driven by nonbanking financial SOEs such as Damu and Kazagro, which are mostly financed from the government budget and provide direct loans to companies at subsidized interest rates. Kazakhstan also has credit cooperatives in selected sectors, such as agriculture, but they have limited financial impact compared to bank finance and government-supported programs. MFIs provide finance to small farms not reached by other sources (Kapparov Chapter 4). There are no value chain financing mechanisms available in Mongolia.

In Tajikistan, most households that control cattle and meat-dairy production usually secure financing through informal networks from friends and extended relatives who work abroad. Financing schemes are available from local financial institutions, but the obstacles are limited awareness of opportunities and SMEs' difficulty meeting lender requirements. Some agricultural sector programs are supported by the EBRD, GIZ, the IFC, and ADB. The government has pledged to provide preferential lending amounting to \$100 million to support Tajik entrepreneurs doing business with Uzbekistan (Mirzoev and Sobirzoda Chapter 7).

Uzbekistan's financial institutions negatively perceive the profitability and creditworthiness of the agricultural sector. Hence, horticultural SMEs cannot access preferred financing under government programs. Entrepreneurs from rural areas are also constrained by bank branches' underdeveloped networks. The low level of financial literacy of farmers keeps them from learning new information about the market and business opportunities. More than 80% of businesses get financial support from family and friends. Due to commercial banks' lack of expertise in value chain financing and existing regulatory limitations, the ability of SMEs to access financing via GVCs is limited.

The continuous increase in trade volumes between CAREC countries and the growing demand in the PRC imply that not only intra-regional integration should be considered. By increasing the modernization and integration of value chains, they can attract investments for renewing their assets. Attracting investments from the Russian Federation and the PRC in the processing sector with the aim of increasing exports to these countries should be considered.

## 1.10 Regulatory Frameworks

Table 1.9 summarizes the major features of regulations related to financial inclusion in the subject countries, including regulatory agencies, identification-related measures, regulation of MFIs, regulation of lending (mainly interest rate caps), and consumer protection.

### 1.10.1 | Institutions Responsible for Regulation

In all countries in this study except Azerbaijan, central banks have major responsibilities for regulating and supervising banks and other financial institutions. In Azerbaijan, the Financial Market Supervisory Authority supervises banks, nonbank credit institutions (NBCIs, including MFIs), and insurance companies,

and takes responsibility for consumer protection. In Georgia, the central bank supervises all depository and lending institutions. In Kazakhstan, the central bank is responsible for the regulation and supervision of banks, insurers, pension funds, investment funds, credit bureaus, and securities markets. In the Kyrgyz Republic, the central bank is the main regulator of financial institutions in the country.

**Table 1.9: Regulatory Frameworks for Financial Inclusion in Central Asia and the South Caucasus Economies**

Country	Regulatory Agencies	Regulation of MFIs	Lending Regulations	Consumer Protection
Azerbaijan	Financial Market Supervisory Authority: banks, NBCIs (including MFIs, insurance, and investment funds)	Law on nonbank credit organizations (2010), lower capital requirements for NBCIs than for normal banks, no specific law on MFIs	Some limitations on consumer loans	Financial Market Supervisory Authority
Georgia	National Bank of Georgia (commercial banks and nonbank financial institutions, excluding pawnshops and online loan providers), State Insurance Supervision Service of Georgia (insurance companies and pension schemes)	Law on microfinance organizations: MFIs cannot take deposits but can borrow, pawnshops and online loans are regulated by the Civil Code of Georgia	Interest rate cap at 100%, total loan fee must not exceed 150% of loan amount itself; limits on foreign currency loans	Reflected in lending regulations
Kazakhstan	NBK (banks, insurers, pension funds, investment funds, credit bureaus, and securities markets). Based on the goals in the Concept for the Financial Sector Development of the Republic of Kazakhstan until 2030 (2030 Concept)	NBK Resolution No. 386 requires registration of MFIs	FinTech Association: voluntary threshold for MFIs of a maximum penalty for debtors of 300% of the principal balance	National law on consumer protection, but nothing specific on financial services, the NBK is tasked with establishing call centers, Committee on Consumer Protection in Financial Services

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**Table 1.9: Continued**

Country	Regulatory Agencies	Regulation of MFIs	Lending Regulations	Consumer Protection
Kyrgyz Republic	National Bank of the Kyrgyz Republic	Only credit unions and MFIs with a license can take deposits, Law on Microfinance Organizations (2002), higher requirements on capital, restrictions on multiple lending, introduction of maximum level of fines	Interest rate cap at 15% over weighted average interest rate, minimal collateral size. maximum ratio of credit payments to borrower's income	Deposit insurance for all banks, a number of legislative acts to protect financial consumers' rights
Mongolia	Bank of Mongolia, Financial Regulatory Commission	Registration required for SMEs to be identified and acquire funding		
Tajikistan	NBT	Law on microfinance organizations (2012), the NBT's regulations on three types of microfinance organization, among MFIs, only microcredit deposit organizations can take deposits	Caps on foreign exchange, interest rates, and risks	NBT consumer protection division
Uzbekistan	The CBU regulates both banks and MFIs	MFIs regulated by the CBU (law on banks and banking)	Liberalized access to foreign exchange for small businesses and private individuals	Law on protection of consumer rights

CBU = Central Bank of Uzbekistan, MFI = microfinance institution, NBCI = nonbank credit institution, NBK = National Bank of Kazakhstan, NBT = National Bank of Tajikistan, SMEs = small and medium-sized enterprises.

Sources: Aliyev (Chapter 2), Boojoo (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

In Mongolia, the central bank implements monetary policy and supervises the activities of commercial banks, whereas the Financial Regulatory Commission monitors nonbank financial institutions, securities companies, the insurance sector, and savings and credits cooperatives. In Tajikistan, the central bank oversees licensing, regulation, and supervision; it is authorized to issue normative acts for banks and MFIs, establish financial standards, impose sanctions and penalties, and request reports. In Uzbekistan, the central bank regulates both banks and MFIs.

Regulatory frameworks still have room for improvement. For example, in Tajikistan, supervision of financial institutions is still mainly compliance-based, with little focus on good governance and risk management. Regulation and supervision need to be strengthened to manage credit, market, operation, concentration, interest rates, and liquidity risks better, as well as to improve the corporate governance and internal control systems of financial institutions. The adoption of international financial reporting standards, more advanced risk assessment tools, stress testing, and crisis management tools are among the main measures that need to be introduced (Mogilevskii and Asadov 2018). Recognizing this, the Prime Minister's Office and the State Committee on Investment and State Property Management have taken measures to improve licensing, permits, and inspections systems, thereby enabling SMEs to spend less time on compliance with regulatory requirements (Mirzoev and Sobirzoda Chapter 7).

In Uzbekistan, more than 75% of total banking sector loans come from state-owned banks, focusing on state-owned large corporates and strategically important industries. These banks are controlled and regulated by the state, mainly through the Ministry of Finance, the Central Bank of Uzbekistan, and the Uzbekistan Fund for Reconstruction and Development (Tadjibaeva Chapter 8).

### **1.10.2 | Licensing Status of Microfinance Institutions**

A consistent financial inclusion policy requires a coordinated regulatory approach. Compared with banks, MFIs typically have greater restrictions imposed on their activities. Therefore, they tend to be regulated separately from banks, which are typically supervised by the central bank or financial regulator, and are usually regulated more lightly than banks. This is particularly the case for Azerbaijan. In Azerbaijan, the minimum required charter capital for registering an NBCI is only AZN300,000, whereas for banks the amount is AZN50 million.

However, having a variety of lenders can spawn a multitude of regulatory frameworks, which can lead to inconsistencies and gaps. For example, in Azerbaijan, the Law on Non-Bank Credit Organizations (2010) defines the rules for the establishment, management, and regulation of NBCIs, with the aim of better meeting the demands of legal entities and individuals for financial resources and creating suitable conditions for access to financial services. The Law on Credit Unions (2000) determines the economic, legislative, and organizational bases for the establishment and operation of credit unions. Instead of defined “microfinance” laws, Azerbaijan has laws for NBCIs that permits them a greater number of activities, although expressly forbidding them from deposit taking. In the Kyrgyz Republic, in response to the rapid growth of MFIs, the central bank has since 2010 strengthened its regulation of MFIs by raising capital requirements to reduce the number of non-working and small MFIs, restricting the amount permitted for multiple lending, and introducing fines.

Some countries bar some or all MFIs from taking deposits (Table 1.5). In Azerbaijan, NBCIs are divided into two groups: those with the right to accept collateral deposits and those without that right. In Kazakhstan, MFIs need to obtain a banking license in order to take deposits. In the Kyrgyz Republic, only credit unions and MFIs with licenses can take deposits. In Tajikistan, the legislation identifies three types of MFI: microcredit deposit organizations, microcredit organizations, and microcredit funds. Of these three, only microcredit deposit organizations can offer deposit products. MFIs are not allowed to take deposits in Uzbekistan.

### 1.10.3 | Consumer Protection

Consumer protection programs are seen as necessary supports for financial inclusion efforts, together with financial education and effective regulation and supervision of financial institutions. Consumer protection can help address the issue of trust as a demand-side barrier to financial inclusion. Consumer protection programs are at various stages of development in the CAREC region.

Most countries in the region have issued laws to protect consumer rights (Table 1.4). For example, in Uzbekistan, the State Committee on Privatization regulates consumer protection. In Kazakhstan, the national law on consumer protection covers consumer protection and access to safe and high-quality goods, but does not specifically address financial services. The situations in the Kyrgyz Republic and Georgia are similar.

In Tajikistan, the central bank in 2015 established a customer compliance department that tracks customer complaints and feedback on financial institutions' activities. In 2017, the Office of the President of Uzbekistan began receiving consumer complaints directly through hotlines and online channels (Ahunov 2018).

In Azerbaijan, consumer protection seems less well developed, and the country has no functioning out-of-court dispute resolution system. The Financial Market Supervisory Authority, which has primary responsibility for protecting financial consumer rights, is still under development and has weak capacity (Ibadoghlu 2018).

#### 1.10.4 | Deposit Insurance

Deposit insurance is widely implemented in the CAREC region to protect bank depositors. Deposit guarantee funds have been established in several countries to provide guarantees up to a certain deposit amount.

The Azerbaijan Deposit Insurance Fund founded in 2007 provides insurance for depositors (physical persons) only, not investors (juridical entities). All deposits are guaranteed if the annual interest rate in national currency is not above 10% and the foreign currency rate is not above 2.5%. Under these conditions, the government guarantees to compensate 100% until 2020. After this date, if the government does not extend the law's force, it will compensate up to only AZN30,000 for all types of deposit. In Georgia, the deposit insurance scheme launched on 1 January 2018 insures all bank deposits up to GEL5,000 (\$2,066) (Babych, Grigolia, and Keshelava 2018). In Kazakhstan, the Kazakhstan Deposit Insurance Fund provides guarantees for all retail deposits denominated in national currency up to T10 million (\$30,000). This threshold incentivizes big depositors to split their deposits between several banks and accounts to guarantee their safety (Kapparov 2018). The Deposit Protection Agency of the Kyrgyz Republic was established in 2011. In Tajikistan, the Deposit Insurance Fund was established in 2003; its assets had reached TJS260 million (6.3% of total deposits) by the end of 2016. The deposit amount covered by the fund in case of bankruptcy of a credit organization increased from TJS7,000 in 2003 to TJS14,000 in 2015 and TJS17,500 in 2017 (approximately \$2,100). In Uzbekistan, all banks have been covered by explicit deposit insurance since 2002. A blanket guarantee on deposits was implemented under a presidential decree in November 2008, and the statutory limit of 250 times the minimum wage was removed in October 2009 (Demirgüç-Kunt, Kane, and Laeven 2014).

### **1.10.5 | Fintech-Related Regulation**

New delivery technologies such as mobile phones and e-money hold promise for promoting financial inclusion, but need appropriate regulatory frameworks to achieve their potential while remaining consistent with financial stability and other regulatory requirements. In many cases, service providers are not banks, making it difficult to implement a consistent approach. Azerbaijan is rated as having a relatively unstable political and regulatory environment, but a very supportive infrastructure and ecosystem for financial technology (Ibadoghlu 2018). In Azerbaijan, the government has created an appropriate legislative framework for the expansion of non-cash operations, and has taken steps to create an appropriate infrastructure. However, its effect has been hampered by various legal restrictions on noncash transactions. The regulatory “sandbox mechanism” is not used in Azerbaijan, which significantly limits the potential development of fintech companies in the market (Aliyev Chapter 2).

## **1.11 Policies to Promote Small and Medium-Sized Enterprise Finance**

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### **1.11.1 | National Strategy**

Although the notion of financial inclusion is relatively new to the CAREC countries, it is becoming a major goal for their governments, which are beginning to include it along with financial education in their national strategies. Overall, the CAREC countries have not implemented any systematic financial inclusion strategies or policies, and few targeted policies have been advanced. Most government efforts in this area have had only short-term effects.

Strategies are needed to set priorities and coordinate overall approaches to expanding financial inclusion. National-level strategies are most desirable, followed by those of the central bank, ministries, and/or financial regulatory bodies. Table 1.10 shows the range of approaches being taken in the CAREC region. Of these countries, the Kyrgyz Republic and Azerbaijan have the most well-articulated financial inclusion strategies, and have incorporated them in their national economic planning strategies. Georgia has a specific national strategy for SMEs, which includes substantial emphases on raising financial literacy and promoting exports. Kazakhstan, Tajikistan, and Uzbekistan have long-standing policies backing their SME support programs, but no articulated national strategies for financial inclusion as such.



**Table 1.10: Strategies and Programs for SME Finance**

Country	National	Central Bank	Ministries/ Regulators	Private Sector
Azerbaijan	Azerbaijan 2020 Vision and other programs highlight the role of entrepreneurship and SMEs, Strategic Roadmap for Development of Financial Services in the Republic of Azerbaijan, Strategic Roadmap for the Production of Consumer Goods by SMEs	Microfinance sector and financial inclusion strategy	SME subsidy programs under the Economy Ministry, presidential decree of 17 September 2017	Azerbaijan Microfinance Association
Georgia	No comprehensive national financial inclusion plan, SME development included in the Georgia 2020 Socio-Economic Development Program, SME Development Strategy of Georgia 2016–2020	National Bank of Georgia received a major grant from the IFC in 2014 to increase access	Ministry of Economy and Sustainable Development, Entrepreneurship Development Agency (Enterprise Georgia), Innovation and Technology Agency (GITA)	Georgian Chamber of Commerce and Industry (GCCCI), Georgian Employers' Association (GEA), Georgian Small and Medium Enterprises Association
Kazakhstan	People's IPO program to increase investments and retail saving, unification of pension funds, T1 trillion and Nurly Zhol programs in 2014–2017 to promote infrastructure and SME lending, Damu Entrepreneurship Development Fund, Business Roadmap 2020 for SMEs		Supporting Resilience of Micro, Small and Medium-Sized Enterprise Finance Project	

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**Table 1.10: Continued**

Country	National	Central Bank	Ministries/ Regulators	Private Sector
Kyrgyz Republic	National Development Strategy for 2018–2040, Microfinance development strategies (2006–2010, 2011–2015) and other programs, Law on State Support for SMEs, Business Service Centers, Easy Credits to Farmers program, Russian–Kyrgyz Development Fund			
Mongolia	SME Program (2018–2020), SME Development Fund	Credit information service	SME Program under Ministry of Light Industry and Agriculture, trade facilitation project under the Ministry for Foreign Affairs; Credit Guarantee Fund	
Tajikistan	National Development Strategy 2016–2030 to include greater complexity and diversification of the economy through SMEs	Signatory to Maya Declaration toward engaging 30% of the population in the formal financial sector, particularly through digital services		Several programs aimed at specific groups of beneficiaries
Uzbekistan	State Fund for Support of Entrepreneurship Development, Public Credit Guarantee, Mandatory lending for SMEs, Every Family is an Entrepreneur program	SME financing targets for Every Family is an Entrepreneur program	Credit Bureau, National Collateral Registry to support lending	Uzbek Association for Microfinance Institutions and Credit Unions

IFC = International Finance Corporation, IPO = initial public offering, SMEs = small and medium-sized enterprises.

Sources: Aliyev (Chapter 2), Boojoov (Chapter 6), Kapparov (Chapter 4), Khishtovani, Saghareishvili, and Basilidze (Chapter 3), Mirzoev and Sobirzoda (Chapter 7), Tadjibaeva (Chapter 8), and Tilekeyev (Chapter 5).

In Kazakhstan, the Business Roadmap 2020 program for SMEs has been winding down in recent years. In Mongolia, the SME program does not explicitly mention financial inclusion; rather, it aims to create a more holistic environment that includes legal and technological innovations (Boojoo Chapter 6). In Uzbekistan, survey participants reported that they encountered situations of legal collisions, where one legislative act contradicts another, thereby reducing the effectiveness of state support measures. The duplication of functions and overlapping initiatives are very frequent (Tadjibaeva Chapter 8).

Azerbaijan and the Kyrgyz Republic have included their policies for financial inclusion in their national development strategies. The Azerbaijan 2020 Vision highlights the role of entrepreneurship and SMEs in economic development, although it contains no specific strategies for financial inclusion. The Central Bank of Azerbaijan Republic developed the microfinance sector and financial inclusion strategy in consultation with all relevant departments, including banking and supervision, credit registry, legal, payments, consumer protection, strategic management, and research. In the Kyrgyz Republic, the National Strategy for Sustainable Development 2013–2017 envisaged measures for SME development, improving access to long-term loans for women entrepreneurs, and a program for the development of women's entrepreneurship.

Nevertheless, there are gaps in the development programs and approaches in these countries. If the financial inclusion promotion programs are not implemented in a comprehensive and centralized way, the strategies may not yield significant results. In addition to common issues affecting the status of financial inclusion, each country faces specific problems affecting development, ranging from dependency on remittances to credit excesses in some of the more advanced countries. In Azerbaijan, overdue credit has become excessive, and there is a lack of policy to resolve this issue. There are also gaps in legislation, especially related to the protection of customers' financial rights.

### **1.11.2 | Specific Strategies**

Central banks, ministries, and other regulatory authorities have implemented various specific strategies and policies targeting different dimensions of financial inclusion. These include accessibility, electronic identification, innovative products and services, credit databases, credit guarantees, and subsidies. Some examples are described below.

#### **Tax Preferences**

Many countries grant taxation advantages or exemptions to SMEs. In Azerbaijan, SMEs as legal entities pay a simplified tax and do not need to pay value-added tax,

profit tax, or property tax, while agricultural producers and industrial agricultural producers are exempt from all taxes except for land tax (Aliyev Chapter 2). In Georgia, there is a preferential tax regime for micro and small businesses. Micro businesses do not pay income tax (except in excluded sectors). For small businesses, the income tax rate is 1%, but where income exceeds GEL500,000 (\$200,000), the rate is 3%. In the agricultural sector, there is a preferential value-added tax regime (Khishtovani, Saghareishvili, and Basilidze Chapter 3). In Kazakhstan, current tax policy favors small enterprises and does not stimulate the consolidation of business. This, in turn, leads to a lack of credit history and audited reporting among potential borrowers among local businesses (Kapparov Chapter 4). In Mongolia, one key challenge is the high informal work sector, which inhibits measures to increase financial access; a response to this could be to provide tax incentives for registered businesses.

### **Bank Resolution Frameworks**

In Tajikistan, in order to address the NPL problem and other issues, a greatly improved bank resolution framework was passed in September 2016, preceded by agreement with key partners such as the IMF, World Bank, and the EBRD over the need to undertake asset quality reviews of the four systemic banks, improve corporate governance of state-owned banks, and lend liquidity support to the two largest banks (Mirzoev and Sobirzoda Chapter 7).

### **Credit Databases**

Information asymmetries, such as a lack of credit data, bankable collateral, and basic accounting information, often discourage financial institutions from lending to SMEs. Innovations to provide more information in this area, such as credit databases, credit guarantee systems, and rules to expand eligible collateral, can ease these asymmetries and increase financial institutions' willingness to lend.

Most CAREC economies have been active in setting up credit bureaus and expanding and consolidating credit databases on households and SMEs; however, in most cases, such efforts are still at an early stage, while efforts have not yet begun in other economies.

In Azerbaijan, the first credit bureau, Azerbaijan Credit Bureau LLC, was established in 2017; since May 2018, it has been exchanging information with 120 organizations, including the central bank, 30 banks and 14 banks under liquidation, 47 nonbank credit organizations, 22 insurance companies, three mobile operators, and three communal service operators. However, it is not yet operating (Aliyev Chapter 2)

and does not meet the normal standards for credit bureaus. In Georgia, Creditinfo Georgia offers a variety of services to various clients, including commercial banks, MFIs, online lenders, leasing companies, and insurance companies. The information gathered includes the past and existing credit of individuals and firms, credit scores and ratings, factors affecting credit scores, changes in credit reports, and credit inquiries. It covers almost 96% of the adult population, higher than any country in the European Union. According to the World Bank's Doing Business Project (2017), Georgia's credit bureau scores eight points out of eight on depth of consumer data. The bureau generates a credit report taking into account the most current information on the individual's (or firm's) characteristics, such as volume of liabilities, length of credit history, frequency of use of bank products, payment history, fulfilling commitments, and whether the individual or firm has overdue loans (see Babych, Grigolia, and Keshelava 2018).

In Kazakhstan, there is a credit registry for credit history on which 14% of SMEs are registered. However, SMEs are not forced to have their reports audited, and there are no additional incentives to do so—e.g., participation in public procurement (Kapparov Chapter 4). The Kyrgyz Republic established a credit bureau in 2003. Its main function is to manage a database of borrowers and their credit history. Over 160 banks and nonbank financial institutions are partners of the credit bureau. In Mongolia, a credit information service is available at the Bank of Mongolia, which holds information only about the amount of credit, which can be accessed by only financial institutions. For collateral, there is a separate registration system (Boojoo Chapter 6).

Two credit information bureaus provide services to credit organizations in Tajikistan: the Credit Information Bureau Tajikistan (CIBT) and the Bureau of Credit History Somonion. The CIBT cooperates with 17 banks and 56 MFIs, and holds information on 602,000 individuals and 25,000 firms, representing 887,000 credit transactions. The Bureau of Credit History Somonion covers five banks and 80 small MFIs, and holds information on 120,000 individuals and 8,500 firms, representing 332,000 credit transactions. Although both credit bureaus have their own clientele, they are not adequate, since the CIBT's scoring is unreliable and credit organizations do not use it. Secondly, not all financial institutions provide information on all their clients, and there are risks associated with these information gaps. Thirdly, the prices for CIBT services are high, possibly due to operational or technical support costs, as the CIBT rents its software. The National Bank of Tajikistan recently began collecting full datasets from credit organizations: it plans to establish a national registry wherein all necessary data from the entire sector will be stored; this registry is expected to provide information to market participants on a fee basis. The Credit Bureau was established in 2017, but has not yet completed state registration (Mogilevskii and Asadov 2018).

In Uzbekistan, the credit bureau is licensed and supervised by the Central Bank of Uzbekistan, and currently includes information from 28 banks, 76 nonbank financial institutions, and one leasing company. Reporting is mandatory, and requires prior consent of the borrower. There is no limit on the size of loans reported. The bureau covers 8.1 million natural persons and 647,000 legal entities. A publicly accessible, unified, online registry was launched in 2015 under the Central Bank of Uzbekistan (Tadjibaeva Chapter 8).

### **Credit Guarantees and Subsidies**

Credit guarantees can also ease access to finance for SMEs, although they encounter several problems, mainly moral hazard and high costs due to nonperforming loans. Guarantee funds act as mediators between borrowers and commercial banks to provide guarantees when a borrower lacks sufficient collateral.

In September 2017, a presidential decree established the Credit Guarantee Fund of Azerbaijan, which provides entrepreneurs with guarantees for manat loans taken out in authorized banks, and in some cases will also provide interest rate subsidies. Since its launch, entrepreneurs have received a total of AZN17.5 million in loans thanks to the guarantees issued by the Fund. In addition, a number of institutions in Azerbaijan provide state-supported funding for SMEs, including the Entrepreneurship Development Fund of the Republic of Azerbaijan, the State Agency for Agricultural Credits, the State Fund for Development of Information Technology, and the Azerbaijan Mortgage and Credit Guarantee Fund. Such funds are provided at rates much lower than market rates (Aliyev Chapter 2). Georgia launched a credit guarantee fund in the first quarter of 2019.

Following the 2008 financial crisis, Kazakhstan widened its schemes to help firms access financing through interest rate subsidies and loan guarantees. Currently, the Damu Fund supports around 5% of the total number of existing SMEs. However, the government plans to consolidate the budget expenses in the near future and even cut them in relative terms (Kapparov Chapter 4). Loan guarantees have become popular in Kazakhstan and are growing rapidly, although the absolute number is still small.

In 2017, the Government of the Kyrgyz Republic established a public joint-stock company guarantee fund with capital supplied from the national budget (25%) and ADB (75%). The fund has representatives in every region, working with seven commercial banks and the Russian–Kyrgyz Development Fund. As of the end of 2018, the guarantee fund had issued 237 guarantees, worth Som238 million (see Tilekeyev Chapter 5).

In Mongolia, the SME Development Fund was established to support financing for SMEs by providing long-term concessional loans for operations. However, the government structure supporting SMEs, including the SME Development Fund, was not sustainable. For instance, the SME fund has been operating under different ministries; also, SMEs cannot apply to the fund when they need funding, but have to wait until its announcements. From 2013 to 2018, MNT76.8 billion for 646 guaranteed credits worth MNT164.4 billion were granted by the Credit Guarantee Fund (Boojoo Chapter 6).

The Credit Guarantee Fund of Tajikistan was established in 2014 and provides credit guarantees to SMEs and technical assistance to Tajik partner financial institutions. Credit guarantees can also be offered in the form of investment guarantees rather than loan guarantees. Of the 23 largest microfinance investment funds, three offer investment guarantees on MFI or SME loan portfolios (Mogilevskii and Asadov 2018). The Entrepreneurship Support Fund offers credit lines to firms, but investors in the past have been reluctant to pool funding through the fund due to a lack of transparency in the screening and funding of SMEs, and inflexible governance arrangements (Mirzoev and Sobirzoda Chapter 7).

Uzbekistan has several programs to subsidize interest rates for SMEs, including banking microcredit. However, there is no evidence that subsidized loan programs have been effective in targeting low-income households, and there is the possibility that, in some cases, subsidized loans are being allocated to those who need the loans less. In 2017, the government launched the program Every Family is an Entrepreneur, which aims to expand low-cost credit to households to spur economic activity. In 2018, the government set up the Entrepreneurship Development Support Fund, which established the framework of the credit guarantee system for SMEs (Tadjibaeva Chapter 8).

### **Support for Start-Ups and Entrepreneurs**

The development of new investment vehicles, such as venture capital, specialized stock exchanges for SMEs and new firms, and hometown investment trusts, can expand SMEs' financing options. Georgia's Innovation and Technology Agency provides products and services to entrepreneurs and start-ups oriented toward innovation and technology, aiming to develop a strong start-up ecosystem. As of October 2018, the agency had assisted 125 start-ups. The state-owned investment fund, the Partnership Fund, supports the energy, real estate, agriculture, and manufacturing sectors (Khishtovani, Saghareishvili, and Basilidze Chapter 3).

## Gender Support

In Kazakhstan, there is no national state program to support women-led businesses. Some multilateral banks have programs to promote lending to women, including the EBRD and ADB (Kapparov Chapter 4). In Tajikistan, some international organizations have developed programs aimed at specific groups—for example, the EBRD provided \$1 million to support female entrepreneurs through the Women in Business initiative.

## Support for Exports

In Mongolia, the Ministry of Foreign Affairs has a program to promote exports, although no assessment of this is available. In an effort to boost SME exports, the government of Uzbekistan created the Export Promotion Fund for Small Business and Private Entrepreneurship under the National Bank of Uzbekistan in 2013. The fund provides the following services: export marketing, support for the registration of export contracts with Uzbekistan's authorities, research on standards in target markets, legal services, and loans and financial services (Tadjibaeva Chapter 8).

## Competition Policy

From 2020, foreign banks will be allowed to establish branches in Kazakhstan. This was a World Trade Organization accession requirement for the country. This could increase the supply of financial products available for SMEs and foster competition in the local market (Kapparov Chapter 4).

# 1.12 Conclusions and Recommendations

Greater access to finance for SMEs can allow them to take greater advantage of investment projects with potentially high returns and participate in international trade. This, in turn, can enhance their prospects for growth, investment, technological upgrading, profitability, and employment. Greater financial access may thereby provide side benefits to the economy as well, such as higher and more inclusive growth, greater financial stability, and improved efficacy of monetary policy. Governments can also take advantage of greater financial access to rely more on cash transfer programs, and reduce corruption and money laundering.

Azerbaijan, Kazakhstan, and Tajikistan have relatively low levels of SME loans. Moreover, financial access can vary significantly between rural and urban areas, and between income or age groups. Although remittances play a large role in several CAREC economies, banks do not typically target this market with specific products or services. Access to other financial products, such as insurance, is quite low.



### **1.12.1 | Pervasive Barriers to SME Finance**

There are numerous barriers to financial inclusion of SMEs in the CAREC economies on both the supply and demand sides, as well as institutional and/or environmental and cultural barriers. On the supply side, the high costs of handling small deposits and loans in physically remote areas, together with information asymmetries and a lack of documentation and collateral, deter financial institutions from extending financial services to SMEs. Regulatory restrictions on capital adequacy, identification requirements, and branch openings, as well as inadequate infrastructure for transport and payment systems, and inadequate legal frameworks for insolvency and collateral registration, compound these problems. The lack of competition in the banking sector can push up interest rates in some countries. Corruption is also a significant problem in several countries, while widespread participation in the informal sector makes it difficult for workers and firms to provide data showing their creditworthiness. Consumer protection efforts in CAREC economies are generally rudimentary, with few specific rules covering consumer finance, and mainly consist of interest rate caps on loans, which may be counterproductive in some cases.

On the demand side, the chief barriers are the lack of cash, ignorance of financial products and services, the lack of management expertise, and the lack of trust in the financial system. Even when financing is available, high interest rates and collateral requirements discourage borrowing. The lack of trust in the financial sector remains a problem in the region, reflecting the legacy of financial and economic turmoil following the breakup of the former Soviet Union. This is especially true in the Kyrgyz Republic. Weak consumer protection regimes and corruption can also discourage demand for finance.

Institutional factors include inefficient bankruptcy laws and weak credit assessment systems, which encourage high interest rates and collateral requirements. Cultural factors also tend to limit women entrepreneurs' financial access in some countries. Despite the predominant role of Islam in the region, a number of countries, such as Azerbaijan and Uzbekistan, do not have legislation to support Islamic banking. This hinders both the demand and supply of credit in these countries.

### **1.12.2 | Need for a Comprehensive SME Finance Strategy**

The CAREC economies notably lack strong financial inclusion strategies. The Kyrgyz Republic and Azerbaijan have the most well-articulated financial inclusion strategies, which are incorporated into their national economic planning strategies, but concrete results remain limited. A number of individual policies

encourage SME finance, such as loan guarantee programs, credit databases, and subsidized loans; in most countries, however, there is no overall financial inclusion strategy. MFIs are growing rapidly in some economies, mainly Georgia and Kazakhstan, but have actually dwindled in the Kyrgyz Republic and are weakening in Azerbaijan in terms of asset quality. Most CAREC economies have some kind of credit bureau (Georgia's in particular is highly rated), and a number of economies also have credit guarantee programs. Mobile phone banking, e-money, internet banking, and other forms of financial technology are generally developing rapidly in the region (except in Tajikistan), albeit from a very low base in most cases.

The barriers to SME finance, especially in agriculture, are pervasive, and a multi-pronged approach is therefore needed to tackle them. A comprehensive strategy for promoting SME finance and participation in GVCs should include the following elements: (i) rationalization of SME definitions; (ii) general measures to promote SME finance; (iii) measures to promote and formalize SME participation in GVCs; (iv) measures to promote value chain finance; and (v) measures to promote the financial literacy of SME managers and entrepreneurs.

In most CAREC countries, many farms and self-employed entrepreneurs are excluded from the definition of SMEs, and hence excluded from programs to promote financial access for SMEs. This naturally makes it difficult to develop an SME-finance and GVC-participation strategy for the agricultural sector. The definition of SMEs should be broadened to cover more entities in the agricultural sector.

A comprehensive strategy for supporting SME finance should be developed, including the following elements:

- Credit guarantee schemes should be introduced in countries where they are not already available.
- Credit databases and credit bureaus should be strengthened and integrated.
- Banking sector regulation should be eased in situations where it stifles innovative products for SMEs and distorts competitive advantages between large firms and SMEs. Reforms could include addressing cashflow-based lending, expanded collateral definitions and alternatives, lending in cash, and better use of credit histories.
- Policies to increase competition in the banking sector should be promoted in cases where lack of competition tends to raise interest rates.
- Regulation of MFIs should be eased where it is currently too strict (e.g., Uzbekistan).

- Collateral registries should be adopted and expanded beyond immovable physical property to facilitate SMEs' access to credit.
- Insolvency resolution regimes should be streamlined and standardized. Support is needed for the development of a sound legal environment and institutional strengthening.
- Consumer protection regimes should be strengthened, including requirements for financial institutions to provide transparent and timely information.
- Local credit unions should be introduced where they currently do not exist.
- Alternative sources of funding such as venture investment funds, business angels, peer-to-peer lending, and crowdfunding platforms should be encouraged through the promotion of fintech and other financial innovations.
- SME start-ups should be promoted by developing incubation and acceleration facilities that offer business advisory and mentoring services, including in relation to finance. Private equity funds should also be encouraged.
- Access to government programs should be made easier. For example, microfinance organizations in Georgia are not eligible to participate in government-initiated programs.
- Legislation for establishing Islamic banking should be introduced in countries where it can contribute to financial access for SMEs.
- An adequate infrastructure to support financial operations and transactions in rural areas could be created in post offices. Since postal services enjoy the trust of the rural population, post offices could be an important financial access point for households in rural areas.
- Promoting a shift from cash to digital payments can also be consistent with a financial inclusion strategy.

It is also necessary to strengthen the governance of regulators, including greater independence and transparency to increase public trust in the financial system. Transparency and proper information disclosure by commercial banks and MFIs should be improved as well. Regulatory issues related to the participation of mobile network operators in innovative financial services must be resolved, and regulatory “sandboxes” should be created to test innovative financial products and services. Finally, improving macroeconomic policy management can help increase trust in the financial system by reducing the volatility of inflation, interest rates, and the exchange rate, thereby reducing the incentive for dollarization.

In most CAREC countries, the agricultural sector shows the potential to develop value chains, but this is frequently hindered by inadequate logistics and storage facilities. The second main thrust of strategy should be to promote the efficiency of value chains and encourage participation by SMEs.

- Investment in efficient transport infrastructure and storage facilities should be encouraged.
- In order to increase SMEs' involvement in value chains and to promote formal relationships between chain participants, government programs should require or consider contracts as an advantage for granting benefits.
- In cases where value chains have a minimal level of support in government programs, further research should be carried out on the current state of SME involvement in existing value chains.
- Land-related regulations need to be reformed to promote efficient use. In Georgia, the restriction on foreign ownership and management of agricultural land should be abandoned, the land registration process should be finalized, and the process of privatization of state agricultural land should be accelerated.

In addition to agriculture and manufacturing, the service sector also has the potential to attract value chains. One example is the large potential for tourism development in Azerbaijan and the Kyrgyz Republic, where a strategy could be to offer transport services to tourism enterprises with conditional requirements for training.

The development of value chain financing is still limited, partly due to perceived high risks in the agricultural sector. In Azerbaijan, surveys show that the banks are most interested in financing the trade or food services that are the end stage in the value chain. Therefore, the third prong of the strategy should aim to increase the attractiveness of value chain financing to domestic financial institutions.

- A strong framework should be developed for value chain financing with banks, financial institutions, and IFIs. Financial programs in CAREC countries should be expanded to cover financing within value chains, which can increase SME value chain involvement and provide further incentives and support for engagement with international companies.
- Trade finance for SMEs should be encouraged.
- Innovative schemes for value chain finance should be introduced, such as group finance and local investment funds in the case of the Kyrgyz Republic.

Financial literacy levels in CAREC economies are generally low, although survey evidence remains limited. A fourth leg of the strategy should aim to carry out more detailed and consistent assessments of the situation of financial literacy of SME managers and entrepreneurs, and develop comprehensive financial education strategies for them.

- More national financial literacy surveys using consistent and internationally comparable methodologies should be carried out in the region.
- Among the CAREC economies, Azerbaijan, Georgia, and the Kyrgyz Republic are the most advanced in the area of financial education, as they have already established national financial education strategies. The Kyrgyz Republic is notable for having developed a financial education program for schools, although it has not yet been implemented. Mongolia has undertaken a national program on financial literacy 2016–2021. So far, Kazakhstan, Tajikistan, and Uzbekistan do not have such programs.
- Effective national strategies for financial education contain four key elements: (i) coordination among major stakeholders, including regulatory authorities, the education ministry, educational institutions, financial institutions, and civil society institutions; (ii) an emphasis on customer orientation and addressing both demand- and supply-side gaps; (iii) a combination of broad-based functional interventions, such as in school curricula, and targeted programs for vulnerable groups according to the availability of resources; and (iv) the adoption of a long-term timeline with flexibility to respond to changing needs.
- Financial education programs can involve financial service providers, industry associations, nongovernment organizations, mass media, higher education institutions, municipalities, and financial consultants. Key issues to be addressed include managing borrowing costs prudently and developing long-term savings goals. Governments could support SMEs by conducting training aimed at increasing SMEs' awareness of market requirements, government programs, and financial products and services.
- Monitoring and evaluating national financial education strategies is vital to build experience and encourage program adaptation. If appropriate incentives are provided, think tanks and universities can help with monitoring and evaluating efforts. Since government support programs will be insufficient to maintain adequate financing, the private sector, such as life insurance firms, must supply long-term financial products suitable for self-protection. Long-term asset allocation by households can support the necessary infrastructure and other investments where long-term finance is required.

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# Problems and Opportunities for Leveraging SME Finance through Value Chains in Azerbaijan

Samir Aliyev

## 2.1 Introduction

Small and medium-sized enterprises (SMEs) have always played a marginal role in Azerbaijan's economy due to the economy's reliance on oil and this sector's being under the influence of large entrepreneurs. According to statistical data for 2016, the share of SMEs in value added in the economy was 6.4%, while that in total production output in the economy and employment, respectively, was 9.2% and 18.5%.

The problem regarding SME access to finance in Azerbaijan is urgent. The devaluation of the Azerbaijan manat in 2015 has become one of the determining factors impacting the country's financial system. The deterioration of the currency exposure due to the sharp devaluation and a significant increase in problem loans have presented serious challenges to the banking sector. The reduced resource potential of the banking sector is one of the key factors curbing SME access to finance. At the same time, the capital market in Azerbaijan does not serve as a source of funding for SMEs. Factors that hamper SMEs in accessing finance are high interest rates for all businesses, heavy lending terms, and lack of lending institutions' interest in providing finance to regions.

The importance of increasing financial inclusivity and financial literacy has recently become urgent in Azerbaijan. The levels of accessibility for the country's population and entrepreneurs, including SMEs, to services offered by financial institutions are not desirable. The existing strategies to enhance financial literacy and financial inclusivity are defined by the Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy adopted in 2016. Ensuring SMEs' effective and favorable access to finance has been included in the core strategic targets in the roadmaps.

Since there is no official statistical database on SME finance, it is difficult to define the distribution of lending by value chains. The survey conducted among the banks holding 50% of the market share found that they are more interested in financing trade or the food service sector, which is the final stage of a product or service. A small proportion of lending institutions prefer agriculture financing. One of the key global value chain areas in which the Azerbaijani economy participates is the agrarian sector. The non-oil sectors dominated by SMEs are trade and agriculture. The agricultural sector contributes to the creation of a value chain across the country through various crops and livestock products. The government's recent legislative and institutional initiatives are aimed at ensuring SMEs' accessibility to finance.

## 2.2 The Role of SMEs in the Economy and SME Finance

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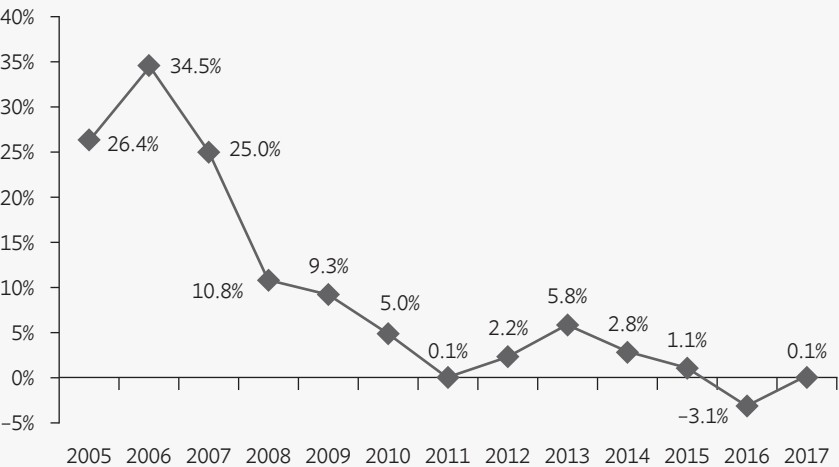
### 2.2.1 | Breakdown of Azerbaijan's Economy (Shares of Gross Domestic Product and Employment) and Growth Performance by Sector (Agriculture, Manufacturing, Services)

Azerbaijan has passed through different stages of economic development during the past 27 years, since it regained independence in 1991. Although the first post-Soviet decade (1991–2001) was marked by both crisis and stability situations, the country experienced rapid economic growth in subsequent years. From 2005 onward in particular, an inflow of large oil revenues to the country under production sharing agreements, signed with foreign oil majors in the previous 10 years, has served as a major catalyst for economic development.

Azerbaijan had an estimated gross domestic product (GDP) in 2017 of AZN70.1 billion (\$41 billion).

The first years, when the government generated much higher revenues, saw a more rapid growth rate, with GDP growth ranging from 26.4% in 2005 to 34.5% in 2016 relative to the previous period. The economy, although at a lower rate, continued to grow during the period prior to the global oil price drop toward the end of 2014, with the real GDP growth rate ranging from 0.1% in 2011 to 5.8% in 2013. However, the economic growth rate has declined significantly, driven by lower oil prices in the past 3 years (Figure 2.1).

**Figure 2.1: Azerbaijan GDP Growth Rate Over Previous Year**

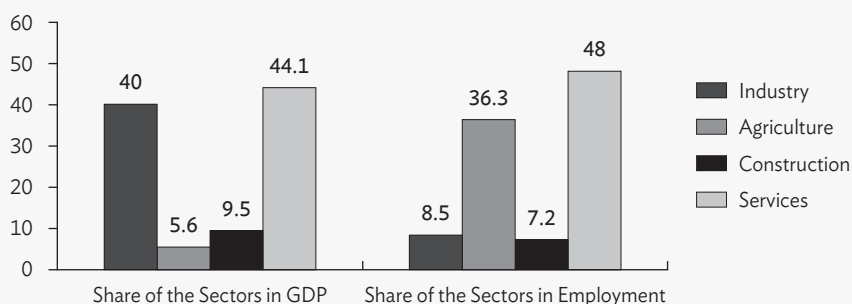


GDP = gross domestic product.  
Source: State Statistical Committee of the Azerbaijan Republic.

An analysis of statistical data found that the share of the hydrocarbon sector in GDP formation now stands at roughly 35%. Although the industrial sector, as a whole, has the highest share in GDP formation in Azerbaijan’s economy (40% for 2017), the entire industry accounts for only 8.5% of total employment. Nevertheless, all service fields (trade, tourism and restaurants, social and household services, transport and communication services, government services) in total account for the dominant share (about 44%) of GDP formation.

Although the agricultural sector has a very high specific weight (36.3%) in employment, only 5.6% of the economy’s GDP is generated through this sector.

As a whole, because of the severe imbalance between this sector’s employment and value added, overall labor productivity in the agriculture sector is extremely low. At present, agricultural value added per worker is about 25 times less than that in the non-agricultural sector. The construction sector accounts for 9.5% of GDP and 7.2% of employment. In 2017, about 4.8 million people (50%) were employed (Figure 2.2) (data from the State Statistical Committee of the Azerbaijan Republic).

**Figure 2.2: Share of the Main Sectors of the Economy in GDP Formation and Employment Generation (percentage of total)**

GDP = gross domestic product.

Source: Data taken from Azerbaijan's State Statistical Committee's national accounts. [https://www.stat.gov.az/source/system\\_nat\\_accounts/](https://www.stat.gov.az/source/system_nat_accounts/); labor market, <https://www.stat.gov.az/source/labour/databases>.

## 2.2.2 | Role of SMEs in the Economy by Sector (GDP and Employment Shares)

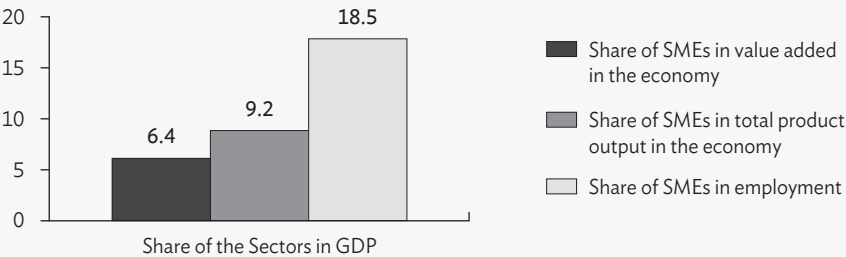
The role of SMEs in Azerbaijan's economy, notably in its expansion in recent years, is insignificant. In 2016, SMEs, which numbered 191,700, accounted for 95% of all businesses. Of these SMEs, 20,900 were legal entities and 170,800 were individual enterprises. Small enterprises dominate in the overall number of SMEs in Azerbaijan, while the number of medium-sized enterprises is moderate. Small enterprises account for the bulk of SMEs—97.9% (187,600)—with medium-sized enterprises reaching 2.1% (4,100). According to the Cabinet of Ministers' decision dated 5 June 2015, small enterprises in Azerbaijan are defined as those with fewer than 25 employees and an annual revenue of less than AZN200,000, and medium-sized enterprises as those with fewer than 125 employees and an annual revenue of less than AZN1,250,000.<sup>1</sup>

However, the position of SMEs in the economy does not reflect the share of their business units.<sup>2</sup>

<sup>1</sup> Cabinet of Ministers' decision on Criteria of the Small, Medium, and Big Entrepreneurship adopted on 5 June 2015, No. 215. <http://www.e-qanun.az/framework/30115>.

<sup>2</sup> Micro, Small and Medium Entrepreneurship in Azerbaijan. <https://www.stat.gov.az/source/entrepreneurship/?lang=en>.

**Figure 2.3: Number of SMEs in Major Economic Indicators (%)**

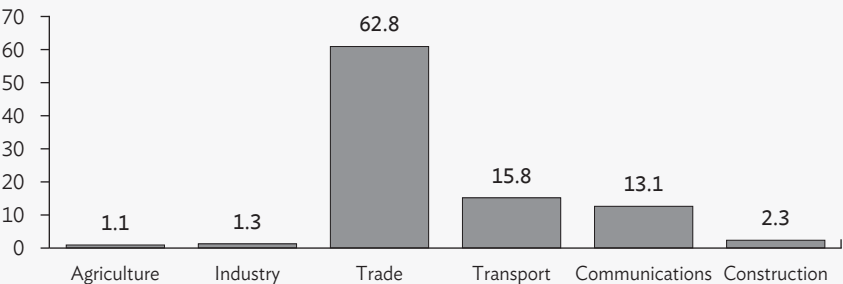


GDP = gross domestic product, SMEs = small and medium-sized enterprises.  
Source: State Statistical Committee of the Azerbaijan Republic.

According to statistical data for 2016, the share of SMEs in value added in the economy was 6.4%, while that in total production output in the economy and employment, respectively, was 9.2% and 18.5%. If we consider the data by sectors of the economy, SMEs primarily continue to provide the dominant share of the services sector (Figure 2.3) (footnote 3).

The shares of SMEs in trade, transport, communications, construction, industry, and agriculture, respectively, are 62.8%, 15.8%, 13.1%, 2.3%, 1.3%, and 1.1% (Figure 2.4).

**Figure 2.4: Share of SMEs in Product Output and Turnover of Services by Sector**



SMEs = small and medium-sized enterprises.  
Source: State Statistical Committee of the Azerbaijan Republic. <https://www.stat.gov.az/source/entrepreneurship/>.

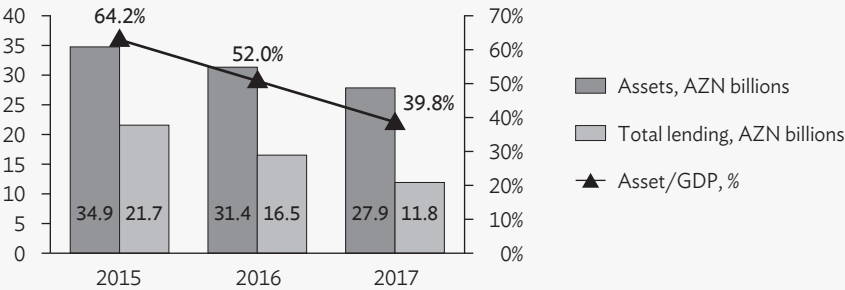
There are no official data for the share of SMEs in the country's total exports, which is one of the important economic indicators. However, our assessment based on the analysis of data on the export structure shows that the actual indicator does not exceed 5%–6%. In 2017, Azerbaijan's total exports stood at \$13.8 billion, of which 89%, or \$12.3 billion, came from the oil and gas sectors. SMEs are totally excluded from oil and gas exports. Therefore, the assessment was carried out on the basis of non-oil export indicators. According to the Center for Analysis of Economic Reforms and Communication under the President of Azerbaijan Republic, out of the total non-oil exports of \$1.54 billion in 2017, \$821.3 million, or 53%, fell to the share of 20 large state- or private-sector subjects of entrepreneurial activity. The remainder of exports worth \$712.7 million was provided by other SMEs, accounting for only 5% of the country's total exports (Review on Export 2018).

### 2.2.3 | Azerbaijan's Sources of Finance for SMEs

The impact of macroeconomic conditions to ensure SMEs' access to financial resources is conditioned by the quality of the financing structure. Preserving the stability of the national currency, the Azerbaijan manat exchange rate for over a decade, and its devaluation by more than 50% in 2015, has become one of the determining factors impacting the country's financial system over the last 3 years. The deterioration of the currency exposure due to the sharp devaluation and a significant increase in problem loans presented serious challenges to the banking sector. This particularly contributed substantially to the decrease in the banking sector's assets and a worsening of the banks' financial performance.

Azerbaijan's bank assets decreased by about AZN7 billion (20%) during 2015–2017, while loans declined at a rate of 50% (AZN10 billion) due to write-offs of nonperforming loans and the closure of one-third of the banks. At the same time, the ratio of bank assets to GDP in 2015 and 2017 decreased from 64.2% to 39.8%. The downward tendency of the share of loans in the structure of bank assets also remains dominant. This indicator stood at around 70% in 2013–2014, falling to 41.5% at the end of 2017. The reduced resource potential of the banking sector is one of the key factors curbing SMEs' access to financing. Since the debt and securities market in Azerbaijan does not serve as a source of funding for SMEs, the banking sector is the sole, indispensable resource for them. From this point of view, negative processes in the banking sector have a direct impact on SMEs (Figure 2.5).

**Figure 2.5: 2015–2017 Bank Assets**



AZN = Azerbaijan manat, GDP = gross domestic product.  
Source: Central Bank of the Republic of Azerbaijan.

Although the securities market in Azerbaijan has expanded significantly in recent years, this segment of the financial market has no impact on SMEs, because their experience of attracting resources through various financial intermediaries and debt instruments has not yet arisen in practice. The securities market mainly trades government securities (short-term bonds issued by the Ministry of Finance and short-term notes issued by the Central Bank of the Republic of Azerbaijan [CBAR]) and partly corporate securities issued by large state-owned companies or belonging to the banking sector. In 2017, for example, the market grew 12%, compared to 2016, to AZN15.7 billion. The government securities market increased from 836.2 million to AZN6.1 billion (+7.3 times), and the derivative financial instruments market was 33.8% up to AZN5.9 billion. The corporate securities market amounted to AZN3.7 billion. The corporate securities market accounted for 44% of shares and 56% of the bond segment.

**2.2.4 | Key Aspects of Azerbaijan’s Financial Situation, Regulatory Framework, Tax Regimes, and Financial Infrastructure**

The heavy reliance of the economy on oil money is a key factor affecting the country’s financial system. This dependence is crucial in ensuring both the stability-oriented fiscal policy and balance of payments equilibrium. One of the lessons learned from the years 2015–2016 is that due to its dependence on oil revenues, it is becoming difficult to balance the budget with the sharp decline in oil prices on the world markets, and alongside the growth of the budget deficit.

Due to the dependence of Azerbaijan exports on oil, it is also a challenge to ensure the balance of payments equilibrium with the sharp decline in oil prices on the world markets. A decrease in currency revenues increases the risk of macroeconomic instability in the country by creating a deficit in the overall balance of payments.

Steps have been taken in recent years toward the establishment of a legal basis for SMEs and the provision of an institutional environment in Azerbaijan. The key laws governing their activities are the Law on Entrepreneurship and the Law on State Support for Small Business. The latter proclaims that the state assists small entrepreneurship, the development of small entrepreneurship programs, and implementation of these programs, creating favorable conditions for small business to acquire financial, material, scientific, and technical information resources.<sup>3</sup>

The Law on Entrepreneurship establishes principles for entrepreneurship activities envisaging common rights and obligations, licenses, and special permits for all entrepreneurship subjects.<sup>4</sup>

In addition, tax and customs laws establish legal provisions that regulate the tax regime and financial reporting for SMEs. The Tax Code of the Azerbaijan Republic<sup>5</sup> creates legal opportunities for SMEs to become simplified taxpayers. First, according to the Tax Code, agricultural producers and industrial agricultural producers are exempt from all taxes, except for land tax. According to official statistics, more than 90% of agricultural products are provided by national entrepreneurs, small enterprises, and family farms whose turnovers are insignificant. So, it is SMEs that take advantage of large-scale tax privileges in the agricultural sector, while non-agricultural SMEs are entitled to pay a simplified tax, which is a combination of several taxes.

Under Article 219.5 of the Tax Code, SMEs as legal entities paying the simplified tax shall not pay value-added tax (VAT), profit tax, or property tax, and as individuals involved in entrepreneurial activity without the creation of a legal entity, profit tax or VAT on subject activity. Individual entrepreneurs who have received investment promotion documents and other SMEs also obtain tax privileges according to the Tax Code. According to the privileges, these entities are fully exempt from land and property taxes, from taxes for imports of machinery, technological equipment, and

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<sup>3</sup> Law on State Support to Small Entrepreneurship, adopted on 4 June 1999, No. 673-IQ, Article 6. <http://www.e-qanun.az/framework/3849>.

<sup>4</sup> Law on Entrepreneurship, adopted on 15 December 1992, No. 405. <http://www.e-qanun.az/framework/7920>.

<sup>5</sup> Tax Code of the Azerbaijan Republic, adopted on 11 July 2000, No. 905-IQ. <http://www.e-qanun.az/code/12>.



facilities for 7 years from the date of receipt of the Investment Promotion Certificate, while legal entities are exempt from profit tax and individual entrepreneurs are exempt from 50% of profit tax.

Under Decision No. 401 of the Cabinet of Ministers, 6 October 2016,<sup>6</sup> SMEs capable of exporting non-oil products have the opportunity to access export promotion financing based on the value of the products they sell abroad.

Steps have been taken in recent years to create mechanisms in Azerbaijan such as important elements of the financial infrastructure and to support SMEs' access to financial resources. Since March 2018, for example, SMEs can obtain extracts of data from the real estate registry through the State Agency for Public Service and Social Innovations under the President of the Republic of Azerbaijan service centers, thus enhancing the ability to receive loans using real estate as collateral. In March 2017, the process was simplified for SMEs willing to take out a loan against their real estate. Thus, according to the new rules, an owner can obtain a certificate for the registered rights on the property and their restriction on the state register via the Electronic Notary Information System in real time.

Finally, with the entry into force in October 2016 of the law regulating the activities of credit bureaus, an important financial institution, which is essential for SMEs, began to operate. Under Article 1 of this law, "the purposes are improvement of opportunities of access to financial services for individual entrepreneurs and legal entities by the forming of a long-term information base about the accomplishment of the financial liabilities, strengthening of financial discipline in debt relations and support to ensuring stability of the financial system in the country."<sup>7</sup> It is the institutions that play a crucial role as a database in giving an objective and comprehensive idea of SMEs involved in resource allocation, as well as providing funding to resource applicants as soon as possible. After the adoption of the law, in December 2017 the first credit bureau was established in Azerbaijan by eight commercial banks. Since May 2018, the bureau has been exchanging information with 120 organizations, including the Central Bank, 30 banks and 14 banks under liquidation, 47 nonbank credit organizations, 22 insurance companies, 3 mobile operators, and 3 communal service operators. Azerbaijan Credit Bureau LLC offers three types of services: (i) credit reports; (ii) issuance of personal credit rating; and (iii) issuance of credit histories.<sup>8</sup>

<sup>6</sup> Rule on promotion financing of the entrepreneurship which export non-oil products, adopted under Decision No. 401 of the Cabinet of Ministers, 6 October 2016. <http://www.e-qanun.az/framework/33870>.

<sup>7</sup> Law on Credit Bureaus, adopted on 28 October 2016, No. 384-VQ. <http://www.e-qanun.az/framework/34274>.

<sup>8</sup> Azerbaijan Credit Bureau LLC, official website – <https://www.acb.az/eng/index.html>.

## 2.3 Status of Financial Inclusion for SMEs

The importance of financial inclusion has recently become real in Azerbaijan. In general, access by the business sector, including SMEs, to the services offered by financial institutions is not at a desirable level, which is also confirmed by the results of studies carried out by international financial institutions (e.g., World Bank) and local research organizations (e.g., Center for Support for Economic Initiatives).<sup>9</sup>

### 2.3.1 | Financial Inclusion and Bank Accounts

In Azerbaijan, it is mainly banks and nonbanking credit organizations and insurance companies that provide services that serve financial inclusion. Focusing on micro and small enterprises and households in urban and rural areas, these services cover sectors such as trade, service, industry, and agriculture. One of the key elements of financial inclusion is the creation of necessary service infrastructure, including the equal distribution of credit institutions across the regions of the country. The closer businesses are to financial services, the greater the accessibility of such services will be. Although there were once a number of credit organizations and branches, the devaluation in 2015 had a negative impact on the country's financial sector. In 2014, there were 45 banks, 752 branches, and 162 departments. There were also 157 nonbanking credit organizations with 287 branches and 999 departments in that period (Azerbaijan Republic Central Bank Statistical Bulletin 2014). As a result of the devaluation, their number has dropped significantly over the past 3 years. According to the Financial Market Supervision Authority,<sup>10</sup> by the end of 2017, the number of banks in Azerbaijan decreased to 30, the number of branches to 509, and the number of departments to 142. There are 223 branches and 1,112 divisions of 123 nonbanking credit organizations. In general, the significant decline in the number of credit institutions has worsened the SMEs' access to financial services.

The increasing number of bank customers on the background of the declining number of credit institutions has negatively affected the quality of banking services. While the number of customers per bank was 114,000 in 2014 (CBAR 2014), with a total of 311,800 bank accounts, in 2017 this figure was 192,000 customers and 537,000 accounts. In 2017, a customer had an average of 2.3 accounts (2.8 in 2014).

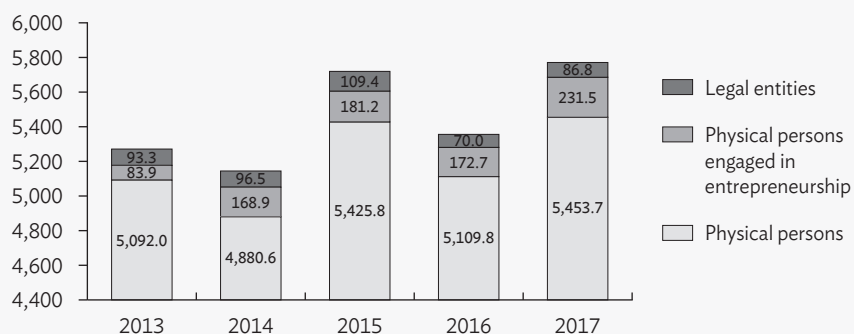
<sup>9</sup> [http://edf.az/ts\\_general/azl/ksid/downloads/maliyye\\_elchatanligi\\_aliyev\\_samir.pdf](http://edf.az/ts_general/azl/ksid/downloads/maliyye_elchatanligi_aliyev_samir.pdf)

<sup>10</sup> <https://www.fimsa.az/en/2017-ci%20il>

**Table 2.1: Number of Active Banks in Azerbaijan**

Banks	2014	2017	Change (+ Increase, - Decrease)
<b>Number of banks</b>	<b>45</b>	<b>30</b>	<b>-15</b>
Banks with foreign capital, including	23	15	-8
with the share of foreign capital ranging from 50% to 100%	8	8	0
with the share of foreign capital not exceeding 50%	13	7	-6
local branches of foreign banks	2	2	0
Local bank branches	752	509	-243

Source: Central Bank of the Republic of Azerbaijan, Financial Markets Supervisory Authority of the Republic of Azerbaijan.

**Figure 2.6: Number of Bank Accounts, 2013–2017 (in '000)**

Source: Central Bank of the Republic of Azerbaijan.

According to official information (CBAR 2017), by the end of 2017, of the total number of bank clients, 231,500 (168,900 in 2014) were individual entrepreneurs engaged in entrepreneurship, and 86,800 legal entities (96,500 in 2014).

Of all these accounts, 13.3 million (10.5 million in 2014) were current and 345,800 (in 2014, 658,200) deposit accounts. Individuals with entrepreneurship activities accounted for 244,400 (184,400) legal entities for 169,400 (175,600) of the current accounts. Unfortunately, there are almost no statistical databases regarding

small and medium-sized businesses in Azerbaijan, which prevents the identification of the share of SMEs in these accounts. Assuming that individuals engaged in entrepreneurship represent SMEs, we can think of 231,500 as SME accounts. However, it is difficult to determine the share of SMEs in relation to bank accounts and deposit accounts of legal entities.

### 2.3.2 | Access to Credit

As per the survey findings of the World Bank with SMEs in 2014, high interest rates coupled with complicated procedures are among the key factors limiting their access to credit, which is one of the key elements of financial inclusion. In addition, the high level of collateral for bank loans, which is the main source of financing for SMEs, limits access to finance.

According to the annual *Doing Business* report, prepared jointly by the World Bank and the International Finance Corporation (IFC), which reflects the business environment affordability assessment, entrepreneurs' access to credit has been dwindling in recent years. In the *Doing Business 2018* report, Azerbaijan was ranked low in terms of the ease of borrowing. In general, in the last 10 years, the level of access to credit has steadily been deteriorating. While Azerbaijan was ranked 15th out of 183 countries in 2010, this figure fell to 122nd place among 190 countries in 2018. The *Doing Business* report section on Getting Credit explores two sets of issues—the strength of credit reporting systems and the effectiveness of collateral and bankruptcy laws in facilitating lending. The lack of private credit bureaus in Azerbaijan also significantly worsens its position in the credit obtaining index.

According to the results of the Business Environment and Enterprise Performance Survey (BEEPS), conducted by the European Bank for Reconstruction and Development (EBRD) in cooperation with the World Bank, access to finance is one of the major obstacles to business development. The results of the survey, in which 390 enterprises, including SMEs, were surveyed, reflect the year 2013. Of the surveyed local enterprises, 21.7% of small businesses operating in the country and 21.6% of medium businesses raised access to finance as the main problem.

SMEs in Azerbaijan are mainly looking at banks and non-banking credit institutions for loans. Entrepreneurs mainly use loans as sources of external funding.

The results of the BEEPS survey show that about half of the SMEs do not need credit. According to the survey, bank loans are the dominant source of external funding for the SMEs, and alternative external sources of financing have not yet been developed. Of the businesses surveyed, 14.7% small businesses and 14.6% medium-sized businesses reported having a credit line (Table 2.2).

**Table 2.2: Businesses' Access to Finance, 2013**

Indicators	Business Size	Specific Weight %
Share of enterprises with bank credits/credit line	Small	14.7
	Medium	14.6
Share of loans requiring collateral	Small	85.7
	Medium	97.2
Share of collateral required for loan repayment (as % of loan amount)	Small	258.5
	Medium	262.3
Share of enterprises with no need for credit	Small	54.1
	Medium	49.3
Share of enterprises with a final loan application refused	Small	23.6
	Medium	23.6
Share of enterprises benefiting from a bank for investment financing	Small	25.3
	Medium	25.1
Share of funds financed from internal funds	Small	74.0
	Medium	82.8
Share of investments financed by banks	Small	25.3
	Medium	16.3
Share of investments financed through ownership loans	Small	0.0
	Medium	0.9
Share of equity investments or equity financing	Small	0.2
	Medium	0.0
Share of operating capital funded through banks	Small	3.6
	Medium	6.3
Share of operating capital funded by the sender's loan	Small	0.9
	Medium	1.7
Share of enterprises raising access to finance as the main problem	Small	21.7
	Medium	21.6

Source: World Bank. Enterprise Surveys. <http://www.enterprisesurveys.org/data/exploretopics/finance>.

As can be seen from Table 2.2, more than 85% of small and medium-sized entrepreneurship loans (small 85.7%, medium-sized 97.2%) are collateral based, the value of which is more than twice as much as the value of the loan. This makes up 258.5% and 262.3% of collateral in the loan portfolio for small and medium-sized enterprises, respectively. For comparison, the figures for Europe and Central Asia, respectively, are 197.9% and 189.8%, on average, while the world average is 217.5% and 198% (World Bank Enterprise Surveys).

At least three-quarters of SMEs are financed through their internal funds. In the absence of internal funding, one-quarter of SMEs attract bank funds for investment financing. SMEs almost never finance themselves through equity financing.

*The SME Policy Index: Eastern Partners Countries 2016* report by the Organisation for Economic Co-operation and Development (OECD) says that as in other Eastern Partnership countries, the issue of access to finance is a problem for SMEs in Azerbaijan (OECD 2015). According to the report, Azerbaijan's position on SMEs' access to finance was 2.70 out of 5 points, which is the worst indicator among the Eastern Partnership countries. According to the methodology of the organization, this level indicates that there are good bases for implementing policies in the field, but they are not put into practice.

The results of the surveys conducted by international and local organizations show that SMEs prefer to solve their financial problems through internal resources. With limited resources, they prefer less risky, less profitable, but more reliable spheres, the reason for which is the difficulty of attracting funds from external sources. Both the high cost of resources and the enterprises' transparency problems limit their ability to attract financial resources externally. It is only those businesses that want to expand that are interested in external sources.

The results of the BEEPS survey show that approximately 51.4% of SMEs do not need credit. QABUS Research and Consulting Company (QRCC), together with the Centre for Media and Public Initiatives (CMPI), conducted a survey among 200 SMEs to study their access to credit in Azerbaijan and the results suggest that when financial resources are needed, it is credit institutions that entrepreneurs go to the most. Forty-five percent of SMEs use bank loans and 5% use nonbank loans. The share of entrepreneurs who approach friends or acquaintances trying to get interest-free funds is 42.5%. Only a small percentage of respondents (2.5%) were forced to seek funding through pawnshops, which have the highest interest rates in the country (QRCC and CMPI 2012).

Although monthly, quarterly, and annual statistical bulletins of entrepreneurship subjects are prepared in Azerbaijan, there is no statistical database on the share of SMEs in this lending. In response to the official inquiry addressed to the CBar and the Financial Market Supervisory Authority (FIMSA), both said that no such statistics were recorded.

The following instruments of external funding sources for small and medium-sized businesses, which are applied in world practice, are used in Azerbaijan in one form or another:

**Financial resources (loans) attracted from credit institutions.** SMEs in Azerbaijan are mostly focused on banks and nonbanking credit institutions for financial resources. SMEs in Azerbaijan mainly use loans as sources of external funding.

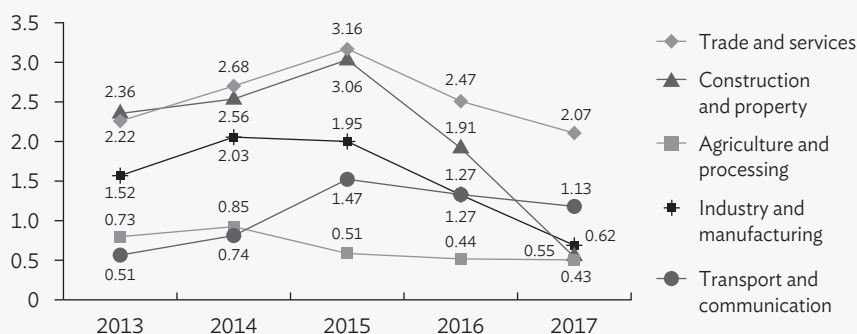
No official information on SME lending is available in official statistical reports released by the banking sector. Neither is such information provided in the quarterly and annual financial statements disclosed by commercial banks in accordance with the legislation. For this reason, it is impossible to obtain reliable information on the level of lending to SMEs and on the specific weight of loans granted to them from certain types of economic activity in aggregate loans used across sectors of the economy. With this in view, as part of the research, inquiries were sent to banks to evaluate SMEs' access to lending resources. The inquiries were submitted to the banks holding almost 70% market share.

In 2017, the banks holding 55% of the total assets and 42% of the aggregate loan portfolio in the banking sector responded to the inquiries. The analysis of the results reveals that the loans the banks allocated to SMEs amounted to AZN433.8 million (10.2%).

The statistical analysis of credit investments for the years 2013–2017 shows that the deterioration of banks' assets as a result of the devaluation in 2015 resulted in restricted lending to them. According to the World Bank, private sector crediting (domestic credit to private sector) dropped to 16.4% in 2017,<sup>11</sup> while it had a 22.1% share in GDP. This restriction led to a decrease in lending, and thus a difficulty for SME financing.

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<sup>11</sup> International Monetary Fund, International Financial Statistics and data files, and World Bank and OECD GDP estimates. <https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS?end=2019&locations=AZ&start=2016&view=chart> (accessed 21 October 2020).

**Figure 2.7: Credit Investments by Sector, 2013–2017 (AZN million)**

AZN = Azerbaijan manat.

Source: Central Bank of the Republic of Azerbaijan.

Lending to small and medium-sized businesses (trade and services, agriculture and processing, transport and communications, construction and property) has diminished over time. While the credit investments demonstrated growth before the devaluation, this began to decline after it (Figure 2.7).

From 2013 to 2015, the total amount of credit lending in the country increased by 41% from AZN15.4 billion to AZN21.7 billion. During this period, the trade and service sector lending grew by 42.3%, the construction and property sectors by 29.7%, industry and manufacturing by 28.3%, and the transport and communication sector by 188.2%. The agricultural and processing sector lending decreased only by 30.1%. In the aftermath of the devaluation, falls were observed in the amount of credit lending both in the country and in separate sectors, with the total amount of lending decreasing by 46.3%. Thus, after the devaluation, credit investments in the trade and services sectors declined by 34.5%, agriculture and manufacturing by 15.7%, construction and property by 82%, industry and manufacturing by 68.2%, and the transport and communications sector by 23.1%.

There are no statistics recorded on SME lending in Azerbaijan and the amount of credit investments is annually disclosed by the CBAR. However, this disclosure shows only the total lending. Our research shows that nearly all of the trade and services in Azerbaijan, most of the agricultural and processing, construction and property, and a certain portion of transport and communications, belong to SMEs. The trend described in Figure 2.7 also includes the pattern of SME lending.



**Factoring and forfeiting.** These services are not a widespread practice of financing in Azerbaijan’s financial system and play a minor role in the financing of SMEs. **Venture capital**, which is the main source for start-ups, has recently become an interesting source of funding in Azerbaijan.

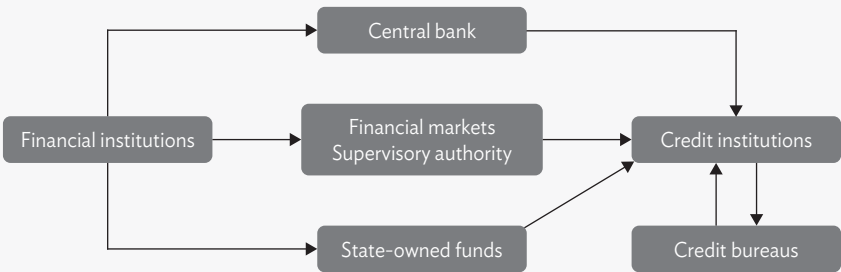
**Leasing.** The challenges of long-term investment financing for SMEs remains problematic in Azerbaijan, especially now when bank loans are difficult to obtain. While there are a few leasing companies operating in Azerbaijan, this service has not yet been developed. In Azerbaijan, leasing services are regulated by special legislation, and there is no control over their activities.

**Capital market financing.** In Azerbaijan, there is little experience in terms of attracting alternative financial resources to credits for SMEs in the form of the issuance of shares and bonds. These sources are usually used by large companies. The volume of the securities market in 2017 amounted to about AZN15.7 billion, AZN3.7 billion of which is accounted for by the corporate securities market. Large enterprises are the major shareholders of the corporate securities market and corporate bonds. Except for arbitrary cases, SMEs are not interested in attracting funds from this market.

### 2.3.3 | Financial Institutions Involved

Financial institutions involved in the financing and financial inclusion of SMEs include regulatory and supervisory agencies (CBAR, FIMSA), state-owned funds providing government financial support, and credit institutions and bureaus providing financial support to business entities (Figure 2.8).

Figure 2.8: Financial Institutions



Source: Author.

The CBAR and the FIMSA mainly regulate, control, and coordinate the financial market.

The experience of the Credit Bureau is new in Azerbaijan. The first credit bureau was established in December 2017 by eight banks together.<sup>12</sup> At present, the functions of the Credit Bureau are operated by the Centralized Credit Registry Service, which had initially been established within the CBAR and later transferred to the FIMSA.

The other market participants are state funds. Just as in international practice, there are a number of institutions in Azerbaijan providing state support, including funding for the development of SMEs. These institutions are as follows:

- Entrepreneurship Development Fund of the Republic of Azerbaijan<sup>13</sup>
- State Agency for Agricultural Credits<sup>14</sup>
- State Fund for Development of Information Technology<sup>15</sup>
- Azerbaijan Mortgage and Credit Guarantee Fund<sup>16</sup>

The main feature of these funds is that the credit resources they give out are secured at the expense of funds allocated from the state budget. At the same time, the loans provided by these institutions are concessional and are less expensive than the other loans on the market.

### 2.3.4 | Inclusion-Related Financial Products and Services

One of the mechanisms promoting financial inclusion is the expansion of cashless transactions. The government has created an appropriate legislative framework for the expansion of noncash operations and has taken steps to create appropriate infrastructure. Within this framework, the number of point of sale terminals has been increased for noncash operations, with payments for state services made electronically available. The development of internet and mobile banking by banks improved the access of SMEs to banking services.

<sup>12</sup> <https://www.azernews.az/business/124329.html>

<sup>13</sup> No. 222 Presidential Decree of 31 July 2018, the National Fund for Entrepreneurship Support was revoked and a public legal entity called the Entrepreneurship Development Fund was established in its place.

<sup>14</sup> Regulations on the State Agency on Agricultural Credits under the Ministry of Agriculture of the Republic of Azerbaijan. Approved by Presidential Decree No. 226 of 20 April 2005.

<sup>15</sup> Official website of the Fund – <http://ictfund.gov.az>.

<sup>16</sup> <http://mcgf.az/?/en/mainpage/>

According to the official information of the CBAR (CBAR 2018), the number of bank payment cards increased from 5.67 million to 5.8 million during 2013–2017, with the volume of transactions on bank cards rising from AZN1.14 billion to AZN1.54 billion and the number of point of sale terminals increasing from 33,300 to 65,500 during this period.

However, despite the purpose of the Law of the Republic of Azerbaijan on Non-Cash Payments, adopted on 16 December 2016 to promote noncash payments in the country, it has been hampered by several restrictions. According to the law, the total amount of taxable transactions by taxpayers engaged in trading or public catering activities exceeding AZN200,000 during the calendar year is AZN30,000, and activities of other taxpayers exceeding a total amount of AZN15,000 are only to be paid noncash. A 1% simplified tax charged for the cashback transactions created difficulties for SMEs, thereby restricting their access to banking services.

### **2.3.5 | Financial Technology Factors Driving Financial Sector Access by SMEs (Peer-to-Peer Lending or Crowdfunding)**

Financial technologies that allow customers to access financial services have just begun to develop in Azerbaijan. Over the past 5 years, Azerbaijani banks have spent about AZN300 million on financial technologies, 49.8% of which was spent on purchasing new programs.<sup>17</sup> The so-called “regulatory sandboxes” mechanism is not used in Azerbaijan, and this significantly limits the possibility of the appearance of fintech companies on the market. Innovative and prospective start-ups are forced to leave Azerbaijan due to the lack of legislation. For example, the Maliyya start-up<sup>18</sup> allowing peer-to-peer (P2P) lending without the participation of financial institutions was forced to move to the United Arab Emirates, where it was granted an Innovative Technology License, a special license for fintech companies.<sup>19</sup>

P2P lending or crowdfunding, which has become a popular means of funding for SMEs throughout the world in recent years, is limited in Azerbaijan. Companies working in this field are newly entering the market. Still, these mechanisms do not play a role in the financing of SMEs.

<sup>17</sup> <http://banco.az/az/news/duneni-bugunu-sabahi-fintech-maliyye-texnologiyalari-nedir>

<sup>18</sup> <http://maliyya.com/#about>

<sup>19</sup> <https://en.trend.az/other/commentary/2889171.html>

*EnterpriseAzerbaijan.com* launched by the Center for Analysis of Economic Reforms and Communication,<sup>20</sup> a state-run entity, provides services to bankable investment projects, playing the role of crowdfunding to finance business ideas of SMEs as well as start-ups.

## 2.4 Financial Knowledge and Skills of SME Entrepreneurs

### 2.4.1 | Assessments of Financial Literacy

As per the approach of the OECD, financial literacy is a set of skills of consumers to understand financial products and concepts to improve their well-being, evaluate their financial risks and opportunities, make informed choices, and take other effective steps. In many countries, there are state programs or strategies for financial literacy; at the same time, work is being done to add financial literacy to training programs. Central banks and commercial banks conduct campaigns for different target groups. In some countries, there are even financial literacy advisory centers.

The financial literacy of consumers of financial services, including entrepreneurs, is not yet at the desirable level in Azerbaijan. Although there are no fundamental assessments conducted in this area, the results of surveys conducted by international organizations reveal the necessity of continuing financial literacy initiatives.

Unlike the local organizations, the assessments done by foreign institutions capture the current reality with regard to financial literacy.

In 2014, Standard & Poor's Ratings Services and the World Bank Development Research Group produced the Global Financial Literacy Ranking as a result of a survey conducted with 150,000 people (over the age of 15) in 140 countries. Azerbaijan was ranked 65th out of 144 countries, implying that 36% of the population in Azerbaijan are financially literate. For comparison, according to the report, the financial literacy levels in Kazakhstan are 40% (ranked 49th), in Uzbekistan 21% (ranked 126th), in the Kyrgyz Republic 19% (ranked 134th), and Tajikistan 17% (ranked 139th).<sup>21</sup>

<sup>20</sup> <http://ereforms.org/>

<sup>21</sup> <https://www.theatlantic.com/charts/VJDhtA8Xe>

In order to assess the financial literacy of the population, the World Bank surveyed the population over 18 years in Azerbaijan as part of the Financial Capability and Consumer Protection survey.<sup>22</sup> Since the survey was conducted in 2009 and 2016, it was possible to compare the levels of financial literacy of the population. The answers show that although there was an upward trend in a range of financial knowledge (inflation and computing knowledge), a backward-trend in compound interest rate knowledge has also been observed. According to the assessment, the lowest score is about the ordinary interest rate (35.4) and the highest score in the correct distribution of ordinary shares (89.8). According to the methodology of the assessment, the lowest score is 0, the highest score is 100 (Table 2.3).

**Table 2.3: Key Financial Knowledge Indicators**

Indicators	Azerbaijan		World	East Asia and Pacific
	2009	2016		
Percentage of adults with understanding of inflation	45.8	67	51.5	38.9
Percentage of adults with understanding of simple interest		35.4	42.3	69.2
Percentage of adults with understanding of compound interest	46.2	45.7	35	58.7
Percentage of adults who can think in real monetary values (money illusion)	61.7		50.5	
Percentage of adults correctly calculating a simple division		89.8	88.2	96.8
Percentage of adults with basic numeracy skills (to identify better bargains)	78.1	78.6	70.1	86
Percentage of adults with basic numeracy skills	52.3		41.2	
Percentage of adults with deposit insurance awareness	5.8		11.3	

Source: World Bank.

## 2.4.2 | Existence of Financial Education Strategy

The government has never had a long-term strategy in the field of financial literacy. At present, the existing strategies to increase financial literacy are reflected in the Strategic Roadmap on National Economy and Key Sectors of the Economy approved by the Presidential Decree of 6 December 2016. The three components of the roadmap are highlighted in the development of financial literacy.

<sup>22</sup> <http://responsiblefinance.worldbank.org/surveys/demand/exploreeconomies/azerbaijan/2016#financial-knowledge>

- Enhancing financial literacy has been identified as one of the five strategic goals in the Strategic Roadmap on the Development of Financial Services in the Republic of Azerbaijan. The country's financial services sector has been analyzed in the form of a strengths, weaknesses, opportunities, and threats (SWOT) analysis in the roadmap, with low financial literacy indicated as one of the weak sides of the sector. Therefore, enhancing the financial literacy of consumers and strengthening the protection of their rights is considered as one of the priority steps to be taken.
- The Strategic Roadmap on the Production and Processing of Agricultural Products in the Republic of Azerbaijan argues that the low level of financial literacy of agricultural producers has led to the smaller share of loans provided to the agricultural sector in the total economy. Financial literacy is included among one of the priority activities "improving financing mechanisms in the agricultural sector" to serve the strategic goal of "facilitating access to finance." According to the roadmap, the financial literacy of agricultural producers, including SMEs, will have increased and their access to finance on favorable terms will be provided.
- The Strategic Roadmap on the Production of Consumer Goods at the Level of Small and Medium Entrepreneurship in the Republic of Azerbaijan includes activities related to the improved financial literacy of SMEs under the strategic objective of "ensuring the effective and efficient access to financial resources of SME subjects." The roadmap indicates that as a result of the increased financial literacy of SMEs, they will become more competitive, which, in turn, will have a positive impact on the proper use of financial resources.

### 2.4.3 | Public and Private Institutions Involved

The CBAR was the first to subscribe to the initiative of financial literacy, implementing various financial literacy projects since 2010. The Ministry of Education and the Azerbaijan Library Confederation are the partners of the CBAR in financial literacy. On the other hand, external organizations joining the process include the OECD, the International Federation of Library Associations, the American Resource Centre, German Agency for International Cooperation, PricewaterhouseCoopers Global, the World Bank, and the German Savings Banks Foundation for International Cooperation.<sup>23</sup>

<sup>23</sup> <https://en.cbar.az/lpages/finance-edu/about-the-project/>

Different public authorities and public legal entities are responsible for implementing activities to increase financial literacy envisaged in the National Roadmap and Strategic Road Map for Major Sectors of the Economy. The Strategic Roadmap for Production of Consumer Goods at the Level of Small and Medium Entrepreneurship shows the Ministry of Economy, the Ministry of Education, the FIMSA, and the Small and Medium Business Development Agency as the main implementers of financial literacy of SMEs in 2017–2020. The CBAR and the FIMSA are responsible for the implementation of the “Identification of Directions to Strengthen Financial Literacy” envisaged in the Strategic Road Map on the Development of Financial Services. The main implementer of “Increasing the Financial Literacy of Agricultural Producers” envisaged in the Strategic Roadmap for the Production and Processing of Agricultural Products, which is to be implemented during 2017–2020, is the Ministry of Agriculture, as well as the Ministry of Economy, the FIMSA, and local authorities.

Along with public bodies, banks, higher education institutions, and public unions are involved in this process. The Azerbaijan Banks Association, the Azerbaijan Micro-Finance Association, together with the CBAR, implement projects on financial literacy.

#### **2.4.4 | Target Groups and Programs**

The main target groups of the financial literacy project, initiated by the CBAR, are students, the broader population, journalists specializing in economics, employees of the CBAR, bank employees, and students studying banking. In addition, the target groups of events held by banks and associations are housewives, entrepreneurs who have started their business, young scholars, and teachers. Currently, there are no special programs to promote financial literacy among SMEs.

#### **2.4.5 | Types of Programs**

Seminars, training, roundtables, printed materials, video clips, and competitions are used as tools for increasing financial literacy. For instance, e-learning materials were developed and a total of 25 events were held in 2012 under the framework of increasing financial literacy. A “Banks for Schools, Schools Banks” week was organized in cooperation with commercial banks, and training was held for commercial banks and teachers with varying approaches (Central Bank of Azerbaijan 2012). In 2013, the second International Savings Day in Azerbaijan and later, the Financial Literacy Month in November were held as a continuation of this initiative.

Issues such as central banking, credits, savings, credit cards, and others were discussed with necessary explanations in those events, covering about 10,000 schoolchildren, young families, and the broader public. In addition, the “Actual Annual Interest Rate” calculator was prepared and posted on [play.google.com](http://play.google.com) in partnership with the German Savings Banks Foundation for International Cooperation (Central Bank of Azerbaijan 2013).

#### **2.4.6 | General Financial Education**

In recent years, various educational events (trainings, seminars, etc.) have been held in Azerbaijan to increase financial literacy. Secondary and higher education institutions are also involved in this process. Activities related to increasing financial literacy in educational institutions are limited to projects. Except for economics-specific universities, subjects that focus on increasing the level of financial literacy are not taught in other higher and secondary education institutions.

#### **2.4.7 | Debt Management Programs**

In Azerbaijan, SMEs have both payable and receivable debts. However, unlike payables, official statistics on the receivables are not disclosed. More than 90% of SMEs are individual entrepreneurs and family businesses without an accounting system in place and, therefore, no accurate accounting of enterprises' receivables is done. The receivables of SMEs arise from the nonpayment for the products and services that SMEs sell. A number of entities are unable to meet their obligations to other institutions, including credit institutions, because they cannot obtain their receivables, and thus face the risk of default. Such a conclusion is made on the basis of the discussions with entrepreneurs within the framework of the study.

Unlike receivable debts, there are statistics on payable debts of SMEs. Due to the devaluation of the currency in 2015, the volume of loans received from the financial institutions of the SMEs has increased up to double, which has created difficulties in repaying them. No program on the repayment of such loans has been made. To repay debts, credit institutions have to set up individual programs with their SME clients.

There is no single strategy in the country to manage either payables or receivables.



## 2.4.8 | Assessment of Effectiveness

It is important to conduct an appropriate assessment to measure the level of financial literacy. Unfortunately, there are no such exams held in Azerbaijan except for a few cases. While the results of the Financial Literacy Survey (Central Bank of Azerbaijan 2009) conducted with 1,200 respondents in the eight economic regions of the country in 2009 allowed for the basis of comparisons, no second survey was carried out later, which would have allowed an evaluation of the situation.

Not only the implemented projects, but also the economic hardships experienced in the financial sector of the country in 2014–2016 also played an important role in enhancing the financial literacy of SMEs. The devaluation of the national currency, the closure of banks, the increased risk of non-repayment of deposits, the bank's preference for foreign currency loans, and other threats raised entrepreneurs' interest in economic issues, with a growing readership of economic news in the mass-media, and the number of economically active portals (fins.az, finans.az, fed.az., kommertsant.az) starting to increase.

## 2.5 Barriers to SME Finance

### 2.5.1 | Supply Side

Factors hindering SMEs' access of to finance are summarized as follows:

**High interest rates.** A high interest rate on credit is among the factors which enfeebles access to credit resources for SMEs. According to the CBAR, the annual interest rate for loans up to 1 year is 17.75% in national currency, 7.75% in foreign currencies, 19.5% and 11% between 1 and 3 years, and 14.31% and 11.65%, respectively, on loans between 3 to 5 years (CBAR 2017). In fact, interest rates for bank loans are higher than the official ones.

The main reason for higher annual interest rates on credit is due to higher rates for resources, in particular deposits, drawn by the banks. The share of deposits in total bank liabilities ranged from 75% to 78% between 2015 and 2018 (Baku Research Institute 2018). Therefore, a higher annual interest rate for deposits gives rise to higher interest rate on credit. According to the CBAR, the annual interest rate for deposits in Azerbaijan manats is 11%–12%, while hitting 14%–15% at some banks, thus causing higher lending interest rates (CBAR Statistical Bulletins).

QRCC and CMPI held a survey on SMEs' access to loans, with 38% of respondents citing a high interest rate as the reason why they had not applied to credit institutions. Up to 85% of the entrepreneurs surveyed had an average annual interest rate of over 20% for their loans (QRCC and CMPI 2012).

**Credit institutions not interested in financing the region.** The official data suggest that, in 2017, Baku had the highest concentration of the country's credit resources (83%). Overall, in 2010–2013, Baku's share in total credits was 87%. Annual interest rates on loans continue to grow, despite the slowdown in the capital from region to region. In Baku, annual interest rates (10.3%) are lower than the national average (11.8%). However, in some regions, such as the Lankaran and Aran economic regions, the annual interest rate is even higher than 22% (CBAR Statistical Bulletins).

**Harsh terms of credit.** Failure to get credit in the required amount and in time is one of the common problems facing SMEs. In the QRCC and the CMPI survey, entrepreneurs have raised this problem (QRCC and CMPI 2012). The analysis of the survey results showed that 31.5% of the respondents were able to take as much credit as required, while the others complained about the small size (29.6%), short term (10.2%), and high interest rates (25%) of loans.

In addition, SMEs are not encouraged to deal with financial institutions due to the excessively high level of collateral requirements and much higher loan rates proposed by banks. It is also clear from the responses of banks surveyed that 94% of loans issued to SMEs in 2017 were secured by collateral and 6% were unsecured.

**High risk in the economy.** Analysis of the CBAR and the FIMSA shows that the share of loans in the structure of bank sector assets has been decreasing in recent years; despite reaching a peak of 73.5% in 2013 the ratio of bank loans to assets started to decline in the following years, dropping to 41.1% in 2017.

The sharp decline in the ratio of loans to assets demonstrates the increasingly limited participation of the banking sector in the economic and real sector development. High risk in the economy leads banks to invest up to 60% of their assets in securities or the CBAR's depositary auctions. The increased share of troubled loans to 14% points to a high risk in the economy.

**Preference toward loans in foreign currency.** The expectations of devaluation accelerated the dollarization of the banking sector as of the end of 2014, with the banks squeezing their loans in national currency and preferring loans in foreign currency.

As a result, the share of foreign currency in total lending increased from 27% in 2014 to 49.4% by the end of 2015, when the devaluation occurred. In the following years, this figure dropped slightly to 40.9% by the end of 2017 due to the relative stability of the national currency. Currently, the dollarization level in trade and the service sector is 43.8%, in the industrial and manufacturing sector 52.1%, in the construction and property sector 24.4%, in transport and the communications sector 85.8%, and 19.4% in agriculture. The low level of dollarization in agriculture is due to the recent increase in the preferential loans provided by the state to this sector.

**Lack of interest in leasing.** Leasing services are poorly developed, and SMEs still rely on the state-run Agroleasing Open Joint-stock Company,<sup>24</sup> working on more favorable terms. Private leasing companies operating in Azerbaijan chiefly lease out consumer goods (automobiles, domestic appliances, furniture, etc.). Current leasing interest rates are higher than bank loans and they are not profitable for entrepreneurs.

SMEs access to finance in Azerbaijan is limited and the Strategic Roadmap for Manufacture of Consumer Goods by Small and Medium Enterprises adopted by the government in December 2016 provides detailed explanations on the problem.<sup>25</sup> The document notes that 51% of SMEs operating in Azerbaijan point to the issue of access to finance as the most serious obstacle to business development. The roadmap also emphasizes that the low level of cash management capabilities in SMEs and weak corporate governance make banks less attractive to provide lending to SMEs. As a result, there is a high rate of denial of loans for SMEs in Azerbaijan. The government acknowledges in its roadmap that, in 2016, one-quarter of the loan applications in the agricultural sector and 36% of microbusiness lending applications were refused by banks.

Analysis of the surveys as part of the study also shows that banks restrictedly use loan financing mechanisms, such as letters of credit and guarantees (about 10%–15% of all loans). The banks' responses show that about 90% of loans to SMEs are ordinary loans secured by collateral. As external security mechanisms do not work effectively, SMEs' personal assets (more than 30% of all loans are provided on these terms), or machinery and mechanisms at their disposal (about 27%), or their real estate (23%) are used as a guarantee for collateral. In other words, according to a third-party warranty, SMEs at best can obtain about 10% of the loan available.

<sup>24</sup> <http://agrolizing.gov.az/en>

<sup>25</sup> [https://azertag.az/store/files/Strateji\\_yol\\_xeritesi/KiC3%A7ik\\_vC9%99\\_orta\\_sahibkarl%C4%B1q\\_sC9%99viyy%C9%99sind%C9%99\\_istehlak\\_mallar%C4%B1n%C4%B1n\\_istehsal%C4%B1na\\_dair.pdf](https://azertag.az/store/files/Strateji_yol_xeritesi/KiC3%A7ik_vC9%99_orta_sahibkarl%C4%B1q_sC9%99viyy%C9%99sind%C9%99_istehlak_mallar%C4%B1n%C4%B1n_istehsal%C4%B1na_dair.pdf)

**Insolvency.** The devaluation that took place in 2015 worsened the solvency of SMEs borrowing in foreign currency. A more than twofold increase in monthly payments in foreign currency due to the devaluation, on the one hand, and the deteriorating turnover due to the slowing sales, on the other, restricted the ability of SMEs to repay their debts. Banks restructured the debt repayments by prolonging the repayment periods and reducing the annual interest rates of loans. However, this did not solve the problem, and the volume of troubled loans kept increasing. The insolvency to repay the incumbent loans and the prolonged periods of the old loans limited entrepreneurs' ability to receive new loans.

## 2.5.2 | Demand Side

**Low financial literacy of entrepreneurs.** The low level of awareness of entrepreneurs about the range of financial services, coupled with their inaccurate and untimely loan applications ultimately reduce their access to credit resources. The results of our in-depth interviews with entrepreneurs in the research process indicate that many of them are unaware of the state funds providing preferential loans. For example, the QRCC and CMPI survey shows that 73.1% of entrepreneurs reported that they had not applied for the state's preferential loans, with 53.9% of them explaining that they had had no information on preferential loans (QRCC and CMPI 2012). Our interviews also show that entrepreneurs do not have the basic knowledge of the capital market, and only see bank loans as a source of finance.

**Low financial transparency.** Low financial transparency in the activities of SMEs complicates their access to finance. For example, in Azerbaijan, there is no experience in attracting financial resources from bonds. These sources are usually used by large companies. While the minimum annual interest rate of 16%–17% of the country's loans is low, attracting funds is even cheaper than that. The inability of SMEs to comply with the financial standards, or the lack of accountability in some cases, deprives them of being a participant in the equity market and it is because of the lack of transparency in financial accountability that SMEs cannot attract resources from abroad.

## 2.5.3 | Institutional Aspects

Although there is a certain institutional environment providing for SMEs' access to finance, some institutional mechanisms do not function properly or exist at all. One such mechanism is the real estate registration and its participation in lending by acting as a guarantee mechanism.

According to the Civil Code and other legislation, the rights acquired through the agreements over land plots and other real estate are subject to state registration. The registration of rights over immovable property is carried out by the State Register of Real Estate Property. The certificate of state registration of real estate rights and their restrictions shall be provided to the rights holder in writing or electronic form on their written or electronic requests. At the request of the rights holder, the extract, which is placed on the electronic government portal is obtained by the notary public in real-time mode via the electronic information system. After approval of the contract by the notary, it is submitted along with other documents to the State Real Estate Register Service for legal registration.

Banks often require collateral for their business loans to SMEs. As a rule, real estate is required as a credit guarantee. Banks are not interested in using movable property as collateral. Cars and gold products cannot be considered as collateral because the practice of movable property as collateral is not widespread in Azerbaijan.

Currently, there are difficulties in obtaining guaranteed credit in Azerbaijan. As part of the study and in-depth interviews, focus-group discussions held with entrepreneurs and professionals in the banking sector show that the collateral requirements of credit institutions are tough. These requirements mainly include the following:

- Real estate (house, premises, land)
- Real estate has to be based in the capital city
- The amount of loan offered to a customer cannot exceed 50% of the market value of the collateral
- Real estate must be state-registered and included in the state registry

The complexity of the current collateral mechanisms leads banks to apply harsh conditions to their customers to insure themselves. Our research suggests that the process of obtaining the right to sell the collateral for a non-repaid loan takes between 6 months to 2 years, which is due to the uncertainty in the relationship between the bank and the customer caused by law and the unfair judicial system.

The adoption of the Encumbrance of Movable Property law on 2 May 2017 created the possibility of movable property obtaining collateral status. According to the law, operated by the FIMSA, a state registry of the Encumbrance of Movable Property was established. Under the law, along with cars, equipment, goods and cattle, goods in circulation, as well as movable assets such as receivables, will be accepted as collateral.

## Regulatory Factors

Insolvency issues in Azerbaijan are regulated by the law on Insolvency and Bankruptcy adopted on 13 June 1997. Under the law, a debtor becomes insolvent when he or she cannot repay the loans. The debtor is considered to be insolvent only when it is announced either by him/herself, the court, or lenders.

Under the law, the bankruptcy process may be initiated by the enterprise through an appropriate decision without the court's involvement. As soon as bankruptcy is announced, the debtor loses their right to dispose of any of the property as part of carrying out business activities or for the purpose of fulfilling their obligations. The debtor can issue such orders only with the permission from the court, property administrator, and temporary property administrator.

The amendments made to the law created more opportunities for the debtor to recover from bankruptcy. According to the change, the lender or debtor can appeal to the court at any time to suspend the bankruptcy process in order to look at the possibility of recovery. A debtor's recovery should be carried out in accordance with the plan of recovery within the maximum duration of 24 months, as determined by law.

The law applies to all legal entities (excluding banks and public entities) and to all profit and nonprofit organizations. At present, there is no legal basis for individuals to declare their insolvency. The Law on Insolvency and Bankruptcy does not prevent entrepreneurs from obtaining finance, yet it is incapable of addressing existing problems.

According to the *Doing Business 2018* report, Azerbaijan ranks 47th out of 190 on the Resolving Insolvency Indicator. According to the report, lenders can get only 40.2 cents of each \$1 from an insolvent entity.

## 2.5.4 | Cultural Aspects

The complicated access of SMEs to financial resources is also explained by the deep-rooted mentality and attitudes of people. First of all, the requirements arising from the religious narratives limit financial sources for entrepreneurs. As an Islamic country, a group of entrepreneurs in Azerbaijan may refuse to take loans from banks by referring to Sharia law, which states that interest is forbidden. The existing banking legislation does not support Islamic banking in the country, as a result of which entrepreneurs susceptible to religious demands are left without bank loans.

Although Azerbaijan is a Moslem country, the financial legislation, and statements by government officials, exclude any initiatives or intention regarding the implementation of the Islamic financial system.

Another cultural aspect with a negative impact on business financing is the lack of an unambiguous attitude of society toward women's engagement in entrepreneurship. In surveys, the negative attitudes (of their family and people around them, etc.) toward women in business is raised as an obstacle (Democracy Monitoring Center 2017).

## 2.5.5 | Gender Issues

Gender disparity in financing SMEs is prevalent. Since women's entrepreneurship is part of the overall entrepreneurship, women are faced with the same financial problems as SMEs. The surveys held with women show that the problem of access to finance is reported to be the main factor hindering their businesses (Democracy Monitoring Center 2017).

There is no gender analysis of access to credit resources available in the official statistical data, including statistical bulletins of the CBAR and the FIMSA. According to the results of the representative statistical survey, Gender Issues in the Production and Sale of Agricultural Products, conducted by the State Statistical Committee of the Azerbaijan Republic in 2012 (State Statistical Committee 2017), women account for only 25.8% of the households receiving loans from financial institutions, while Global Findex argues that the share of women receiving loans from financial institutions was 15% in 2014.<sup>26</sup>

The Entrepreneurship Development Fund of the Republic of Azerbaijan (EDF) granting preferential loans to entrepreneurs at the expense of public funds provides gender analysis of loans. The fund gave out a total of AZN2.09 billion to entrepreneurs in the country during 2012–2017, of which AZN61.3 million or 2.9% was accounted for by woman entrepreneurs (National Entrepreneurship Support Fund 2012–2016).

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<sup>26</sup> <http://datatopics.worldbank.org/financialinclusion/country/azerbaijan>

## 2.6 Status of Domestic and Global Value Chains in Azerbaijan

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For Azerbaijan, whose economy is dependent on resources, it is key to develop value chains on the basis of non-resource spheres in accordance with the diversification strategy. The government has precisely targeted economic diversification in its road map for the prospective development of the economy adopted in late 2016, and identified areas, such as the agrarian sector, food industry, tourism, financial services, and information technologies, as key sectors.

A value chain is a set of activities that an organization in a specific industry carries out to deliver a valuable product or service for its customers. The value chain of a finished product (service) sometimes runs through a full range of activities—including design, production, transportation, marketing, distribution, storage, etc., which are separate links in this chain.

The concept of a “global value chain” is used in relation to commodities and services that are the object of international trade. Countries contribute to the process of creating a global value chain in a different way. The participation of countries in the creation of a global value chain occurs either through the import of some components of products or services they export, or the export of various raw materials and components for goods and services produced in different countries.

The service sector plays an important role in ensuring the Azerbaijan economy’s participation in the global value chain. In 2017, the services sector (including construction) accounted for 55% of value added in the economy. However, according to the government’s Road Map, only 3% of Azerbaijan’s SMEs are able to earn export revenues. Given that all SMEs are concentrated in the non-oil sector and non-oil exports account for only 2% of GDP, it is clear that export revenues from SMEs are very small. It should also be taken into account that the activities of SMEs in Azerbaijan are mostly focused on manufacturing products of low and medium technological levels of the value chain. This includes primarily agrarian products, the food industry and construction industry, which do not require high technological processes.

The level of participation of any country in global value chains is directly dependent on the potential for the national economy’s diversification. The more the economy is diversified, the more sectors are involved in the creation of added value; the economy produces more products and services; to release products and services in the same sector, raw materials and materials of other sectors are consumed in



the form of intermediate products. In this respect, the priority area for economic diversification should play the role of locomotive for the development of other sectors and form a new demand for their products. Diversification of the economy can take place on the basis of product development, which replaces imports on the basis of large domestic demand, and diversification of exports on the basis of areas where the country has comparative advantages.

Azerbaijan's non-oil exports for 2017 totaled \$1.538 million, accounting for 11% of total exports. Table 2.4 lists the product structure and value of non-oil exports:<sup>27</sup>

**Table 2.4: Product Structure and Value of Azerbaijan Non-Oil Exports**

Description of Goods	Value, in \$ Million	Share in Non-Oil Exports, %
Live animals and edible products of animal origin	12.6	0.82
Edible vegetables and certain roots and tubers	210.0	13.65
Edible fruit and edible nuts: peel of citrus fruit	292.8	19.04
Animal and vegetable fats and oils	17.0	1.11
Sugars and sugar confectionery	40.2	2.61
Products of processing of vegetables, fruits, nuts, and other parts of plants	15.5	1.01
Miscellaneous food products	3.3	0.21
Alcoholic and non-alcoholic beverages and vinegar	21.9	1.42
Tobacco and manufactured tobacco substitutes	15.3	0.99
Products of the chemical industry	79.5	5.17
Organic chemicals	67.3	4.38
Plastics and articles thereof	101.1	6.57
Raw hides and skins (other than fur skins) and leather	14.9	0.97
Cotton	51.9	3.37
Other made up textile articles; worn clothing	20.5	1.33
Precious metals and articles thereof	141.5	9.20
Products of the ferrous and non-ferrous metal industry	245.0	15.93
Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	36.0	2.34
Electrical machinery and equipment and parts thereof	14.4	0.94
Other non-oil products	138.0	8.97

Source: State Statistical Committee of the Azerbaijan Republic.

<sup>27</sup> Database on Azerbaijan's foreign trade structure: <https://www.stat.gov.az/source/trade/>.

As can be seen, the bulk of non-oil exports—about 44%—are agricultural and food products, while the metallurgy industry accounts for 25% of total non-oil exports.

### 2.6.1 | Agricultural Sector: Primary and Intermediary Products Participating in Value Chains

The agricultural sector is one of the leading areas enabling Azerbaijan economy's participation in global value chains. This is due to exports of various agricultural and agro-industrial products. The total volume of agricultural and agrarian-industrial production exported from Azerbaijan constituted \$658.9 million; of that, \$502 million, or 76% of exports, consisted of fresh fruit and vegetables.<sup>28</sup>

The agricultural sector participates in the formation of value chains across the country through both the production of various crops and livestock production. According to the results of 2017, the aggregate output of the agricultural sector at the actual prices is AZN6.580 billion. AZN3.561 billion, or 54.1% of this amount, is from cattle-breeding, and AZN3.019 billion or 45.9% is from plant-growing production.

Based on official statistics, the bulk of agricultural products is provided by small farms. Thus, AZN5.935 billion, or 90%, of the AZN6.580 billion worth of agricultural production was provided by family farmers and households of individual entrepreneurs in 2017. There is no information in the official sources on the exact portion and distribution of aggregate loans made available to the agricultural sector among the small, medium-sized, and large enterprises. Only information on the total volume of loans allocated to agriculture is disclosed. According to the information provided by the CBAR, only 3.7%, or AZN29.2 million, of the loans for the whole economy were assigned to agricultural producers.

There is currently some concern regarding the development level of these sectors and what they can contribute to the economy in the future. What remain as serious problems in particular are the extensive growth of the agrarian sector, the smaller size of the agricultural area per capita (about 0.45 hectares), the non-use of cooperative models and the fragmented distribution of land plots among 800,000 farmers, the weak development of the processing industry that would purchase the crops of local farmers at the right time and at affordable prices, and exporting the bulk of their value chain as raw materials and intermediate products at lower prices without entering the stage of processing.

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<sup>28</sup> Data obtained from the State Statistical Committee (2018).

The extensive expansion of the agrarian sector manifests itself primarily in low productivity. Azerbaijan now lags behind developed countries, producing around four times less in both cattle breeding and crop production.

The number of food industry enterprises in the country is limited and their processing capacity is insignificant. Most of them fail to contribute to the formation of a global value chain because they lack the capacity to export. For comparison, it is worth mentioning that the number of enterprises specializing in meat processing in Azerbaijan is less than 50 and the number of wine factories is less than 20. However, in Moldova, whose economy is four to five times smaller than Azerbaijan’s, the number of specialized meat-processing enterprises and wine plants is 200 and 50, respectively.

### 2.6.2 | The Potential of the Processing Industry for Establishing Value Chains

The extractive industry constitutes a significant part of Azerbaijan’s industry. According to official statistics, only 27.5%, or AZN8.9 billion, of industrial production with a value of AZN32.3 billion was generated in the processing industry, while 66% of the processing industry was provided by two areas—food products (including beverage production) and oil products processing. The food industry in Azerbaijan has no potential to create a large value chain; intermediate products formed mainly in the agricultural sector and raw materials are directly converted to end-products through the processing industry (Table 2.5).

**Table 2.5: 2017 Industry Structure in Azerbaijan**

Fields and Sectors	Share of Industries, %
All industries	100
Extractive industries	70.3
Food industry (including tobacco)	8.2
Petroleum products processing	6.4
Chemical industry	1.3
Metallurgy industry	1.2
Energy power sector	4.6
Production of building materials	1.7
Other	6.3

Source: State Statistical Committee of the Azerbaijan Republic. Azerbaijan’s industry statistical database. <https://www.stat.gov.az/source/industry/>.

Other sectors of the processing industry hold very little part in overall industry. The share of textiles, apparel, and leather products (including footwear production) manufacturing in the total industrial output is slightly above 0.5%. The share of construction materials in the total industrial production is 1.3%, that of the chemical industry 1.2%, and the metallurgy industry 1%. In 2017, exports of processing industry products amounted to \$3.1 billion.

The share of small entrepreneurs is insignificant in the processing industry. In 2016, only 3% of the products of the processing industry, which totals AZN8.9 billion in actual prices, were provided by small enterprises. In turn, small entrepreneurs produced 3.4% of food processing industry products and 16% of construction materials. However, small entrepreneurs dominate in terms of the number of enterprises. Thus, out of 1,777 enterprises operating in the processing industry, 1,058 were small and 719 large and medium-sized enterprises.

### **2.6.3 | Opportunities to Participate in Global Value Chains through the Services Sector**

There has been a steady increase in the tourism sector in Azerbaijan in recent years. This growth was particularly strong between 2010 and 2015. The number of tourism enterprises in Azerbaijan increased by 4.5%, while employment within the tourism sector rose by 6% per year. The number of tourists rose by 8.5% during the period. According to the World Tourism and Travel Council, the tourism sector in Azerbaijan accounts for 2.8% of direct GDP and 2.6% of employment, which is slightly different from the average 3% of GDP in the world and 3.6% of direct employment. This means there is potential for further development.<sup>29</sup>

Only the tourism sector has the potential to develop the value chain both domestically and globally. According to official statistics, the total turnover of the country's export of tourism services as of 2017 stood at around \$2.5 billion. However, this figure was \$1.3 billion in 2013.

The development of the tourism sector, in particular improving its export potential, is among the government's main targets. Nevertheless, this sector should first be able to compete with the fastest-growing tourist destinations in the region, in particular, Turkey and Georgia. Natural conditions in these two countries are

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<sup>29</sup> Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy. <http://www.e-qanun.az/framework/34254>.

perfect for tourism activities. In particular, Georgia's tourist arrivals have grown by three times, with tourist numbers being over twice as large as that country's population over the past 5 years. But Azerbaijani tourism grew only by 22%. Azerbaijan in this situation will be able to shape the competitive tourism sector by improving the quality of its tourism infrastructure, creating favorable prices and applying simplified visa procedures under the same conditions for all countries.

In 2017, there were 16,795 SMEs in the tourism sector, accounting for 10% of the total number of SMEs. Their total turnover stood at AZN817 million, accounting for 15% of SMEs' total product and service turnover. According to official data, SMEs accounted for 48.5% of the tourism sector.<sup>30</sup>

## 2.7 Value Chain Financing Analysis

The share of SMEs in lending is appropriate to their role in the economy. Thus, the share of SMEs in the economy is slightly above 6%, and about 10% of all loans are provided to them. This picture is similar across sectors of the economy. Trade is the sector with the highest share of SMEs and 63% of total turnover in this area is provided by SMEs. In turn, 42.4% of the loans provided to SMEs are used by the trade sector.

In agricultural production, SMEs account for 1.1%, and 3.6% of SME loans had been used by this sector. Although the share of the sector in value added is less than 5%, nearly 25% of all loans provided to SMEs went to that sector. But the exports from this sector significantly exceed those from other areas. In 2017, the tourism sector generated \$3 billion in export revenues for the country, while the total export revenue of SMEs across all sectors of the economy is substantially less than that. According to the Government's road map, only 3% of Azerbaijan's SMEs are able to earn export revenues. Given that all SMEs are concentrated in the non-oil sector and non-oil exports account for only 2% of GDP, it is clear that export revenues from SMEs are very small in the tourism sector. It should also be taken into account that the activities of SMEs in Azerbaijan are mostly focused on manufacturing products of low and medium technological levels of the value chain.

<sup>30</sup> Small and Medium Entrepreneurship in Azerbaijan. <https://www.stat.gov.az/source/entrepreneurship/>.

This includes primarily agrarian products, the food industry, and the construction industry, which do not require high technological processes. According to the banks surveyed, the services sector accounts for 77% of all loans issued to SMEs, while the agrarian sector accounts for 3.6%, construction materials for 2.2%, the construction sector for 1.1%, and the food industry for 0.6%.

The statistical data available to evaluate the level of SME financing through the value chain in Azerbaijan need sharpening in order to conduct in-depth research. Now let us look at how the information on the value chain financing scheme is disclosed in the context of agriculture.

First, and most typical in agriculture, the actors, and especially farmers, *self-finance* their operations through savings. The analysis of interviews with 270 farmers from across all regions of the country between 2015 and 2016 as part of the Azerbaijan Agricultural Finance Facility (AZAFF 2016) showed that 40.4% of respondents self-finance their operations. One of the mechanisms for self-financing is the establishment of credit unions. Under the Law of the Republic of Azerbaijan on Credit Unions, the Credit Union can be constituted by no fewer than 11 individual and (or) juridical persons in the statutory order. According to official figures, 54 credit unions are functioning in Azerbaijan.<sup>31</sup> There is no database on the volume of resources required for credit unions.

Since cooperatives, as well as the network of credit cooperatives created jointly by farmers, have not been formed in rural areas across Azerbaijan, self-financing has still to be developed. The reason for this was reported to be the lack of a legal framework to establish agrarian cooperatives until recently. The law on agriculture cooperation was adopted only in 2017, but the government's action plan on the development of cooperation was adopted in 2018. As the result of this policy, some improvement in this sector is expected starting in 2019.

Second, value chain financing is informal. Of the farmers interviewed within the AZAFF project (AZAFF 2016), 19.3% said they had borrowed money from family members, 4.3% from friends and 0.2% from pawnbrokers. Examples also include input suppliers who sell fertilizer to farmers on credit, or commodity traders who supply cash advances so rural storekeepers can acquire commodities from farmers.

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<sup>31</sup> <https://www.fimsa.az/en/List%20of%20Credit%20Unions>

Third, it is a formal financing mechanism in the form of credit and technical support from state, international, and private financial institutions. With financial support from the World Bank, the Government of Azerbaijan implemented the Agricultural Competitiveness Improvement Project<sup>32</sup> to facilitate the access of agricultural producers to markets by enhancing selected value chains, which is one of its targets. In the process of implementing the project with the total cost of \$53.25 million, an information-propaganda campaign was conducted for potential participants in 30 districts, and conceptual documents for agribusiness value chains for various manufacturing enterprises (engaged in dried fruits, meat processing, etc.) operating in several districts (Barda, Samukh) were prepared and submitted to the World Bank for approval. The banks, as part of the project, offered to finance the same value chain through authorized banks. Another project, the AZAFF, is a joint project of the European Union and the EBRD. Within the project, up to \$40 million had been allocated to partner financial institutions to provide lending to entrepreneurs or individuals in the agrarian sector.

The abovementioned funding mechanisms in the agrarian sector are present in any form at each stage of the value chain from field to table. Farmers mostly seek to self-finance their operations—or, if that is not possible, go to financial institutions. At the same time, they seek to benefit from the state's favorable financial and technical support.

At the *input supply* stage, technical support is provided by processing enterprises and the state (through Aqrolizing ASC, a state-owned leasing company). For example, a sugar-producing company supplies farmers with seeds, fertilizers, and pesticides, and the costs incurred are deducted from the value of the product to be sold in the future. The state-owned agroleasing company provides farmers with seeds, fertilizers and pesticides, subject to a market price of 70%.<sup>33</sup> Animal husbandry agroleasing is leased to farmers by applying a 50% discount on animal value.<sup>34</sup> Similar support is also provided by *private processing* and state companies during the service process (Table 2.6).

In the *production process*, processing companies provide technical support to farmers to collect, harvest or market their products. For example, cotton processing plants supply to farmers harvesters and transportation means during the cotton harvest.

<sup>32</sup> <http://akia.gov.az/en/projects/view/3>

<sup>33</sup> <http://agrolizing.gov.az/az/menu/213>

<sup>34</sup> <http://agrolizing.gov.az/az/menu/229>

The costs of machinery and equipment are then deducted from the value of the cotton they receive from the farmer. At the processing stage of the product, manufacturers will make a prepayment to the producers for the future product under futures contracts (Table 2.6).

**Table 2.6: Value Chain Financing Scheme**

Value Chain Level	Within Chain Finance	Source of Finance
Input supply	<ul style="list-style-type: none"> <li>• Supplying seeds, fertilizers, and pesticides</li> <li>• Supplying breeding animals (bloodstock)</li> </ul>	<ul style="list-style-type: none"> <li>• In-kind support from processing companies (with a condition of subsequent repayment)</li> <li>• State's in-kind support on concessionary terms</li> </ul>
Service providing	<ul style="list-style-type: none"> <li>• Provision of technical means for cultivation, irrigation, and spraying</li> <li>• Provision of essential equipment and medicines for animal housing (raising), survey, and feeds</li> </ul>	<ul style="list-style-type: none"> <li>• In-kind support from processing companies (with a condition of subsequent repayment)</li> <li>• State's in-kind support on concessionary terms</li> </ul>
Production	<ul style="list-style-type: none"> <li>• Technical support for harvesting, transporting it to warehouses or sales points (e.g., delivery of harvesters for the cotton harvest)</li> <li>• Technical support for the processing of dairy and meat products, transportation to warehouses or sales points (e.g., milking equipment and dairy products' quality control devices)</li> </ul>	<ul style="list-style-type: none"> <li>• In-kind support from processing companies (with a condition of subsequent repayment)</li> <li>• State's in-kind support on concessionary terms</li> </ul>
Processing	<ul style="list-style-type: none"> <li>• Making a prepayment for a future product under futures contracts</li> </ul>	<ul style="list-style-type: none"> <li>• Financial support from wholesale companies and/or exporters (in the form of initial payment)</li> <li>• Favorable financial support from the state</li> <li>• Financing by credit institutions</li> </ul>
Wholesale/Export	<ul style="list-style-type: none"> <li>• Providing loans to exporters and wholesale sellers</li> <li>• Certification, logistics and sales organization on a "single window" principle</li> </ul>	<ul style="list-style-type: none"> <li>• Financial support from international and local financial institutions</li> <li>• Technical support by the government Support to Family Business (ABAD) public legal entity (AZPROMO)</li> <li>• Financial support from export-oriented companies and individual entrepreneurs</li> </ul>
Retail	<ul style="list-style-type: none"> <li>• Prepayment to producers or wholesalers by retailers</li> </ul>	<ul style="list-style-type: none"> <li>• Financial institutions</li> <li>• Companies</li> <li>• Large supermarket chains</li> </ul>

Source: Author.



At the wholesale/export stage of the value chain, loans are provided to exporters and wholesalers by financial institutions. The certification, logistics and sales organization of products are carried out on the “one-stop shop” principle by the state-run ABAD public-legal entity.<sup>35</sup> At the same time, the manufacturer brand is put on the product, with a relevant trademark indicating that it is manufactured under the supervision of ABAD. Retailers make initial payments to wholesalers for the products to be purchased (Table 2.6).

Recently, farmers have been provided with technical and financial assistance at all stages of the value chain thanks to the state’s increasing attention to the agrarian sector. At the same time, banks within the framework of programs of international financial institutions (World Bank, EBRD, the Asian Development Bank, among others) channel a certain amount of funding into the agrarian sector. Despite all this, banks are not interested in attracting their funds to the agrarian sector. Banks prefer to allocate loans for the wholesale, export, and retail stages, which are the final stages of the value chain.

## 2.8 Policies to Promote SME Finance

### 2.8.1 | Relevant Contents of National Strategy

Financing entrepreneurs, including SME operations, has been reflected in the Law on Entrepreneurship of the Republic of Azerbaijan, dated 15 December 1992. The law also envisages the activity of the National Fund for Entrepreneurship Support at the Ministry of Economic Development in order to provide financing to entrepreneurship activities. Under the Presidential Decree on Improving the Mechanism of State Support for the Development of Entrepreneurship in Azerbaijan, dated 31 July 2018, the National Fund for Entrepreneurship Support was liquidated and the public legal entity Entrepreneurship Development Fund was established under the Ministry of Economy.

The Law on State Support for Small Entrepreneurship of the Republic of Azerbaijan, adopted on 4 June 1999, stipulates small enterprises’ access to concessional financing as the main directions of state aid. The scope of this law is limited to small entrepreneurship.

<sup>35</sup> <http://abad.gov.az/en/about>

The Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy focus on 11 major sectors of the economy, three of which, mentioned below, envisage increasing SMEs' access to financial sources and implementing mechanisms for state support to financing.

1. One of the five strategic targets in the Strategic Roadmap for Manufacture of Consumer Goods by SMEs is to grant SMEs effective and favorable access to financing. It identifies four priority areas to achieve strategic targets:
  - Conduct reforms to solve winding-up and insolvency issues
  - Create SME Loan Guarantee Fund
  - Improve activities related to property issues and boost access to finance
2. One of the five strategic targets in the Strategic Road Map for Manufacture of Agricultural Products is to provide simplified access for SMEs to financing opportunities. It identifies three priority areas to achieve strategic targets:
  - Improve mechanisms for financing agriculture
  - Boost agricultural insurance
  - Promote agricultural investments
3. One of the five strategic targets in the Strategic Road Map for Financial Services is to develop the financial markets. It identifies three priority areas to achieve strategic targets:
  - Create favorable environment for emitters and financial intermediaries;
  - Increase access of investors to financial markets;
  - Increase active participation in inter-bank exchange market

The establishment of mechanisms and institutions to improve SME finance in Azerbaijan is currently carried out in accordance with the strategic targets of these Road Maps.

Financial inclusion is one of the priorities of the Strategic Roadmap for the Development of Financial Services. The document notes that improving the access to finance for micro, small, and medium-sized enterprises (MSMEs) can help to increase productivity, increase employment opportunities, and provide a more productive distribution of resources in separate companies and across the whole country.

Women's entrepreneurship is one of the main targets of the development in the Strategic Roadmap for Manufacture of Consumer Goods by SMEs. Creating incentive mechanisms for the development of women's entrepreneurship, the development of information support, creation of business incubators, organizations, associations, and professional organizations are measures to be taken within the roadmap.

The development of financial services is also among the strategic goals of the Azerbaijan government. The financial services market plays an important role in economic development, both in terms of access to essential financial resources of the economy or the formation of corporate governance culture to ensure the economy's efficiency, as well as ensuring its participation in the global value chain through the domestic service markets. The strategic targets defined by the government in the roadmap are largely associated with the prospects of the money market and partly the stock market. However, the formation of a financial market that supports sustainable economic development depends on the mutual activities and parallel development of the monetary and capital markets. The money market carries out the accumulation and distribution of free cash as a debt in the short term, and serves as an exchange of resources. In the capital market, resources serve as a capital that increases their value, which is a "long money" market. But, for example, no strategic objectives, priorities, and relevant indicators have been reflected in the said Road Map for the development of private investment funds and private pension funds, which are very important capital market institutions. However, the number of investment funds and private pension funds to be formed potentially in the country for the next 20 years, as well as their possible capitalization level, could be defined as target indicators. The Law on Labor Pensions (adopted in 2006), which provides legal opportunities for the creation of private pension funds in the country, has been in effect for 11 years and the Law on Investment Funds (adopted in 2010) for 7 years. However, neither investment funds nor private pension funds have been created in the country over the past period. Despite the fact that there is a separate law governing the activities of investment funds, the lack of capital markets and the lack of interest in companies to become a stock company are the main reasons for the creation of investment funds. The main reason for the absence of private pension funds is the low level of formal employment (33%). Records for employees of the public sector with a two-third share of official employment are maintained through the state-owned pension fund.

### **2.8.2 | Level of Policy, National or Otherwise**

The regulatory acts regulating the enhancement of SMEs' access to financial resources are part of Azerbaijan's national legislation and their implementation is mandatory in line with the legislation. The strategic roadmaps, which focus on the

development of various sectors of the economy, including the financing of SMEs, cover the government's strategic outlook until 2020, long-term outlook by 2025, and target outlook for the period after 2025.

### 2.8.3 | Institutions Involved

The Strategic Road Map for manufacture of consumer goods by SMEs specifies the institutions providing financial services for SMEs. They are the Entrepreneurship Development Fund of the Republic of Azerbaijan (EDF),<sup>36</sup> the Azerbaijan Export and Investment Promotion Foundation, the State Agency for Agricultural Credits, the State Fund for Development of Information Technologies under the Ministry of Communications and High Technologies of the Republic of Azerbaijan (see section 2.2.3 for more details).

In addition, the state bodies such as the CBAR, the FIMSA, the Ministry of Taxes, the State Customs Committee, and the Ministry of Finance have been involved in the process.

The Small and Medium Business (SMB) Development Agency of the Republic of Azerbaijan was established in accordance with the Decree of the President of the Republic of Azerbaijan dated December 28, 2017. The Agency Charter and structure were endorsed by the Decree of the President of Azerbaijan dated 26 June 2018. According to the decree, the Agency will support the development of small and medium-sized businesses in the country and provide a range of, in particular, financial services to the SMEs. To that end, SMB houses, Centers of Small and Medium Business Development, the Public-Private Partnership Development Center, and Foundations of Small and Medium Business Development, were created under the Agency.<sup>37</sup>

### 2.8.4 | Specific Strategies

**Support for trade finance.** Trade finance has developed in Azerbaijan in recent years, with its products offered by a limited number of banks. There are no specific strategies that support trade finance in Azerbaijan.

**Interest rate subsidies.** One of the requirements in the Strategic Roadmap for Manufacture of Consumer Goods by SMEs is to establish the credit guarantee fund.

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<sup>36</sup> The Entrepreneurship Development Fund was renamed from the National Fund for Entrepreneurship Support on 21 July 2018.

<sup>37</sup> <https://smb.gov.az/nav/about-us>

In accordance with this, the Azerbaijan Republic Credit Guarantee Fund Open Joint Stock Company was created under a Presidential Decree, dated 29 November 2017. The legislation was amended under another Presidential Decree dated 25 December 2017, and the Azerbaijan Mortgage and Credit Guarantee Fund CJSC was established through the merger of the Azerbaijan Mortgage Fund and the Credit Guarantee Fund.<sup>38</sup> The fund's major objective is to provide guarantees to entrepreneurs for manat loans taken from authorized banks, and grant subsidies for a part of the interest calculated on these loans. The rules on subsidizing interest rates on loans received by entrepreneurs in manats were approved under a Presidential Decree, dated 29 November 2017. According to the rules, the amount of secured loans is AZN30,000 to AZN5 million. The interest subsidy term for loans of up to 3 years is 8% per year and 10% for loans of over 3 years. Notably, the interest subsidy is provided for loans with annual interest rates not exceeding 20%. The interest rate subsidy does not apply to concessional loans provided through the government's financial resources.

Since its launch, entrepreneurs have received AZN17.5 million in loans thanks to the guarantees issued by the fund. At present, a system of automation of guarantee and interest subsidy provision has been created to simplify the access of entrepreneurs, including SMEs, to lending and to secure the transparency and efficiency during the appeal process. The electronic system will be put into operation in the second quarter of 2019.<sup>39</sup>

**Credit databases.** Loans in Azerbaijan had been long governed by the Centralized Credit Registry (CCR), which was established under the CBAR in 2005. The nature of data submissions and submission procedures for the CCR are governed by the Law of Azerbaijan on Banks (Article 35.4) and the Law of Azerbaijan on Nonbank Credit Institutions (Article 22.1). Currently, the CCR is operating within the FIMSA.<sup>40</sup>

On 28 October 2016, the Law on Credit Bureaus was adopted, paving the way for the creation of a legal base for private credit bureaus. In December 2017, eight banks established the first private bureau—the Azerbaijan Credit Bureau LLC,<sup>41</sup> which started functioning on 15 January 2018 and provided access to debt obligation details to data users from 6 March 2018. As of 1 April 2018, the CCR no longer provides users' access to data, pursuant to Article 23.3 of the Law on Credit Bureaus.

<sup>38</sup> <http://mcgf.az/?/en/mainpage//>

<sup>39</sup> <http://mcgf.az/post/563>

<sup>40</sup> <https://www.fimsa.az/en/centralized-credit-registry>

<sup>41</sup> <https://www.azernews.az/business/124329.html>

### 2.8.5 | Assessment of Effectiveness, Gaps, and Issues

In Azerbaijan, SMEs have not been marked as target groups in legislation related to business financing until recent years. Although the objective of the EDF at the Ministry of Economy is to finance SMEs, its major beneficiaries have been large and medium-sized enterprises. In addition, in particular, small enterprises have been unable to access the concessional lending source provided by the government. Moreover, the EDF has not given sufficient priority to SME finance since it operates as a public legal entity endorsed under the Presidential Decree, dated 31 July 2018.

Small enterprises have been outside the area of special state concern in Azerbaijan. The Law on State Support for Small Entrepreneurship, adopted on 4 June 1999, stipulates small enterprises' access to concessional financing as the main directions of state aid, yet its implementation has not been ensured.

The Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy, as a legal framework, was geared to supporting some mechanisms. A number of laws were adopted to ensure the creation of the lending base and guarantee mechanism in accordance with the roadmaps. The law on Encumbrance of Movable Property has been adopted to increase the accessibility of SMEs to secured loans, because the lack of a unified system for the registry of movable property had hindered financial institutions in lending more funds to small enterprises secured by their movable assets. The World Bank<sup>42</sup> reports that, of SME assets in Azerbaijan, only 22% are land and property, while 34% and 44% are accounts receivable, and plant and equipment, accordingly.

The State Registry of the Encumbrance of Movable Property has been operating since 15 March 2018. The registry was established to enhance SMEs' access to financing and enable them to take loans through any movable property as collateral. The registry's activity is still limited.

Institutions including the Credit Guarantee Fund, the Azerbaijan Credit Bureau, and the Registry of the Encumbrance of Movable Property geared to increase SME finance, have been recently established and therefore the scope of their activities is limited. At this early stage, it is premature to assess the efficiency of their work.

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<sup>42</sup> <https://mpcr.fimsa.az/en/about>

## 2.9 Conclusions and Recommendations

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### Conclusions

Although the number of SMEs in Azerbaijan is increasing, their contribution to the country's economy is insignificant. One factor that hampers the development of SMEs is their poor access to finance. While assessing the business environment in the country, both international and local organizations point to the difficulty SMEs face in attracting finance to enhance their business.

SMEs in Azerbaijan mainly prefer bank loans as external funding sources. However, high loan rates, the severity of conditions, a shortage of the required amount, and reduced grace periods weaken SMEs' access to this kind of finance. The experience of securing finance from the alternative securities market is not at the level of SMEs. A lack of interest in transparency and accountability limits SMEs' ability to benefit from financial market sources.

State support mechanisms have been established in the country to ensure SME development and finance, resulting in the functioning of a number of institutions. However, these institutions are unable to fully support the finance required by the market. On the other hand, large enterprises are gradually driving SMEs out of state support.

One of the key areas of Azerbaijan economy's participation in the global value chain is the agrarian sector. However, our surveys found that the banks are most interested in financing the trade or food service, which are the end stage in the value chain. Although the financial institutions established by the state prefer to issue preferential loans for the agricultural sector, the share of the agrarian sector in total lending is low because of the high risk in the sector.

A preference of banks for secured loans, the lack of a full functioning of movable property's collateral mechanism, and shortcomings in this mechanism as a whole, reduce SMEs' access to secured loans.

## Recommendations

It would be appropriate to initiate the following steps to increase SMEs' access to finance:

- **Apply Islamic banking** through providing support to the development of Islamic financial mechanisms and institutions by amending the existing legislation. It should be approved by separate legislation, such as a Law on Islamic Banking or could be included in a special section of the Law on Banking to allow credit organizations to conduct Islamic banking.
- **The credit guarantee mechanism should be strengthened.** The Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan,<sup>43</sup> which was established by the reorganization as a merger of the Azerbaijan Mortgage Fund and the Credit Guarantee Fund, should be divided and the Credit Guarantee Fund should function separately. The target of this change should be to increase the share of private and international funds and to decrease the share of public funds.
- **Improve the collateral mechanism in the banking sector to facilitate SMEs' access to lending.** This involves improving the process of pledging property and decreasing its term, including the number of court procedures.
- **Implement a mechanism for venture financing to meet risks SME innovative start-ups may be exposed to.** The legislative framework is being improved to develop start-ups, and to stimulate innovative investment. To that end, it is anticipated that a bill on Venture Funds will be adopted, while the law on Investment Funds will be amended.
- **Support the application of financial technologies.** It is necessary to take stimulating measures under legislation for the application of P2P lending or crowdfunding, which are financial mechanisms for SMEs.
- **Increase SME access to the Entrepreneurship Development Fund.** The fund should focus only on supporting mechanisms for SME development. It is appropriate to seek to apply the government's concessional financial mechanisms to SMEs through amending the fund's statute. Besides financing various investment projects, the fund should target activities such as programs for beginning entrepreneurs, for active entrepreneurs, and for women in business. Examples of such Funds are the Damu Fund<sup>44</sup> in Kazakhstan and the KOSGEB<sup>45</sup> in Turkey.

<sup>43</sup> <https://mcgf.az/menu/51>

<sup>44</sup> <https://www.damu.kz/en/o-fonde/o-nas/zadachi-missiya-videnie/>

<sup>45</sup> <http://en.kosgeb.gov.tr/site/tr/genel/detay/337/vision-mission-basic-values>



- **Expand financial services for international trade transactions carried out by SMEs and promote foreign direct investment** through providing methodological support to increase the compliance of products exported by SMEs with relevant standards and requirements, and issuing grants and preferential loans to producers.
- **Strengthen the legislation for improving competitiveness in Azerbaijan.** The government should move quickly to adopt the Competition Code, which was prepared by the government in 2006 but not yet adopted by parliament. Such legislation will weaken monopoly power and will ensure competition in the economy, and thereby strengthen the development of SMEs. Besides this, the code will cover the implementation of entrepreneurship activity based on free economic competition, fair estimation and wide choice of commodities and services, formation of prices according to the free action of demand and supply in the markets, limited interference of the government in competitive markets, and key principles such as development and protection of economic competition as public interest.
- **Improve the financial literacy of SMEs.** This action merits particular focus given the notable increase of nonperforming loans of financial institutions in recent years. Financial literacy is prioritized by the government and, according to the Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy, the SMB Development Agency has assumed the responsibility for the financial literacy of SMEs.<sup>46</sup> For more effective and broad implementation of this obligation, the agency should carry out diagnostic analyses to measure the literacy level of entrepreneurs countrywide and the needs assessment of SMEs. In the base of this analysis, a Financial Literacy Strategy for SMEs should be prepared. Risk management, strategic and business planning, accounting and financial management, and other important knowledge and capacities should be included in the strategy.

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<sup>46</sup> <http://smb.gov.az/nav/about-us>

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# Leveraging SME Finance through Value Chains in Georgia

Giorgi Khishtovani, Mariam Saghareishvili, and Sopho Basilidze

## 3.1 Introduction and Overview of the Role of SMEs in the Economy and SME Finance

### 3.1.1 | SMEs' Role in the Economy

In this chapter, various existing definitions of small and medium-sized enterprises (SMEs) in Georgia are introduced, while the trends of employment, value added, and average monthly remuneration in the SME sector in Georgia are also analyzed.

#### SME Definition

In Georgia, there is no universally accepted definition of SMEs. The definitions of SMEs differ in the National Statistics Office of Georgia, in the Law of Georgia on Accounting, Reporting, and Audit,<sup>1</sup> and in the Tax Code of Georgia.

The size of an enterprise determined by the National Statistics Office of Georgia is as follows:

- Small-sized enterprises refer to all enterprises of organizational-legal form where the annual average number of people employed does not exceed 50 and the annual average turnover is below GEL12 million (\$4.7 million).<sup>2</sup>
- Medium-sized enterprises refer to all enterprises of organizational-legal form where the annual average number of people employed ranges from 50 to 250 and the annual average turnover ranges from GEL12 million (\$4.7 million) to GEL60 million (\$12.5 million).
- Large-sized enterprises refer to all enterprises of organizational-legal form where the annual average number of people employed exceeds 249 and/or the annual average turnover exceeds GEL60 million (\$12.5 million).

<sup>1</sup> <https://matsne.gov.ge/en/document/view/3311504?publication=4>

<sup>2</sup> Throughout the text, the annual nominal exchange rates lari/dollar are used. The data were taken from the National Bank of Georgia.

Meanwhile, the size of enterprises according to the Law of Georgia on Accounting, Reporting, and Audit is determined as follows:

- Microenterprise (category IV)—an entity whose indicators, at the end of the reporting period, meet at least two of the following three criteria: (i) the total value of assets does not exceed GEL1 million (\$0.4 million); (ii) the revenue does not exceed GEL2 million (\$0.8 million); and (iii) the average number of persons employed during the reporting period does not exceed 10.
- Small enterprise (category III)—an entity that is not an enterprise falling under the fourth category and whose indicators, at the end of the reporting period, meet at least two of the following three criteria: (i) the total value of assets does not exceed GEL10 million (\$4 million); (ii) the revenue does not exceed GEL20 million (\$8 million); and (iii) the average number of persons employed during the reporting period does not exceed 50.
- Medium enterprise (category II)—an entity that is not an enterprise falling under the third or fourth categories, and whose indicators meet, at the end of the reporting period, at least two of the following three criteria: (i) the total value of assets does not exceed GEL50 million (\$20 million); (ii) the revenue does not exceed GEL 100 million (\$40 million); and (iii) the average number of persons employed during the reporting period does not exceed 250.
- Large enterprise (category I)—an entity whose indicators, at the end of the reporting period, meet at least two of the following three criteria: (i) the total value of assets exceeds GEL50 million (\$20 million); (ii) the revenue exceeds GEL100 million (\$40 million); and (iii) the average number of persons employed during the reporting period exceeds 250.

In the Tax Code of Georgia, another set of definitions for enterprise types are provided for which a preferential tax regime is in force. The size of enterprises is determined by the Tax Code of Georgia as follows:

- Microbusiness status—entrepreneurs (natural persons) who do not use hired labor, conduct economic activity independently, and have an annual gross income of up to GEL30,000 (\$12,000).
- Small enterprise status—entrepreneurs whose gross income from economic activity during a calendar year does not exceed GEL500,000 (\$200,000).

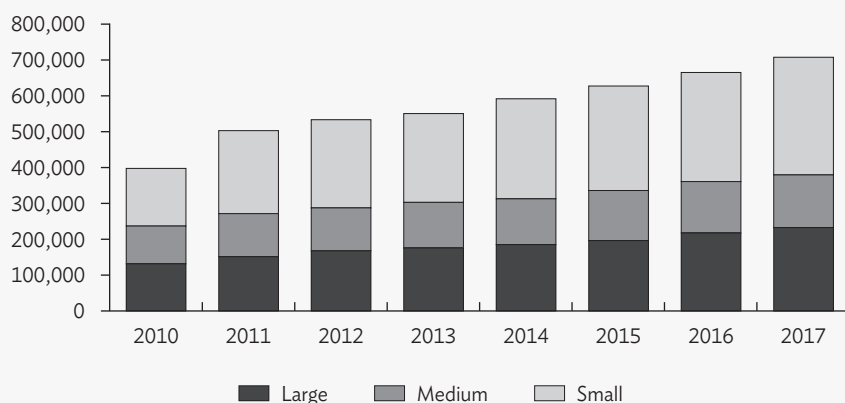
Moreover, financial institutions in Georgia also have different ways of determining an enterprise's size.

For this document, the definition and methodology given by the National Statistics Office of Georgia will be used when analyzing the statistical data.

## SME Employment

In 2017, SMEs accounted for 67% of Georgia's total private sector employment—in total, 474,575 people (large enterprises accounted for 23%). During 2011–2017, SME employment increased, with the highest annual growth rate recorded in 2014—8.9% (National Statistics Office of Georgia) (Figure 3.1).

**Figure 3.1: Employment in the Private Sector of Georgia**



Source: National Statistics Office of Georgia.

The largest proportion of employed people in SMEs were employed in the wholesale and retail trade; repair of motor vehicles and motorcycles sector<sup>3</sup> in 2017 with employment in this sector accounting for 29.2% of total SME employment (138,592 people) (Table 3.1). Between 2011 and 2017, the number of people employed in this sector increased, with the largest growth rate recorded in 2014, when the number of people employed in this sector rose by 14%.

The trade sector is followed by the manufacturing and construction sectors, as 12.5% and 12.3% of employed people in SMEs were employed in those sectors, respectively.

<sup>3</sup> According to the classification of economic activities NACE rev 2, later referred to as “trade.”

**Table 3.1: SME Employment by Economic Sector, 2017**

Economic Sector	SME Employment	Share of Sector in SME <sup>a</sup> Employment
Agriculture, forestry, and fishing	8,546	1.8%
Mining and quarrying	4,385	0.9%
Manufacturing	59,469	12.5%
Electricity, gas, steam, and air-conditioning supply	2,172	0.5%
Water supply, sewerage, waste management, and remediation	3,139	0.7%
Construction	58,446	12.3%
Wholesale and retail trade; repair of motor vehicles and motorcycles	138,592	29.2%
Transportation and storage	27,389	5.8%
Accommodation and food service activities	34,574	7.3%
Information and communication	13,430	2.8%
Real estate activities	14,341	3.0%
Professional, scientific, and technical activities	20,194	4.3%
Administrative and support service activities	14,181	3.0%
Education	19,582	4.1%
Human health and social work activities	30,959	6.5%
Arts, entertainment, and recreation	10,452	2.2%
Other service activities	7,458	1.6%
Sector is not specified	7,268	1.5%
Total SME sector employment	474,576	100%

SME = small and medium-sized enterprise.

<sup>a</sup> Based on the definition of the National Statistics Office of Georgia.

Source: National Statistics Office of Georgia (2017).

The agriculture, forestry, and fishing sector accounted for only 1.8% of SME employment.<sup>4</sup> However, it should be noted that during 2011–2017, in this sector the number of people employed increased, with the largest growth rate being recorded in 2012, when the number of people employed in this sector rose by 39.2%.

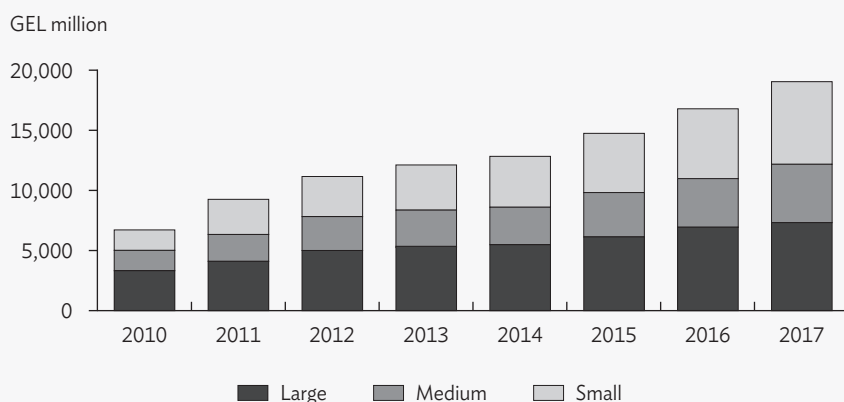
<sup>4</sup> According to the National Statistics Office of Georgia, the SME agricultural sector includes only primary production of agriculture. Therefore, the SME employment and SME value added in the agricultural sector given in the document include only primary production of agriculture.

Moreover, while the growth rate of SME employment in this sector increased between 2011 and 2017, the number of people employed in large enterprises in this sector decreased in the period 2016–2017. Therefore, new businesses have been created in this sector; however, they struggle to become medium- or large-sized.<sup>5</sup>

### SME Value Added

According to the latest statistics, in 2017, SMEs accounted for 61.6% of Georgia's total value added in the private sector—in total, GEL11.72 billion (\$4.67 billion) (for large enterprises it accounted for 38.4%) (Figure 3.2). The share of SMEs in total value added in the private sector has been increasing since 2012.<sup>6</sup> During 2011–2017, value added for SMEs increased, with the highest annual growth rate being recorded in 2012 (20.7%).

**Figure 3.2: Value Added in the Private Sector of Georgia**



GEL = Georgian lari.

Source: National Statistics Office of Georgia.

<sup>5</sup> It should be noted that in 2017, 735,900 people (43% of employed people in Georgia) were employed in the agriculture, forestry, and fishing sector, while SME employment in agriculture amounted only to 8,546 people. That is because in Georgia there are a large number of small unregistered farms, and they are not included in SME statistics. According to Georgia's 2004 general population census, there were 691,577 farms, and the size of the majority of them (67%) was 0.1–1 hectares (National Agricultural Census of Georgia 2004).

<sup>6</sup> In 2013, the share of SMEs in total value added in the private sector was 56%.



**Table 3.2: SMEs' Value Added by Economic Sector, 2017**

Sector	Value Added in GEL million (in \$ million)	Share of SMEs <sup>a</sup> Value Added
Agriculture, forestry, and fishing	118 (47)	1.0%
Mining and quarrying	147 (59)	1.3%
Manufacturing	1,445 (576)	12.3%
Electricity, gas, steam, and air-conditioning supply	270 (108)	2.3%
Water supply, sewerage, waste management and remediation	48 (19)	0.4%
Construction	2,273 (906)	19.4%
Wholesale and retail trade; repair of motor vehicles and motorcycles	2,850 (1,136)	24.3%
Transportation and storage	1,038 (414)	8.9%
Accommodation and food service activities	510 (203)	4.3%
Information and communication	322 (128)	2.7%
Real estate activities	587 (234)	5.0%
Professional, scientific, and technical activities	566 (226)	4.8%
Administrative and support service activities	329 (131)	2.8%
Education	193 (77)	1.6%
Human health and social work activities	437 (174)	3.7%
Arts, entertainment, and recreation	154 (61)	1.3%
Other service activities	57 (23)	0.5%
Sector is not specified	381 (152)	3.2%
SME value added	11,722 (4,673)	100%

GEL = Georgian lari, SME = small and medium-sized enterprise.

<sup>a</sup> Based on the definition of the National Statistics Office of Georgia.

Source: National Statistics Office of Georgia.

The largest proportion of value added in SMEs was created in the trade sector in 2017, with this sector accounting for 24.3% of total value added of SMEs (GEL2.85 billion [\$1.14 billion]) (Table 3.2). Between 2011 and 2017, the value added in this sector increased, with the largest growth rate being recorded in 2017, when the value added in this sector rose by 16%.

The trade sector was followed by the construction and manufacturing sectors in 2017, with 19.4% and 12.3% of SMEs' value added being created in those sectors, respectively. During the period 2011–2017, value added in those sectors increased.

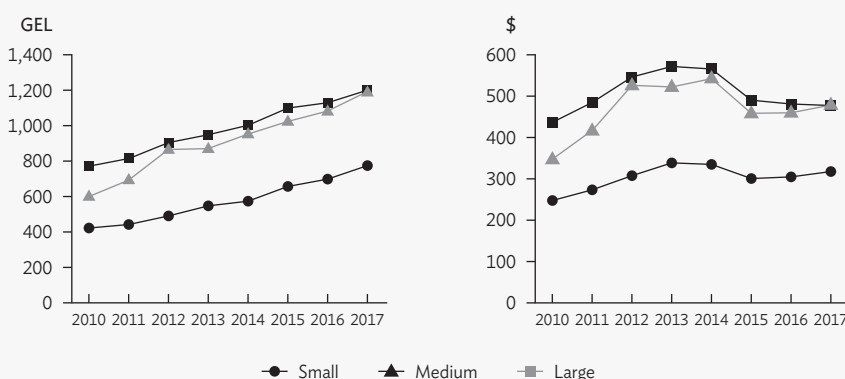
The agriculture, forestry, and fishing sector accounted for only 1% of SMEs' value added (GEL118 million [\$47 million]). Between 2011 and 2017, with the exception of 2014, in this sector value added created increased, with the largest growth rate being recorded in 2012, when the value added created in this sector rose by 80.9%.

### Average Monthly Remuneration

In 2017, in Georgia, the average monthly remuneration of employed persons in the private sector was GEL1,019.7 (\$404.7), which exceeded the overall average monthly salary of Georgia in 2017—GEL999.1 (\$396.7). In small enterprises, monthly remuneration amounted to GEL776.1 (\$309.4), while in medium enterprises it was GEL1,196.9 (\$477.1) and in large enterprises it was GEL1,195.9 (\$476.7). During 2014–2017, the average monthly earnings in all kinds of private enterprises increased (Figure 3.3).

Between 2011 and 2017, the average growth rate of monthly remuneration in SMEs exceeded the average growth rate in large enterprises (small—9.1%; medium—10.5%; large—6.5%).

**Figure 3.3: Average Monthly Remuneration of Employed Persons by Enterprise Size**



GEL = Georgian Lari.

Source: National Statistics Office of Georgia (2017).

Georgia's SME sector is concentrated in low value-added sectors (OECD 2016b), such as the trade sector. Employment, as well as value added in the SME sector in Georgia, has increased, with the majority of SME employment and value added being in the trade sector. The proportion of people employed in this sector within total SME employment has increased since 2011, while the share of value added created in this sector has decreased since 2015.

The proportion of people employed and value added created in the manufacturing sector in the total SME sector has decreased since 2015.

In the agricultural sector, while the share of employed people in this sector in total SME employment has increased since 2015, its contribution in terms of value added created has not changed notably.

### 3.1.2 | SME Funding

In order to respond to the challenges facing SMEs in Georgia and to support their development, the Government of Georgia, donor organizations, and financial institutions all implement projects and create SME-oriented products and services. The government provides subsidies and implements projects to support SME development. Financial institutions, especially commercial banks and microfinance organizations, provide business loans and other services to SMEs. Donor organizations mainly provide grants for SMEs' capacity building and development. Details regarding the activities of the listed stakeholders are discussed later in this chapter.

#### Government

The government supports SMEs' development through several programs covering all economic sectors. The Ministry of Economy and Sustainable Development of Georgia and the Ministry of Environmental Protection and Agriculture of Georgia are the main implementers of programs supporting SMEs in the country. To support SMEs, the government provides subsidies and technical assistance. In addition, the government cooperates with financial institutions to subsidize bank interest payments in several government programs.

In 2017, the government spent GEL369 million (\$147 million) from the total state budget of GEL11.7 billion (\$4.7 billion) to support entrepreneurship, innovations, technologies, and agricultural development (3.1% of the total state budget) (Table 3.3).

**Table 3.3: Government Spending by SME Program Type**

	Thousand GEL (\$ thousand)	% of Total State Budget
	2015	
Developing Entrepreneurship	22,959 (10,113)	0.2%
Development of Innovations and Technologies in Georgia	6,713 (2,957)	0.1%
Agricultural Development	306,052 (134,814)	3.2%
Total	335,724 (147,884)	3.5%
	2016	
Developing Entrepreneurship	41,106 (17,368)	0.4%
Development of Innovations and Technologies in Georgia	9,362 (3,956)	0.1%
Agricultural Development	320,915 (135,595)	3.1%
Total	371,382 (156,919)	3.6%
	2017	
Developing Entrepreneurship	39,348 (15,685)	0.3%
Development of Innovations and Technologies in Georgia	6,050 (2,412)	0.1%
Agricultural Development	324,061 (129,178)	2.8%
Total	369,459 (147,275)	3.1%

GEL = Georgian lari.

Source: Ministry of Finance of Georgia (2018).

Georgia's government is involved in promoting and supporting SMEs through the following programs and initiatives:

- Produce in Georgia,<sup>7</sup> launched by the Ministry of Economy and Sustainable Development of Georgia and the Ministry of Environmental Protection and Agriculture of Georgia;
- United Agroproject,<sup>8</sup> launched by the Ministry of Environmental Protection and Agriculture of Georgia; and
- supporting start-ups in the field of innovation and technology, launched by the Ministry of Economy and Sustainable Development of Georgia.

<sup>7</sup> <http://www.enterprisegeorgia.gov.ge/ka>

<sup>8</sup> <http://apma.ge/>

■ **Produce in Georgia**

The Produce in Georgia program, implemented by the agency Enterprise Georgia, is designed to encourage the establishment of new businesses and/or the expansion of existing businesses. This program consists of three components: an industrial component, the hotel industry, and micro and small business support. These components were launched in 2014. As of 2017, the total number of supported projects had reached 5,563 and the total subsidies amounted to GEL81.5 million (\$32.5 million), which is 0.2% of Georgia’s GDP (Table 3.4). The micro- and small business support component has the largest share in terms of number of projects (96% of all projects). The micro- and small business support component, together with the industrial component, took up the biggest share of total subsidies<sup>9</sup> (47% of total subsidies per component).

**Table 3.4: Results of the Produce in Georgia Program, 2018**

	Number of Projects	Amount of Subsidies in GEL (in \$)	% of GDP
Industrial Component	213	38,568,616 (15,374,341)	0.10%
Hotel Industry	37	4,322,600 (1,723,088)	0.01%
Micro- and Small Business Support	5,313	38,656,512 (15,409,379)	0.10%

GDP = gross domestic product, GEL = Georgian lari.  
Source: Agricultural Project’s Management Agency (2018).

■ **United Agroproject**

Under the program United Agroproject, several large-scale SME support programs are implemented, such as Plant the Future, where entrepreneurs are assisted financially and technically to arrange perennial and nursery gardens. Financial assistance here entails cofinancing the purchase of saplings and the installation of drip irrigation systems. As of 2017, the program had 658 beneficiaries and the total funding amounted to GEL22 million (\$9.3 million). Notably, the number of beneficiaries and the amount of funding have increased every year. Specifically, in 2016, the number of applications rose 2.4-fold and the funding amount almost doubled (Table 3.5).

<sup>9</sup> Total subsidies include direct financial assistance and subsidizing interest rate for credits.

**Table 3.5: Results of the Plant the Future Program, 2018**

	Number of Applications	Number of Beneficiaries	Amount of Funding in GEL (in \$)	% of GDP
2015	112	110	4,127,038 (1,817,935)	0.01%
2016	274	262	8,062,315 (3,406,541)	0.02%
2017	307	286	10,148,508 (4,045,430)	0.03%

GDP = gross domestic product, GEL = Georgian lari.

Source: Agricultural Project's Management Agency (2018).

Through the Preferential Agrocredit program, enterprises engaged in agricultural production, processing, and storage receive agrocredit and agroleasing from specific commercial banks and financial institutions. The program aims to support all participants of the agricultural sector (primary production, processing, storage, etc.) to establish new businesses or to expand existing ones. As of 2017, 27,685 loans had been issued in lari, with a total budget of GEL1 billion (\$0.5 billion) and 2,283 issued in dollars, with a total budget of \$223 million. The number of loans in lari are volatile compared to the number of loans in dollars. In 2017, compared to 2016, both the number of loans (+125%) and the total amount (+292%) in lari increased, while the number of loans (-96%) and total amount (-91%) in dollars declined due to the larization<sup>10</sup> process (Table 3.6).

The programs supporting agroprocessing and storage entail cofinancing SMEs in agroprocessing and storage. As of 2017, 10 projects were funded with a total budget of GEL3.4 million (\$1.4 million). The enterprises are cofinanced in lari as well as in dollars. Since 2014, 42 enterprises have been cofinanced with a total spend of \$9.4 million.

Through the Agroinsurance program, beneficiaries can insure agricultural land up to 5 hectares, and, in the case of cereals, up to 30 hectares. The aim of this program is to develop the insurance market in the agricultural sector and to reduce the risks in this sector. The Agroinsurance program covers the risks of hail, flood, storm, and autumn frost (only for citrus). Between 2014 and 2017, 68,879 insurance policies were purchased by program beneficiaries, and insurance premium subsidies carried out by the agency amounted to GEL29.3 million (\$13.9 million) (Table 3.7).

<sup>10</sup> Larization/de-dollarization measures the use of domestic currency in the Georgian economy. The larization strategy entails the promotion of the lari and increasing public trust in the currency (National Bank of Georgia 2018).

**Table 3.6: Preferential Agrocredit Program in Georgia**

	Local Currency			Foreign Currency		
	Number of Loans	Total amount in million GEL (in \$ million)	Total Amount/GDP	Number of Loans	Total Amount (in \$ million)	Total Amount/GDP
2013	5,818	158 (95)	0.59%	399	55	0.34%
2014	15,170	344 (195)	1.18%	437	62	0.38%
2015	3,266	185 (81)	0.58%	576	50	0.36%
2016	1,056	72 (30)	0.21%	835	52	0.36%
2017	2,375	281 (112)	0.74%	36	5	0.03%

GDP = gross domestic product, GEL = Georgian lari.  
Source: Agricultural Project’s Management Agency (2018).

**Table 3.7: Agroinsurance Program in Georgia**

	Number of Insurance Policies	Insurance Premium in GEL million (in \$ million)	Insurance Premium Subsidies Carried Out by Government in GEL million (in \$ million)	Insurance Premium Subsidies Carried Out by the Beneficiaries in GEL million (in \$ million)	Total Amount (Insurance Subsidies Carried Out by Government)/GDP
2014	21,056	12.6 (7.1)	11.8 (6.7)	0.7 (0.4)	0.04%
2015	7,634	3.4 (1.5)	1.9 (0.9)	1.4 (0.6)	0.01%
2016	18,795	11.9 (5.1)	8.2 (3.5)	3.6 (1.6)	0.02%
2017	21,394	11.6 (4.6)	7.4 (2.9)	4.2 (1.7)	0.02%

GDP = gross domestic product, GEL = Georgian lari.  
Source: Agricultural Project’s Management Agency (2018).

In addition, the Agricultural Project’s Management Agency (APMA) supports the rehabilitation of tea plantations, thereby helping young entrepreneurs to increase their role and involvement in the sector.

Other Sources of Funding

Georgia’s Innovation and Technology Agency provides products and services to entrepreneurs and start-ups oriented toward innovation and technology, with the aim of developing a strong start-up ecosystem. As of October 2018, the agency had assisted 125 start-ups.

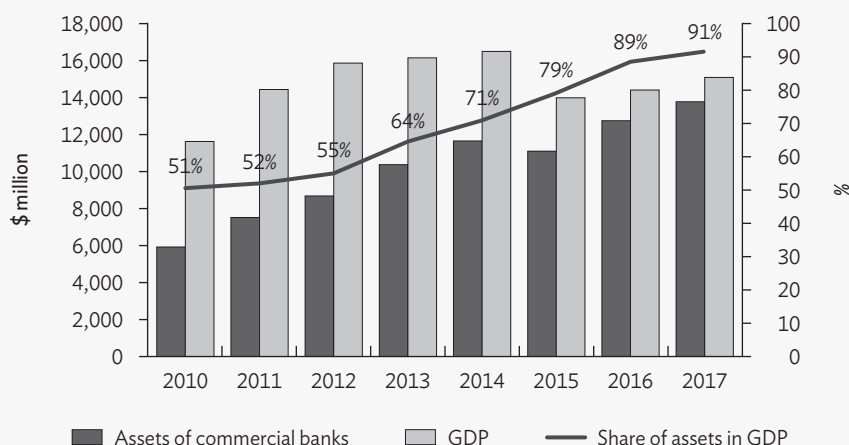
The state-owned investment fund, the Partnership Fund, supports the energy, real estate, agricultural, and manufacturing sectors.

### Financial Institutions

Another source of funding for SMEs is loans and other services from financial institutions. During 2010–2017, the financial sector of Georgia grew significantly. In 2017, compared to 2010, the assets of financial institutions<sup>11</sup> in Georgia increased by 130% (accounting for \$14.7 billion) and the assets-to-GDP ratio increased to 96.7% in 2017, compared to 54.8% in 2010 (National Bank of Georgia 2017) (Figure 3.4).

Assets of commercial banks accounted for 94% of financial institutions' assets in 2017. In 2017, 16 commercial banks were functioning in Georgia. Between 2010 and 2017, the number of commercial banks decreased from 19 to 16; however, the share of commercial banks' assets in Georgia's GDP has been increasing since 2010 (from 51% to 91%) (National Bank of Georgia 2017) (Figure 3.4). There is a duopoly in the banking sector. TBC Bank and the Bank of Georgia are the two major players, with a 71% asset share in the total financial institutions' assets in 2016.

**Figure 3.4: Commercial Banks' Assets in Georgia**



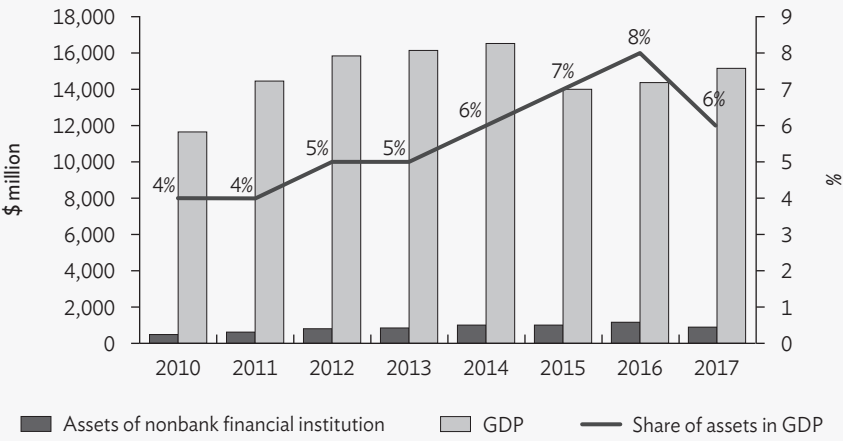
GDP = gross domestic product.

Source: National Bank of Georgia (2017).

<sup>11</sup> Financial institutions include commercial banks, nonbanking depository institutions, microfinance organizations, exchange bureaus, stock exchanges, insurance companies, and pension schemes.



**Figure 3.5: Nonbanking Financial Institutions’ Assets in Georgia**



GDP = gross domestic product.  
Source: National Bank of Georgia (2017).

Assets of nonbanking financial institutions accounted for 6% of financial institutions’ assets in 2017. The share of nonbanking financial institutions’ assets in Georgia’s GDP increased between 2014 and 2016; however, in 2017 it decreased from 8% to 6% (Figure 3.5).

Between 2010 and 2017, the number of microfinance organizations in Georgia increased (by 26 units) and so did the value of their assets (by 249.9%). During this period, the number of nonbanking depository institutions, exchange bureaus, and pension schemes decreased; however, the value of their assets increased (Table 3.8).

Commercial banks and microfinance organizations are the major sources of SME finance. Commercial banks offer various products to SMEs, including current accounts, deposits, guarantees, and credits, although loans are the most popular product. Banks offer SMEs working capital financing, fixed assets financing, and trade financing. Commercial banks collaborate with the Georgian government and provide preferential credits to SMEs under several government programs. Microfinance organizations are not eligible to participate in government programs as sources of funding due to several restrictions. First, the loan amounts suggested in the programs are higher than these organizations are capable of issuing.

**Table 3.8: Number of Financial Institutions in Georgia**

Financial Institutions	Number of Units (2010)	Number of Units (2017)	Assets (2017) (\$ million)	Assets/GDP
Commercial Banks	19	16	13,790	90.9%
Nonbanking Depository Institutions	18	8	3.3	0.02%
Microfinance Organizations	49	75	607.5	4%
Exchange Bureaus	1,627	1,126	29.7	0.2%
Stock Exchanges	1	1	1.4	0.01%
Insurance Companies	16	16	231.3	1.5%
Pension Schemes	6	3	13,790	0%

GDP = gross domestic product.

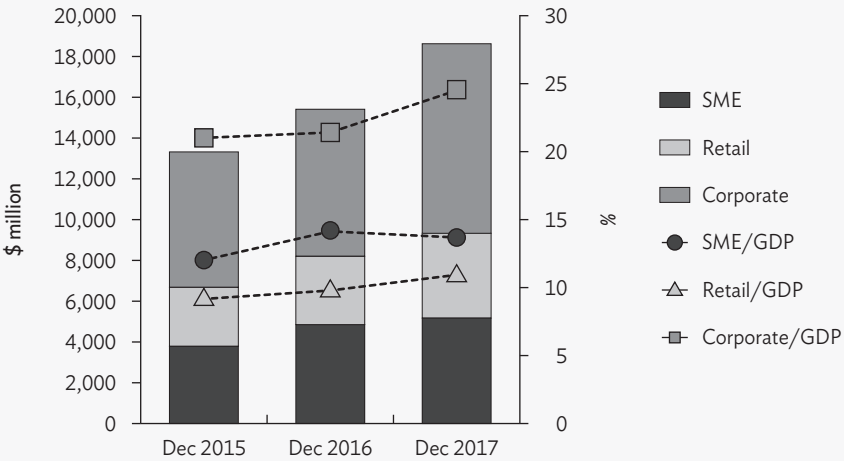
Source: National Bank of Georgia (2017).

Second, government programs require that a document confirming the existence of a current account be given to their beneficiaries, and microfinance organizations are not able to provide such a document. However, microfinance organizations do still provide financial assistance to SMEs. According to the statistics, SME, retail, and corporate loans (issued by commercial banks) have undergone an increasing trend year on year. As of December 2017, GEL18.5 billion (\$7.4 billion) had been issued by commercial banks (+20% compared to 2016). Loans issued to SMEs amounted to GEL5.3 billion (\$2.1 billion) (+7% compared to 2016). During the last 3 years, the proportion of SME loans in total loans ranged between 28% and 31%.

Notably, in 2016, the increase in SME loans was higher (+28% compared to 2015) than that in retail (+14%) and corporate (+9%) loans. However, in 2017, the growth rate for SME loans was 7%, which was below corporate (+28%) and retail (+25%) loans (Figure 3.6).

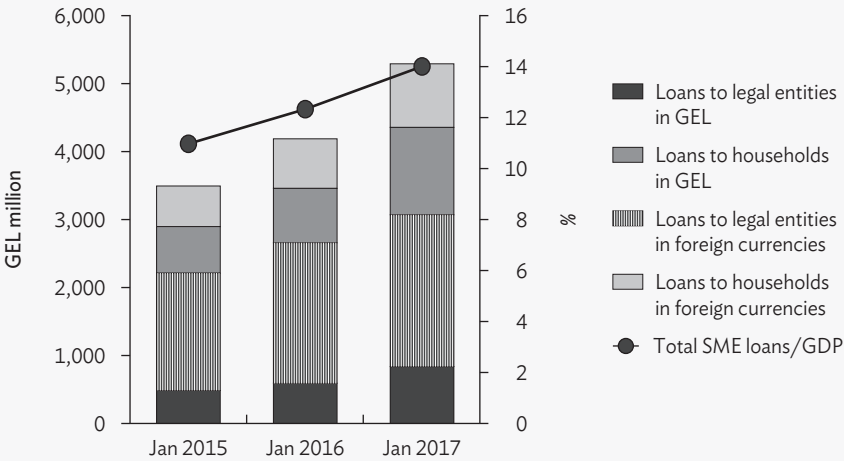
According to the statistics of the National Bank of Georgia, as of 2017, 42% (GEL2.2 billion [\$0.9 billion]) of SME loans were loans to legal entities in foreign currencies and 25% (GEL1.3 billion [\$0.5 billion]) were loans to households in lari. In recent years, the number of SME loans in Georgian currency have been increasing at a faster rate than those in foreign currency, which can be explained by the country's strategy of de-dollarization (larization). The proportion of total SME loans to GDP has increased since 2015. In 2017, the ratio of SME loans to GDP was 0.14 (Figure 3.7).

**Figure 3.6: Commercial Bank Loans by Segments**



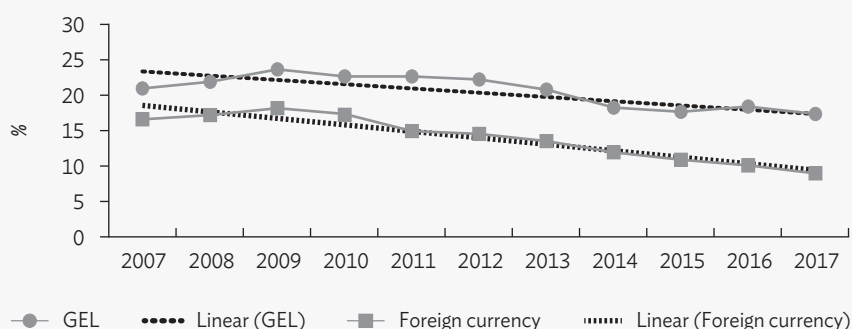
GDP = gross domestic product, SME = small and medium-sized enterprise.  
Source: National Bank of Georgia (2017).

**Figure 3.7: Commercial Bank Loans for SMEs (stocks)**



GDP = gross domestic product, GEL = Georgian lari, SME = small and medium-sized enterprise.  
Source: National Bank of Georgia (2018).

**Figure 3.8: Average Annual Interest Rate on Commercial Bank Loans, 2007–2017**



GEL = Georgian Lari.

Source: National Bank of Georgia (2018).

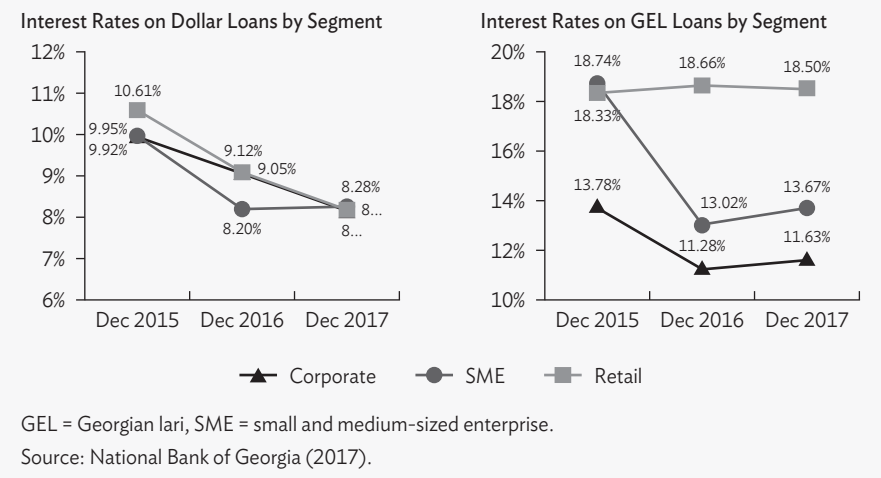
Interest rates on commercial banks' loans have declined since 2007. In 2017, the annual interest rate in domestic currency was 17.3%, which was one percentage point lower than the same indicator in 2016. The annual interest rate in 2017 on loans in foreign currency equaled 8.9%, which represented a decline of 1.1 percentage points compared to 2016 (Figure 3.8).

In 2017, the average interest rate for SME loans in GEL was 13.67%. The average interest rate for SME loans in foreign currency was 8.28%. In this period, the interest rate for SMEs in foreign currency was almost the same as the average interest rate for commercial banks' total loans. However, the interest rate for SME loans in GEL was 3.63 percentage points lower than the average interest rate in GEL for aggregated commercial banks' loans (Figure 3.9).

The interest rate for SME loans in dollars is higher than for retail and corporate loans, while the interest rate for loans in Lari is lower than the interest rate for retail loans and higher than the rate for corporate loans.

Georgia's partner countries and international organizations support the country's economic and social development through different projects. Existing programs entail capacity-building and funding projects. Importantly, financial assistance alone for SMEs is not enough for their development, so donor organizations also provide technical assistance (training, information sharing) to increase SMEs' knowledge of business management, funding opportunities, accounting, etc.

**Figure 3.9: Interest Rates on Lari and Dollar Loans by Segment**



In particular, the European Union supports SMEs’ development through the European Neighborhood Program for Agriculture and Rural Development (ENPARD) and the EU4Business program. Funding is also provided through the United Nations Development Programme, and the United States Agency for International Development (USAID) implements programs for SMEs’ development, such as Restoring Efficiency to Agriculture Production and Zrda Activity in Georgia. In addition, the Asian Development Bank, the Swiss Agency of Development and Cooperation, the Austrian Development Agency, the Danish International Development Agency, the International Fund for Agricultural Development, and the US Department of Agriculture are involved in financing Georgian SMEs.

**Donor Organizations**

The total amount of funding for SMEs through the years is difficult to calculate, but below are some of the programs implemented to support SMEs in the agricultural sector:<sup>12</sup>

- Through ENPARD,<sup>13</sup> the European Union supports agricultural and rural development in the country. This program consists of three phases and is being implemented during the period 2013–2022 with a total budget of €179.5 million.

<sup>12</sup> Ministry of Environmental Protection and Agriculture of Georgia. <http://mepa.gov.ge/Ge/InternationalProjects>.  
<sup>13</sup> <http://enpard.ge>

The first phase of ENPARD was implemented between 2013 and 2017 and concentrated on supporting the development of agricultural cooperatives in the country. Primarily, cooperatives were created in the following subsectors: apiculture, cereals, hazelnuts, viticulture, potatoes, vegetables, dairy, berries, etc. Although a significant amount of money (approximately GEL26 million) has been invested in the development of cooperatives, according to a survey conducted in 4 consecutive years (2014–2017), access to finance was still cited as the main constraint for such development (ISET 2017).

- Under the program EU4Business, the European Union supports eastern neighbors, including Georgia, in the development of their SMEs. According to the annual report (EU4 Business 2018), as of June 2018, the European Union had contributed €64.7 million. Access to finance programs cover 76% of its ongoing projects.
- Since 2013, USAID’s Restoring Efficiency to Agricultural Production program has been implemented to help input suppliers and new agribusinesses enter the market with funding of \$22.5 million (footnote 12).
- USAID’s Zrda Activity in Georgia has been implemented since 2013. It aims to stimulate Georgian MSMEs’ growth through grants, technical support, and training, and gives assistance to improve market links and find investment opportunities. \$14.7 million is to be spent for these purposes (footnote 12).
- The International Fund of Agricultural Development also provides support to Georgian agriculture. Its work in Georgia is directed toward increasing investments in the agricultural sector, increasing agribusiness participants’ access to international markets, and promoting sustainable rural development in the country.

Donor organizations are implementing projects countrywide, covering most regions and municipalities. Donors are more oriented toward increasing SMEs’ awareness and capacity in order to enter international markets, adapt to new technologies, and produce more competitive products on international markets.

### **3.1.3 | Key Aspects of the Country’s Financial Situation, Regulatory Framework, Tax Regime, and Financial Infrastructure**

#### **Financial Sector in Georgia**

Georgia was ranked 92nd among 183 countries in the International Monetary Fund’s financial development index, 80th in its financial institutions index, and 98th in its financial markets index (2013) (IMF 2016).

In the financial market development pillar of the World Economic Forum's Global Competitiveness Index 2017–2018, Georgia was ranked 63rd among 137 countries. Compared to 2010–2011, in 2017–2018 Georgia improved its position in every pillar of this index except for the financing through local equity market pillar. During the period 2010–2018, Georgia's position improved most in the legal rights index with a rise of 48 places.

The capital market in Georgia remains underdeveloped, as in 2016 the ratio of capital market assets<sup>14</sup> to GDP was 7% (Giucchi et al. 2018).

### **Georgia's Ranking in Ease of Doing Business**

Georgia was ranked 6th among 190 countries in the Ease of Doing Business ranking 2019. Among the 10 indicators of the Ease of Doing Business ranking 2019, Georgia's best result was in the starting a business indicator (2nd place) and protecting minority investors indicator (2nd place), while its lowest position was in the resolving insolvency indicator (60th place) and trading across borders indicator (43rd place).

Georgia's unfavorable position in the resolving insolvency indicator could be linked to SMEs' access to finance problem (Table 3.9). This represents an institutional risk for the financial sector, resulting in higher interest rates and higher collateral requirements. In addition, Georgia's 43rd place in trading across borders can be connected to the level of its SMEs' involvement in global value chains, which hinders their access to finance.

### **Georgia's Ranking in the Logistics Performance Index**

Georgia was ranked 124th among 167 countries in the Logistics Performance Index 2018. Among the six pillars of the index, Georgia's best results were in the infrastructure pillar (108th place) and customs pillar (109th place), while its lowest positions were in the logistics quality and competence (139th place) and tracking and tracing (130th place) pillars.

### **Tax Regime in Georgia**

In 2018, Georgia was ranked 22nd among 190 countries in the World Bank's Ease of Doing Business index's Paying Taxes indicator, representing a rise of 80 places since 2008 (102nd place). According to Forbes' 2009 Tax Misery and Reform index, Georgia was ranked 4th, putting it among the countries with the lowest tax burden in the world.

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<sup>14</sup> Capital market assets include bond and equity markets.

**Table 3.9: Georgia's Ranking in the Financial Market Development Pillar of the Global Competitiveness Index**

Indicator	Measure	Rank 2017–2018
Availability of financial services	The degree to which the financial sector provides the products and services that meet the needs of businesses	92
Affordability of financial services	The degree to which the cost of financial services (e.g., insurance, loans, trade finance) impedes business activity in Georgia	81
Financing through local equity market	The extent to which companies raise money by issuing shares and/or bonds on the capital market	131
Ease of access to loans	The degree of ease with which businesses obtain a bank loan	46
Venture capital availability	The degree of ease with which start-up entrepreneurs with innovative but risky projects obtain equity funding	80
Soundness of banks	The assessment of banks by representatives of micro, small, medium-sized, and large enterprises	64
Regulation of securities exchanges	The extent to which regulators ensure the stability of the financial market	102
Legal rights index	The degree of legal protection of borrowers' and lenders' rights	12

Source: World Economic Forum (2017).

Georgia has implemented numerous reforms in this direction since 2004. The tax system has been simplified, types of tax were reduced from 21 to 6 with several types eliminated (e.g., social tax, vehicle tax, natural resource tax, environment tax, tax on gambling),<sup>15</sup> and an electronic tax filing system for tax reporting has been introduced (IMF 2018).

Currently in Georgia there are six types of tax: income tax, profit tax, value-added tax (VAT), excise tax, property tax, and customs tax (Table 3.10).

For micro- and small businesses (with businesses categorized according to the Tax Code of Georgia's definition of enterprise size), there is a preferential tax regime.

<sup>15</sup> Tax Code of Georgia.



Microbusinesses in Georgia<sup>16</sup> do not pay income tax; however, there are some activities (25 in total) in which enterprises are not able to attain microbusiness status. In the agricultural sector, such activities include agricultural production that is done by tractors and combines. Moreover, trade activity is not permitted for microbusinesses unless the treatment and delivery of produced or purchased goods are carried out by the businessperson.

**Table 3.10: Types of Taxes in Georgia**

Type of Tax	2018
Income Tax	20%
Profit Tax	15%
VAT	18%
Excise	Various
Property Tax	1%
Customs Duties	Differentiated 0%, 5%, & 12%

VAT = value-added tax.  
Source: Revenue Service, Georgia.

According to the Tax Code of Georgia, for small businesses<sup>17</sup> income tax is 1%,<sup>18</sup> but where income exceeds GEL500,000 (\$200,000), a small business pays 3% income tax. If its income exceeds GEL500,000 (\$200,000) for 2 consecutive years, its small-business status expires.

For nearly 85% of products, Georgia has abolished import tariffs. From the previous 16 import tariff rates, only 3 remain (0%, 5%, and 16%). Import tariffs are set on 174 products, of which 119 are agricultural value chain products.

In 2017, the Estonian tax model was largely replicated in Georgia, according to which the existing profit tax was changed to tax on distributed profits. The rate of 15% remained; however, only the part of the profit that is distributed is taxable. These rules will not affect commercial banks, credit unions, insurance organizations, microfinance organizations, and pawnshops until January 2019.

<sup>16</sup> Microbusiness status—entrepreneurs (natural persons) who do not use hired labor, conduct economic activity independently, and have an annual gross income of up to GEL30,000.

<sup>17</sup> Small-enterprise status—entrepreneurs whose gross income from economic activity during a calendar year does not exceed GEL500,000.

<sup>18</sup> Tax Code of Georgia. <http://www.rs.ge/5393#>. From profit tax to distributed profit tax—retained profit tax is 0% from 2017.

In the agricultural sector there is a preferential VAT regime.<sup>19</sup> The following activities are exempt from VAT with the right of deduction:

- Supply of agricultural products produced in Georgia (other than eggs and chicken [*gallus domesticus*], that is, uncut, fresh, or frozen), before their industrial processing; and
- Supply of products obtained from goods fully made in Georgia (including chopped/minced meat), as well as the supply of cheese made as a result of industrial processing of products obtained from animals living in Georgia and also the supply of shell-less nuts.

Agricultural cooperatives profit from primary production (produced in Georgia) supply before their industrial processing is exempt from profit tax before 1 January 2023. Moreover, dividends and property (apart from land) of cooperatives are not taxed.<sup>20</sup>

## 3.2 Status of Financial Inclusion for SMEs

According to the World Bank definition, financial inclusion<sup>21</sup> for SMEs means having access to financial products and services that they need. This chapter analyzes the main indicators<sup>22</sup> that measure financial inclusion. According to the SME financial inclusion base set, three dimensions measure financial inclusion for SMEs (AFI 2015).

The first dimension measures SMEs' access to financial services through bank branches and payment services. According to the World Bank's Financial Access Survey, in 2015, the total number of branches of financial institutions (mainly commercial banks and microfinance organizations) amounted to 1,236 units. The number of commercial bank branches per 100,000 adults was around 32, and this indicator has increased every year. In 2017, the number of branches of banks and microfinance organizations per 1,000 enterprises was around 10.<sup>23</sup>

<sup>19</sup> Tax Code of Georgia.

<sup>20</sup> Tax Code of Georgia, Article 99.

<sup>21</sup> <https://www.worldbank.org/en/topic/financialinclusion>

<sup>22</sup> <http://www.worldbank.org/en/topic/financialinclusion/brief/how-to-measure-financial-inclusion>

<sup>23</sup> Authors' calculations from Bank of Georgia, Georgian Statistics Office of Georgia (2017). In 2017, 124,614 SMEs were operating in Georgia. The number of branches of commercial banks and microfinance organizations amounted to 1,331. Per 1,000 enterprises, the number of branches =  $1,331 \times 1,000 / 124,614 = 10$ .

The accessibility of financial services is also evaluated according to the number of ATMs in Georgia. In 2015, countrywide, there were 2,117 ATMs available in the country, which is around 70 machines per 100,000 adults (World Bank 2017).

The second dimension measures how SMEs use (GPFI 2016) financial services in terms of the frequency and duration of using such products. According to the data,<sup>24</sup> in 2015, 11,627 SMEs (12.9% of the total number) borrowed funding from commercial banks, microfinancing organizations, and other financial intermediaries. In the same period, SME deposits with commercial banks constituted 3.5% of the country's GDP.

Data analysis shows that access to, and usage of, financial services has increased every year, which means that the level of financial inclusion is improving. The representatives of financial institutions admitted in the interviews that they communicate with their clients and offer financial products other than loans that are more suitable for their businesses (see Appendix 3.1). Financial institution representatives admitted that awareness and usage of financial products increases every year.

### 3.3 Financial Literacy and Skills of SME Entrepreneurs

#### 3.3.1 | Assessments of Financial Literacy in Georgia

According to the European Investment Bank (EIB 2016), the level of financial literacy of Georgia's SMEs hinders them from using financial products efficiently. In Georgia, an assessment of financial literacy for SMEs has not been conducted yet; however, in 2016, the National Bank of Georgia did an assessment of the financial literacy of Georgia's population by using OECD methodology (OECD 2016a).

Georgia ranked 24th among 30 countries in financial literacy (2016) (OECD 2016a). The financial literacy score of the Georgian population above the age of 18 was 12.3 out of 21 (58.8 on a 100-point scale) (National Bank of Georgia 2016b).<sup>25</sup> This is lower than the OECD average of 13.7. This is an intermediate outcome, indicating that in Georgia there is a need to improve financial literacy.

<sup>24</sup> World Bank's Financial Access Survey.

<sup>25</sup> The research was done using OECD methodology.

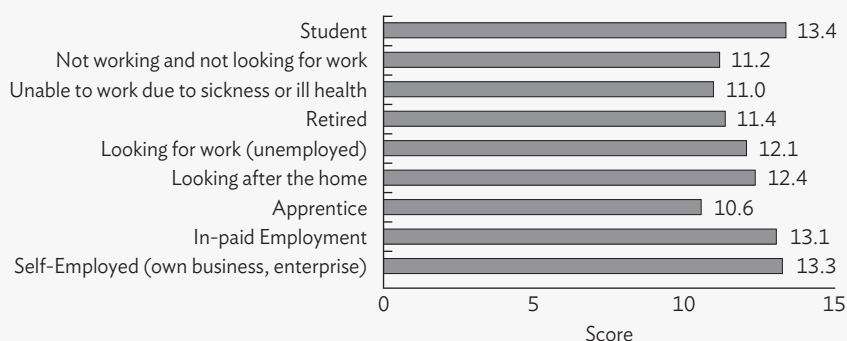
The financial literacy score is obtained through a combination of measuring knowledge, behavior, and attitude. In Georgia, the distribution of scores for these three components was as follows:

- Financial knowledge:<sup>26</sup> Georgia was ranked 17th among 30 countries, with a score of 4.5 out of 7 (OECD average—4.9).
- Financial behavior:<sup>27</sup> Georgia was ranked 27th among 30 countries, with a score of 5 out of 9 (OECD average—5.4).
- Financial attitude:<sup>28</sup> Georgia was ranked 27th among 30 countries, with a score of 2.8 out of 5 (OECD average—3.4).

### Financial Literacy Scores by Employment

Financial literacy scores vary according to employment status. Overall, employed people attained higher financial literacy scores than unemployed people. The highest financial literacy score was attained by students (13.4). An above average financial literacy score of 13.3 was also attained by self-employed people, which included people running their own businesses. Although the financial literacy score of self-employed people was high compared to the other groups, it is still not particularly high (Figure 3.10).

**Figure 3.10: Financial Literacy Scores by Employment**



Source: National Bank of Georgia.

<sup>26</sup> Financial knowledge measures populations' knowledge of financial concepts (e.g., simple and compound interest rates, risk, return, inflation) and ability to apply numeracy skills in financial situations.

<sup>27</sup> Financial behavior measures the extent to which people behave in financially literate ways, e.g., the decision-making process before buying, paying bills on time, long-term financial goals, saving, budgeting, shopping around for financial products, and making ends meet.

<sup>28</sup> Financial attitude assesses attitudes about money and planning for the future.

The National Bank of Georgia's study (2016a) showed that only 11.7% of Georgia's population is business-minded, meaning that they distribute income, make savings, set long-term financial goals, and take rational risks. The problems of business-minded entrepreneurs were also outlined during the interviews. Representatives of government and financial institutions admitted that some Georgian SMEs do not have long-term goals and concentrate on short-term investments, take irrational risks, and have unrealistic expectations. However, some interviewees mentioned that SMEs' financial literacy level is improving every year.

### 3.3.2 | Financial Education Strategy in Georgia

Improving financial literacy among SMEs is one of the priorities of the SME Development Strategy of Georgia 2016–2020 under the strategic direction Improvement of Access to Finance. To achieve this, educational programs based on market needs have to be elaborated and training has to be conducted. In this process, together with the Ministry of Economy and Sustainable Development of Georgia, the National Bank of Georgia is involved.

Although, in Georgia, a strategy for financial education for SMEs has not been created yet, the National Strategy for Financial Literacy in Georgia was elaborated by the National Bank of Georgia (National Bank of Georgia 2016b). The aim of the strategy is to improve the financial literacy levels of the Georgian population to enhance their financial well-being and to protect their rights.<sup>29</sup>

The main focuses of the strategy are the following:

- raising awareness of the benefits of financial education;
- enhancing coordination and collaboration among stakeholders; and
- extending opportunities to learn.

The strategy covers the whole population of Georgia, although the following higher-need target groups have been identified:

- the young generation—pupils and students;
- unemployed people;

<sup>29</sup> The information given in this chapter is based on the National Strategy for Financial Literacy in Georgia. [https://www.nbg.gov.ge/uploads/publications/financial\\_literacy\\_strategy/finlit\\_strategy\\_eng.pdf](https://www.nbg.gov.ge/uploads/publications/financial_literacy_strategy/finlit_strategy_eng.pdf).

- people employed by large companies and organizations;
- rural population; and
- people facing special life events.

Under this strategy, the National Bank of Georgia cooperates with the Ministry of Education, Science, Culture, and Sports of Georgia, the Administration of the President of Georgia, commercial banks, microfinance organizations, donor organizations, and educational institutions. Programs implemented under the National Strategy for Financial Literacy are as follows:

- SchoolBank project
- Brochures and videos
- Financial football
- Training in Georgian armed forces
- Video and web banners about mortgage loans
- Financial literacy program for migrants

Among the target groups of this strategy, SMEs are not represented; however, recently the National Bank of Georgia has been focusing on SMEs' financial education. The National Bank of Georgia has implemented the two following programs to increase SMEs' level of financial literacy:

- **Brochure: Improve Your Financing Decisions.**<sup>30</sup> The National Bank of Georgia together with the European Fund for Southeast Europe produced brochures for small businesses, covering the following topics: how to assess the risks and opportunities of borrowing in foreign currency; ascertaining how much risk one can afford to take; the impact on their cash flow; and the impact on their profit, loss, and equity. These brochures are accompanied by a cash flow tool, a debt service ratio tool, and a balance sheet tool. These practical tools were created to help small businesses when taking financial decisions. The brochures were distributed among financial institutions and universities to be accessed by small businesses.<sup>31</sup>

<sup>30</sup> [https://www.nbg.gov.ge/uploads/publications/efse/EFSE\\_broschure\\_eng.pdf](https://www.nbg.gov.ge/uploads/publications/efse/EFSE_broschure_eng.pdf)

<sup>31</sup> <https://www.nbg.gov.ge/cp/index.php?m=550&newsid=1564&lng=eng>

- **Financial Education Program for Micro and Small Enterprises.**<sup>32</sup>

The National Bank of Georgia together with the European Fund for Southeast Europe and the Export Development Association has implemented a financial education program for micro and small enterprises. Books for micro and small enterprises will help them take financial decisions, and obtain information about sources of funding and financial services. Training was conducted with micro and small enterprises in the Samtskhe-Javakheti and Kvemo Kartli regions. Approximately 80 micro and small businesses were trained.<sup>33</sup>

The representatives of micro and small businesses were able to acquire both theoretical and practical knowledge. Moreover, training for trainers was also conducted. The National Bank of Georgia plans to continue this process and to cover other regions of Georgia.

Each program has its own evaluation methods. Primarily, the programs whose target groups were the young generation and SMEs have been evaluated based on pre- and post-test results. Videos and web banners have been evaluated based on the number of views. The overall evaluation of the strategy is expected to be conducted after 2021.

### 3.4 Barriers to SME Finance

The SME sector is increasing in Georgia; however, according to the SME Development Strategy of Georgia 2016–2020, limited access to finance is the main problem hindering SMEs' competitiveness. According to the World Bank's Enterprise Survey 2013, 20.9% of firms listed access to finance as the main obstacle for their operations. The Global Competitiveness Index also lists access to finance as the second most problematic factor with regard to doing business in Georgia (WEF 2017).

Barriers to finance can come from both the supply and the demand side. The regulatory framework, institutional aspects, and gender and cultural issues can also be barriers limiting access to finance. Barriers listed in this chapter are derived from existing studies and opinions of government representatives, financial institutions, donor organizations, and field experts.

<sup>32</sup> [https://www.nbg.gov.ge/uploads/fin\\_ganatl\\_mewarm/mikroda\\_mcire.pdf](https://www.nbg.gov.ge/uploads/fin_ganatl_mewarm/mikroda_mcire.pdf)

<sup>33</sup> The National Bank of Georgia plans to expand this number and cover more regions.

## Barriers from the Supply Side

The supply side is represented by banks and microfinance organizations, the government, donor organizations, and other funds that provide finance for SMEs. In Georgia, one of the main sources of SMEs' finance is financial institutions, especially commercial banks and microfinance organizations; therefore, supply-side barriers are related to financial institutions' loans and other services. Access to finance barriers related to financial institutions are listed below:

- **Limited financing channel other than banking.** The capital market is underdeveloped in Georgia. The main sources of financing for SMEs are commercial banks and microfinance organizations. Moreover, there is a duopoly in the banking sector. The lack of competition in the financial market results in unfavorable conditions (high interest rates, high collateral requirements, limited financing opportunities) for SMEs.
- **High collateral requirements.** In 2017, 58% of legal entities' loans were secured by collateral. According to the findings of the 2016 OECD report, ENPARD cooperative research,<sup>34</sup> and expert opinions, financial institutions require high collateral for SME loans. According to one study (Hanedar, Broccardo, and Bazzana 2014), Georgia was first among less-developed countries (e.g., Albania, Kazakhstan, Hungary, Ukraine, Estonia, Azerbaijan, Moldova, Belarus, etc.), with a 228% average collateral-to-loan ratio.<sup>35</sup> However, high collateral requirements are problematic, especially in the agricultural sector, where real estate's contribution is insufficient because of its low and volatile price across rural areas of Georgia. However, representatives of financial institutions admit that collateral requirements are not the main drivers of decisions to fund SMEs. Some of the interviewed financial sector representatives claim that solvency, income/expenditure, a company's leverage, and quality of servicing loans are more important aspects. Another reason for high collateral requirements is insolvency and bankruptcy risks. Those risks increase expected costs for financial institutions, resulting in higher collateral requirements.
- **High interest rates.** According to the World Bank Enterprise Survey (2013), interest rates are one of the main factors leading Georgian SMEs not to apply for financial institutions' loans. In addition, in the recently conducted value chain analyses by the PMC Research Center (2018a), value chain participants admitted that interest rates for financial products remain high.

<sup>34</sup> Association of Young Economists of Georgia.

<sup>35</sup> Turkey had the lowest (120%) average collateral-to-loan ratio. Real estate can be considered as collateral.



In 2016, the average interest rate charged to SMEs in OECD countries varied from 1.5% to 5.5%, except for three countries with an interest rate of around 9.5% (OECD 2018), while interest rates charged to SMEs in Georgia were 13% in lari loans and 8% in dollar loans. From the perspective of financial institutions, interest rates correspond with the risks characterizing the sector. A volatile exchange rate, a lack of financial education among SMEs, and a lack of experience among SMEs all increase the risks that result in higher interest rates.

- **Limitations for start-ups.** Establishing a new business is associated with higher risks due to a lack of experience in the sector, higher dependence on cost-benefit projections, and the risk of the entrepreneur having unrealistic expectations. Therefore, financial institutions support start-ups more cautiously and financing covers only specific sectors. Some of the financial institutions support start-ups in the agricultural sector, but only for highly productive agricultural fields (such as animal breeding). Others support start-ups in the tourism sector (e.g., hotels). When financing start-ups, financial institutions study the experience of the start-upper (the start-upper might not have entrepreneurial experience in this sector, but may have been employed in this sector for a long time) and require the start-upper's financial contribution.
- **Insufficient knowledge of regional loan officers in agriculture.** According to the evaluation of the state program Preferential Agrocredit, farmers complain about a lack of agricultural professionals and knowledge of agricultural specifications in commercial banks' regional offices. According to the interviews conducted in our study, representatives of financial institutions do not deny the merits of these complaints. However, some respondents did claim they have agricultural experts in their branches, who are locals and know the agricultural potential of the region/village as well as the particular entrepreneur. In addition, the OECD report states that regional loan officers are unable to assess SMEs' risks (OECD 2016b).

Supply-side barriers related to the government are as follows:

- **Access to information about government programs.** The government is implementing many programs supporting SMEs; however, according to the interviews, some potential beneficiaries do not have information about these programs. In addition, there is a lack of information about the existence of state programs that give SMEs the opportunity to combine resources of different programs in order to finance their businesses.
- **Land fragmentation.** Land fragmentation is a problematic issue for SMEs that apply for government programs, because some programs have minimum requirements for the size of the area.

Supply-side barriers from SMEs' service providers:

- **Consulting.** In order to apply for state projects or loans from financial institutions, SMEs should develop business plans. Entrepreneurs might have profitable business ideas but are unable to develop them and obtain financing. Therefore, consulting companies can help SMEs to develop business plans. Consulting services are not free of charge, however the expected benefit for the business could exceed the cost.

According to the interviews with government representatives and field experts, there are three main constraints in this regard. First, there is a lack of qualified consulting companies. Second, SMEs do not have information about consulting companies, so they develop business plans on their own, or do not apply for the projects at all. Third, the agency Enterprise Georgia provides assistance to the program beneficiaries in developing business plans; however, only a few beneficiaries use this service.

## Demand Side

The demand side refers to SMEs and the aspects that hinder their access to finance. Demand-side barriers are as follows:

- **Financial literacy.** According to the studies and interviews, the level of financial literacy of Georgian SMEs hinders them from using financial products efficiently (detailed information is given in Section 3.3).
- **Low management skills.** According to the interviews, a lack of management skills hinders SMEs' development in terms of accessing finance. Some Georgian SMEs are unable to manage resources (including financial resources) and stocks effectively. These cases are assessed as risky by financial institutions, resulting in requests for high collateral and higher interest rates. Low management skills become more problematic when businesses are expanding.
- **Lack of formal relationships (e.g., contracts).** A set of Georgian agricultural value chain researches conducted by the PMC Research Center (2018a, 2018b, 2018c) showed that value chain participants mainly have informal relationships with each other. This means that, when applying for a loan, SMEs are unable to prove their involvement in value chains. According to the interviews, representatives of financial institutions stated that formal relationships within a value chain can improve SMEs' access to finance.

- **Challenges in financial reporting.** One of the main constraints for SMEs in accessing finance is financial reporting. On the one hand, this makes financial services and products more expensive, because banks have to assess SMEs' finances themselves. On the other hand, a lack of financial reporting could be a reason for a loan application being rejected.
- **Lack of experience and knowledge.** According to the interviews, the following issues can be grouped under this barrier:
  - Farmers do not have information about new technologies, and therefore productivity stays low;
  - A lack of agricultural specialists means SMEs have to hire foreign experts to manage processing or other issues. This labor force is very expensive, resulting in higher costs; and
  - Farmers do not know about domestic and foreign market requirements. They do not have information about prices, demands on the markets, or standards and regulations of foreign markets.

Financial institutions consider SMEs' experience and knowledge when issuing loans; therefore, shortcomings in this regard can reduce SMEs' access to finance.

## Other Barriers

Besides supply- and demand-side barriers, interviewees outlined some additional barriers, such as:

- **Infrastructural constraints.** Access to sources of communication, such as the internet, represents a barrier for SMEs in obtaining information about government programs, or financial institutions' and donor organizations' products and services, or in finding possible partners within value chains.
- **Land registration.** Since 1992, agricultural land registration reform has been implemented periodically. However, according to a recent policy document, (ISET 2018) land registration reform has not been implemented with a systemic approach, and the reform has faced many challenges, such as problems with documentation, controversy about land size and boundaries, infrastructural problems, and a lack of land measurement professionals. Unregistered land cannot be taken as collateral; therefore, problems in land registration also hinder SMEs' access to finance.
- **Regulations in the financial sector.** To reduce the level of indebtedness in Georgia, and to protect borrowers' rights, the government has adopted several laws and regulations (for details, see Khishtovani 2018) relating to retail loans.

The main principle of the regulations is that a financial institution shall not issue a consumer loan without undertaking detailed analysis of the consumer's solvency. The thresholds for maximum payment-to-income ratios and maximum loan-to-value ratios have been set. Moreover, the maximum annual effective interest rate on consumer loans has been reduced from 100% to 50%.<sup>36</sup> The above-mentioned laws and regulations are expected to decrease the financial sector's retail loan portfolio. Although these regulations are being imposed on retail loans, they could affect the SME sector, especially SMEs in the agricultural sector. In the agricultural sector, the majority of farmers are not registered as legal entities and, when demanding finance, they apply for retail loans. As their businesses are not registered, they are not able to declare their income, making it difficult for them to get financing. Impact assessments of these regulations have not been conducted.

- **Restrictions of microfinance organizations.** As microfinance organizations are not eligible to participate in government programs, commercial banks are the only source that can enable SMEs to participate in programs the government offers in collaboration with financial institutions.
- **Regulations for the owning of agricultural land by foreign citizens.** According to the new state constitution, from 16 December 2018, foreigners cannot own agricultural land in Georgia.<sup>37</sup> These new regulations are expected to have a negative effect on the agricultural sector's development in Georgia, and foreign direct investments in the agricultural sector and the price of agricultural land are expected to decline. When applying for loans in financial institutions, SMEs in the agricultural sector use agricultural land as collateral, and often the value of land is insufficient to cover the demanded collateral requirements. Due to the new regulations, the value of agricultural land is expected to decline even more and, therefore, the problems faced by SMEs in trying to access finance are expected to worsen. An impact assessment of this regulation on the SME sector has not been conducted.

According to field research, in Georgia, there are no gender-related barriers obstructing access to finance. Both genders have equal opportunities to obtain loans from financial institutions and to get finance from government-initiated programs.

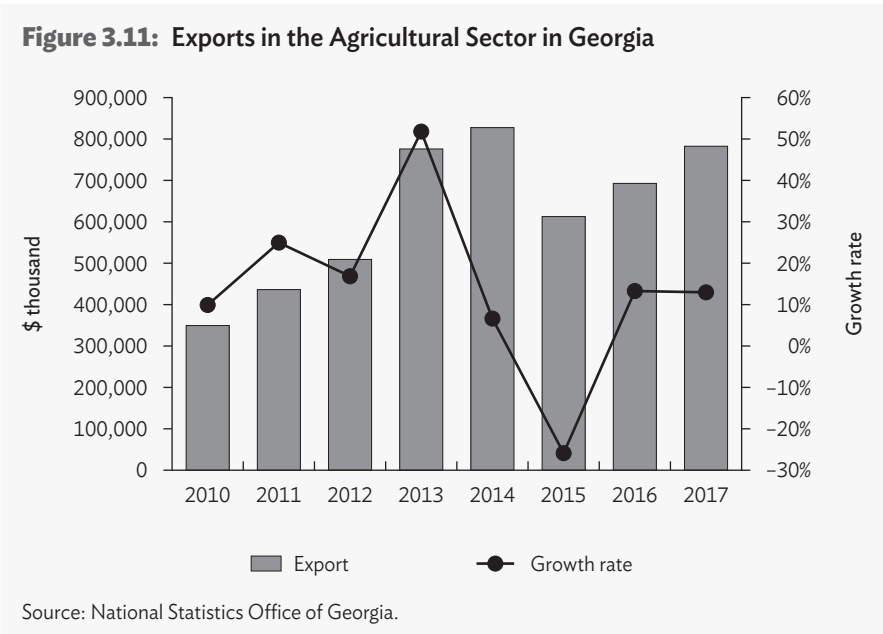
<sup>36</sup> Civil Code of Georgia, 625.

<sup>37</sup> <https://matsne.gov.ge/en/document/view/30346?publication=35>, Article 19.

### 3.5 Status of the Agricultural Sector’s Value Chain in Georgia

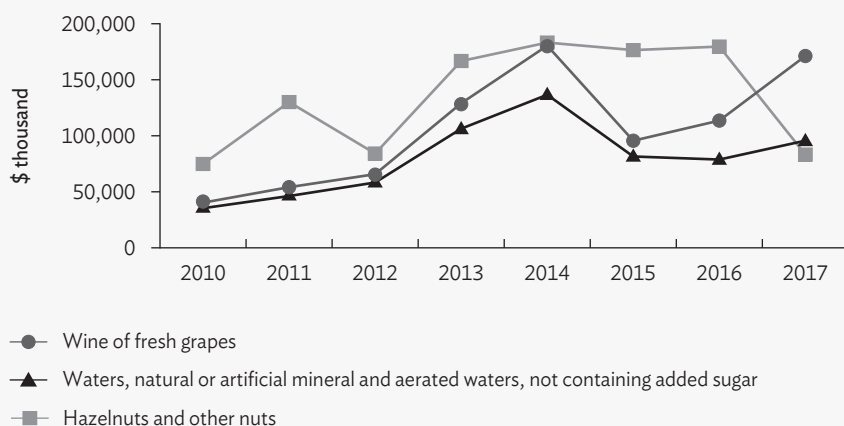
#### 3.5.1 | Current Situation Analysis

In 2017, Georgia exported agricultural products<sup>38</sup> worth \$783 million.<sup>39</sup> During 2010–2017, with the exception of 2015, the export of agricultural products increased (Figure 3.11).



In 2017, according to Harmonized System commodity codes, the majority of exported goods were in the following categories: beverages, spirits, and vinegars (53.3% of agricultural product exports); edible fruit and nuts, citrus or lemon peel (13.7% of agricultural product exports); and tobacco and manufactured tobacco products (6.6% of agricultural product exports) (Figure 3.12).

<sup>38</sup> According to Harmonized System commodity codes 01–24.  
<sup>39</sup> According to commodity groups—Animal and animal products, Vegetable products, and Foodstuffs.

**Figure 3.12: Georgia's Exported Products**

Source: National Statistics Office of Georgia.

Wine, water, and hazelnuts are the three main agricultural products that Georgia exports in large volumes (13% of all exports and 45% of agricultural value chain products exported in 2017). The share of these products in agricultural value chain products exported ranged between 50% and 60% during 2013–2016; however, in 2017 the share amounted to 45%, mainly due to the decreased volume of exported hazelnuts (Box 3.1). While the volume of exported wine and water increased in 2017 compared to 2016 (by 50.9% and 20%, respectively), the volume of exported hazelnuts decreased by 53.7%.<sup>40</sup>

Besides the main exported agricultural products, in their interviews, field experts outlined several products that have the potential to penetrate domestic and global value chains in the near future. The products they named included berries, almonds, and kiwi fruit. According to recent research, tea, fresh and processed fruit and vegetables, honey, flavoring, dried fruit, water, and alcoholic and nonalcoholic beverages were identified as being competitive on international markets (Ministry of Economy and Sustainable Development 2016).

<sup>40</sup> This decrease can be explained by Asian Parosana and fungal diseases, which decreased the quantity and quality of Georgian hazelnuts.

**Box 3.1: Hazelnut Sector in Georgia**

The Ferrero Hazelnut Company's (AgriGeorgia) entry into Georgia's market in 2007 boosted the development of the hazelnut sector in the country and enabled its inclusion into the global value chain. Ferrero purchased land in Samegrelo-Zemo Svaneti for hazelnut tree plantations and built manufacturing facilities, thereby becoming one of the largest employers in the Samegrelo-Zemo Svaneti region. The company brought to Georgia expertise on the growing of hazelnuts as well as modern manufacturing methods and technologies. New technologies and expertise helped local farmers to improve the quality of production, which led to Ferrero purchasing hazelnuts from local, Georgian producers. AgriGeorgia provides support through consultations, training, machinery, and seedlings to enterprises that wish to improve their hazelnut production.

It can be concluded that Ferrero's entry into Georgia made local hazelnut production profitable and placed Georgia's hazelnut production into the global value chain. Therefore, this addition to Georgia's market reduced the risks for local financial institutions in supporting this sector and thereby increased hazelnut producers' access to financing.

Before Ferrero entered the country, Georgia exported hazelnuts in very small amounts—in 2006, the value was \$56.6 million, while in 2016, export value reached \$179.7 million.

Currently, in Georgia, along with large enterprises, SMEs are actively involved in the global hazelnut value chain. Relationships among value chain participants are mainly formal. Georgian producers' exports are not limited to primary production of hazelnut and include manufactured production as well, such as hazelnut flour and butter.

According to the Global Competitiveness Index 2017–2018, in Georgia, companies' presence in value chains is low as Georgia was ranked 75th among 137 countries in the value chain breadth indicator. According to the index, the quantity and quality of local suppliers are also low and clusters have not been developed.

The structure of the value chain can vary across sectors. The general structure of the agricultural value chain in Georgia can be seen as follows (FAO 2008):

**Main participant**

- Input suppliers (intermediate goods)
- Primary production
- Distribution
- Storage
- Processing
- Retailers
- Exporters

### Supporting actors

- The Government of Georgia (e.g., the Ministry of Environmental Protection and Agriculture of Georgia, the Ministry of Economy of Georgia)
- Financial institutions (banks, microfinance organizations, insurance companies)
- Extension and educational institutions
- Associations (farmers, processors, etc.)
- Donors and other nongovernmental organizations
- Export logistics (transport, documentation, etc.)

To assess the status of domestic and global value chains for agricultural products, this chapter reviews the status of each value chain participant in Georgia.

**Input suppliers:** Inputs for primary production are supplied by agromarkets or nurseries. According to research conducted by the PMC Research Center (2018b), the quality of supplied inputs is quite low, which results in low productivity and low product quality. Inputs are imported for some agricultural products (PMC Research Center 2018c) for two main reasons. First, local production of inputs is not developed<sup>41</sup> in the country, and second, local farmers prefer to buy imported raw materials, because of their higher quality. Crucially, there is a lack of certified nurseries in Georgia.

**Primary production:** Due to land fragmentation,<sup>42</sup> there are many small producers in Georgia. According to the interviews, Georgian farmers mainly sell their products in local markets, directly or through intermediaries (e.g., collectors, distributors, processing enterprises). Relationships between farmers and intermediaries are mainly informal.

**Storage and processing:** There is a lack of storage and processing enterprises in Georgia (PMC 2018c). The products are mainly sold fresh. Respondents admitted that the existing storage and processing enterprises are unsatisfied with the quality and price of products offered by farmers. In addition, there is a lack of specialists in the management of storage and processing enterprises.

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<sup>41</sup> Only two beneficiaries used the state program “Plant the Future” for nursery gardens during 2015–2017.

<sup>42</sup> The average area of land plots is 1.4 hectares (geostat.ge).



**Retailers and exporters:** Agricultural products are mainly sold in agrarian markets and in supermarkets in Georgia and in foreign countries. The relationships between farmers and local agrarian markets are direct or through intermediaries, while local supermarkets are mainly connected with intermediaries. Intermediaries export products on their own or through exporters.

According to the field research results, the level of communication between different participants of the agricultural value chains in Georgia is low and the level of participation of SMEs in the value chains also remains low. In Georgia, large firms are trying to create their own chains, which could be classified as supply chains. The relationships between value chain participants are mainly informal (EBRD 2013).

Furthermore, the PMC Research Center conducted a set of value chain analyses<sup>43</sup> on agricultural products, such as mandarins, raspberries, broccoli, tomatoes, peaches, walnuts, onions, laurels, potatoes, trout, blackberries, and carrots. These products were chosen based on their potential in domestic and international markets. The analyses showed that the value chains are not fully functional for these products. According to the studies, value chain participants face challenges that prevent them from increasing the value added in the chain and reduce products' competitiveness. These challenges include a lack of qualified workforce, a lack of processing facilities, a lack of industry specialists, a lack of coordination among value chain participants, underdeveloped nurseries, a lack of refrigeration facilities and technologies, a low diversity of the export markets, and a lack of knowledge and motivation among farmers to adopt innovations.

To sum up, the Georgian agricultural sector's value chains face many challenges. By strengthening each actor of the value chain, the productivity of products might improve.

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<sup>43</sup> [http://research.pmcg-i.com/index.php?option=com\\_k2&view=itemlist&layout=category&task=category&id=37&Itemid=137&lang=eng](http://research.pmcg-i.com/index.php?option=com_k2&view=itemlist&layout=category&task=category&id=37&Itemid=137&lang=eng)

## 3.6 Value Chain Financing Analysis

Value chain finance refers to the flow of financial resources within the chain to provide participants with the necessary funds for efficient production, for the reduction of risks, and to develop the chain (FAO 2010a).

### 3.6.1 | Availability and Development of Value Chain Financing in Georgia

Links between value chain participants can be direct or indirect, depending on the length of the chain. Programs implemented by the government, donor organizations, and financial institutions finance different value chain actors. Table 3.11 lists value chain actors with relevant institutions' programs that are financially and technically supporting their development.

**Table 3.11: Value Chain Actors and Relevant Financing Programs**

Value Chain Participant	Supporting Program
Input suppliers	<ul style="list-style-type: none"> <li>• Government program <i>Plant the Future</i></li> <li>• Financial institutions</li> </ul>
Primary production	<ul style="list-style-type: none"> <li>• Government program <i>Plant the Future</i></li> <li>• Government program <i>Program of Agroproduction Promotion</i></li> <li>• Government program <i>Agroinsurance</i></li> <li>• Financial institutions</li> </ul>
Distribution	<ul style="list-style-type: none"> <li>• Financial institutions</li> </ul>
Storage (warehouses, coolers, dryers)	<ul style="list-style-type: none"> <li>• Government program <i>Preferential Agrocredit</i></li> <li>• Government program <i>Cofinancing of Agro Processing and Storage Enterprises</i></li> <li>• Government program <i>Program of Agroproduction Promotion</i></li> <li>• Financial institutions</li> </ul>
Processing	<ul style="list-style-type: none"> <li>• Government program <i>Preferential Agrocredit</i></li> <li>• Government program <i>Cofinancing of Agro Processing and Storage Enterprises</i></li> <li>• Government program <i>Program of Agro-production Promotion</i></li> <li>• Government program <i>Produce in Georgia</i></li> <li>• Financial institutions</li> </ul>
Retailers	<ul style="list-style-type: none"> <li>• Financial institutions</li> </ul>
Exporters	<ul style="list-style-type: none"> <li>• Enterprise Georgia – Export support</li> <li>• Financial institutions</li> </ul>

Source: Agricultural Projects' Management Agency (APMA), Enterprise Georgia.

**Input suppliers:**<sup>44</sup> The government program Plant the Future cofinances and provides technical assistance<sup>45</sup> to beneficiaries making nursery gardens.<sup>46</sup> Financial assistance here entails cofinancing 50% of the total project to make a nursery garden, but the amount should not exceed GEL150,000 (\$59,790) for each beneficiary.

**Primary production** (footnote 44): The Plant the Future program provides financial and technical assistance in arranging perennial gardens. The program provides 70% cofinancing in purchasing seeds and saplings, and no more than 50% (not more than GEL2,500 [\$997] per hectare) cofinancing for installing drip irrigation systems. This program is mainly focused on fruits, nuts, and berries. This component is much more popular than the nursery gardens component. During 2015–2017, 658 projects were financed by GEL22.3 million (\$8.9 million) and the number of beneficiaries is increasing every year.

Another APMA program, Program of Agroproduction Promotion, cofinances smallholder farmers and agricultural cooperatives operating in primary production with 40% of the total project amount, while the other 60% is cofinanced by the beneficiary. Smallholder farmers can get funding up to \$15,000 equivalent in lari. In the case of cofinancing cooperatives, the amount depends on the number of members (no more than \$15,000 equivalent in lari for each member).

The government program, Aggroinsurance, covers the risks of hail, flood, storm, and autumn frost (only for citrus crops). Program beneficiaries can insure up to five hectares of agricultural land and, in the case of cereals, up to 30 hectares. Beneficiaries receive 70% cofinancing for each crop under this program but, in the case of wine, only 50%. Currently the program does not cover all agricultural products, e.g., honey production and livestock are not insured. Moreover, the program does not cover risks other than climate risks in agriculture, such as biological, price, and institutional risks.

**Distribution:** Logistics is not financed under government programs. However, according to the interviews, commercial banks and microfinancing organizations provide loans to distribution companies.

<sup>44</sup> Agricultural Projects' Management Agency (2016).

<sup>45</sup> Technical assistance means conducting training for beneficiaries in plant propagation, and certification of planting material.

<sup>46</sup> According to APMA data, this component is not popular with beneficiaries. Since 2015, only two beneficiaries were financed in the Samegrelo–Zemo Svaneti region.

**Storage (warehouses, coolers, dryers)** (footnote 44): APMA implements several projects with regard to developing storage enterprises. One of these projects entails 40% cofinancing of storages, on the condition that cofinancing of legal entities (including cooperatives) must be a maximum of \$100,000 equivalent in lari. Cofinancing can be applied to modernize existing storages, to arrange new ones, to purchase new equipment, and to implement modern standards for certification.

The agency implements another project cofinancing the development of storage enterprises through three sources: first, 40% cofinancing, up to GEL600,000 (\$239,174); second, preferential credit or leasing, cofinancing up to 50% (maximum GEL1.5 million [\$597,934]); and third, a contribution of at least 10% from the beneficiary in enterprise capital. Notably, every entrepreneur who qualifies for the required scheme and provides the necessary information to the agency gets funding without competition from other applicants. Meanwhile, storages can be financed by preferential agrocredit for fixed assets. The amount of funding ranges between GEL20,000 (\$7,972) and GEL1.5 million (\$597,935). The agency subsidizes loan interest rates for up to 66 months, at 11% of the total amount annually. This program includes agroleasing as well.

**Processing** (footnote 44): Processed goods accumulate a higher value within the country. APMA finances agroproduction through three programs: preferential agrocredit, promotion of agroproduction, and cofinancing of agroprocessing enterprises. These projects mainly entail the establishment of processing enterprises through cofinancing. Cofinancing of agroprocessing enterprises provides financial and technical assistance to establish new enterprises. Promoting agroproduction includes 40% cofinancing of no more than \$100,000 equivalent in lari per project. Preferential agrocredit provides cofinancing under several components of the project.

The government program Produce in Georgia provides credit and leasing to establish new enterprises and to expand existing ones. The amount of credit in the program varies between GEL150,000 (\$597,935) and GEL5 million (\$1,993,116). For the first 24 months of the program, interest rates are cofinanced by the government.

**Retailers:** APMA is not aiding this part of the value chain; however, financial institutions are providing services for retailers. A representative of one of the leading financial institutions admitted in the interview that retail is one of the leading sectors that this financial institution is financing.

**Exporters:** This part of the value chain is one of the least developed in the agricultural sector. Leading commercial banks are financing trade and export through several products (**loans, factoring, letters of credit and guarantees**); however, SMEs' knowledge of these products is very low and they are consequently unpopular. Donors and international organizations consider trade financing to be an important tool for SMEs' development. For example, the EBRD launched a new project, Trade Ready to support SMEs' trade finance<sup>47</sup> and to provide business advice in the process.

Enterprise Georgia also supports SMEs involved in exports. The agency works in two directions—export promotion and export development. Export promotion entails the organization of international exhibitions and trade missions and connecting Georgian producers with foreign partners. Meanwhile, export development means providing information about customs tariffs in international markets and export procedures in Georgia, and providing training for export managers.<sup>48</sup>

Since 2012, agriculture has been identified as one of Georgia's priority sectors and agricultural value chain development has been earmarked as one of the priority actions for the country (Ministry of Agriculture of Georgia 2015). The set of agricultural programs implemented during the last 6 years reflects the sector's importance. However, links between value chain actors are not strong yet. Financial institutions are also involved in value chain creation and, according to the interviews, financial institutions connect their clients to each other to promote communication and partnership within value chains. For example, they connect input suppliers with producers, or processing companies with logistics; additionally, they allocate finances to develop these linkages and value chains.

### 3.6.2 | Comparison with Best Practices

The FAO suggests two methods of value chain financing (FAO 2010a):

- Internal value chain financing
- External value chain financing

<sup>47</sup> The project will equip SMEs with knowledge of international markets, financial products used for trade financing and attracting investments through improved financial accounting, preparing business plans, etc. They developed a tool, *trade passport*, to identify strengths and weaknesses of enterprises and to provide training/assistance to develop a company's capacity. Financial support for the project is provided by the European Commission. Notably, this project does not directly increase SMEs' access to finance; however, it does provide knowledge and tools to improve SMEs' access to finance.

<sup>48</sup> <http://www.enterprisegeorgia.gov.ge/en/export-support>

Internal value chain finance takes place within the value chain. Each value chain participant provides credit to the other participants within the chain. Forms of internal value chain finance can include input supplier credit, credit issued by a marketing company, or credit issued by the leading company in the chain.<sup>49</sup> For example, in Myanmar, input suppliers provide credit with a postponed payment structure for farmers (ADB 2015).

Internal value chain financing is not yet developed in Georgia. Primarily, Georgian SMEs involved in value chains have informal relationships with their partners. Few of them have contracts or other elements of formal cooperation (e.g., contract farming) with other chain participants. In most cases, they have verbal agreements. In order to develop an internal value chain financing method, SMEs should first formalize their partnerships within the value chain. According to the interviews, this problem is more acute for small farms than it is for medium-sized enterprises. Although internal financing is not prevalent in Georgia, according to a recent study (ALCP 2017),<sup>50</sup> farmers prefer to get loans from input suppliers, rather than from financial institutions. Therefore, introducing methods for internal value chain financing could contribute to further development of value chains.

External value chain financing takes place beyond the value chain. Financial institutions issue loans to value chain participants if those participants have contracts with other members of the chain.

This type of financing is more common in Georgia; however, contract farming remains unpopular. Banks usually do not require contracts from their beneficiary SMEs, but they study their clients' income and expenditure, and then provide credit on their terms. Some farmers are willing to consider this type of financing. For example, one of the Georgian input suppliers (ISET 2016) has an agreement with farmers and retailers. The input supplier provides inputs for the farmer (all kinds of input needed for production) and, when the good is produced, the retailer takes it from the farmer and sells it on the market. The financial flow of the agreement is as follows: The financial institution issues a loan to the farmer, but the money is transferred to the input supplier SME, which is responsible for supplying all necessary inputs to the farmer; the farmer then produces the good and delivers it to the retailer; the retailer sells the product and covers the loan (with interest) from the financial institution.

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<sup>49</sup> <http://www.inclusivefinanceplatform.nl/documents/bankers%20guide%20to%20avcf.pdf>

<sup>50</sup> <http://alcp.ge/pdfs/10fc006f0cba20f5dbed959a7bd5e778.pdf>

Each chain participant has a written agreement with the others. This model is a good example of how external financing can develop a value chain. When the system works, it is much easier to expand the chain and increase production.

External value chain financing is more common in Georgia than the internal alternative, and this type of financing is usually associated with getting loans from financial institutions. However, there are several other sources of finance, which can be cheaper<sup>51</sup> than taking out such a loan. These products include:

- **Factoring:** A farmer delivers a product to the buyer and prepares an invoice for it. The buyer does not pay the farmer directly. Instead, the farmer sells the invoice to a financial institution and gets paid for the sold product. Afterwards, the financial institution delivers the invoice to the buyer for the final transaction.
- **Leasing:** The leasing company provides the SME with equipment/machinery for a certain period defined in the contract. The SME covers the agreement in installments. When all duties are fulfilled, the leasing company can repossess or sell the equipment/machinery to the SME. In this case, the risk is lowered compared to taking out a loan.
- **Repo finance (FAO 2010b):** Repurchase agreement. A commercial bank buys the product from the seller and signs a contract to sell it back to the seller within an agreed time.
- **Private equity:** A bank (investor) may buy shares in a company to provide capital for investments.
- **Warehouse receipt:** When farmers deliver their product to a warehouse, they get a receipt. This receipt can be used as collateral for loans.

Some of these products, such as factoring and leasing, are available in Georgia.

Besides financial institutions, there are other sources of value chain financing, such as credit cooperatives, revolving funds, and credit associations; however, currently these kinds of financing sources are not available in Georgia:

- **Credit cooperatives:** A financial organization established on the basis of cooperation and providing financial support to households and businesses—for example, Credit Agricole<sup>52</sup> or Navy Federal Credit Union. Credit Agricole was established in 1885 and was owned by the members of farmers' unions.

<sup>51</sup> Depending on the market conditions and costs to credit risks.

<sup>52</sup> [http://iset-pi.ge/images/Policy\\_Briefs/HistoryOfCr%C3%A9ditAgricole.pdf](http://iset-pi.ge/images/Policy_Briefs/HistoryOfCr%C3%A9ditAgricole.pdf)

It issued credit to rural populations and businesses. The institution played an important role in the development and modernization of French agriculture.

- **Revolving funds:** These institutions are set up to provide business with finance that is available due to continuous replenishment from investments.<sup>53</sup> Revolving funds provide financial assistance with lower interest rates (World Bank 2016). than other commercial loans.
- **Credit associations:**<sup>54</sup> Institutions eligible to provide short, intermediate, and long-term farm credits in the agricultural sector. The institutions are cooperatively owned and require a lower effective interest rate from customers.

Both external and internal value chain financing need to be developed in Georgia. External financing suggests more diverse financial services and products. Therefore, raising awareness about these products and about internal value chain financing could be important for value chain development.

### 3.7 Policies to Promote SME Finance

Recognizing the important role of SMEs, the government developed the SME Development Strategy of Georgia 2016–2020. The aim of the strategy is to create a favorable environment for SMEs, and to increase their competitiveness, which in turn will result in increased income and job creation.

The Ministry of Economy and Sustainable Development of Georgia is the main implementer of the strategic actions. The national institutions involved in the promotion of SME creation are the Entrepreneurship Development Agency (Enterprise Georgia) and the Innovation and Technology Agency. Business associations such as the Georgian Chamber of Commerce and Industry, the Georgian Employers' Association, and the Georgian Small and Medium Enterprises Association provide support to SMEs as well.

The five strategic directions outlined in the strategy<sup>55</sup> are as follows:

- Further improvement of legislative and institutional framework, as well as operational environment for SMEs;

<sup>53</sup> <https://www.collinsdictionary.com/dictionary/english/revolving-fund>;  
<http://www.businessdictionary.com/definition/revolving-fund.html>

<sup>54</sup> <https://www.capitalfarmcredit.com/abol/faq#b>

<sup>55</sup> [http://www.economy.ge/uploads/files/2017/ek\\_\\_\\_politika/eng\\_sme\\_development\\_strategy.pdf](http://www.economy.ge/uploads/files/2017/ek___politika/eng_sme_development_strategy.pdf)



- Improvement of access to finance;
- SMEs' skills development and promotion of entrepreneurial culture;
- Export promotion and SMEs' internationalization; and
- Facilitation of innovation and research and development in SMEs.

In the strategy,<sup>56</sup> under each direction, priority actions were established. Improving access to finance and increasing SMEs' involvement in global value chains are the two most important strategic directions. For the former, the following priority actions were planned, and relevant activities were implemented (Table 3.12):

**Table 3.12: Priority Actions and Activities under Strategic Direction  
—Improvement of Access to Finance**

Priority Action	Activity
Improvement of financial literacy among SMEs	<ul style="list-style-type: none"> <li>• Training course for Enterprise Georgia's beneficiaries within the micro- and small-business support program component</li> <li>• Educational brochures and video clips for SMEs</li> <li>• Informing SMEs about amendments to Tax Code</li> <li>• Workshops related to Estonian model of taxation</li> </ul>
Supporting SMEs in the implementation of IFRS in accounting	<ul style="list-style-type: none"> <li>• IFRS for SME awareness-raising materials were developed and IFRS for SME awareness-raising training were conducted in 2017</li> </ul>
Increasing knowledge about fundraising among SMEs	<ul style="list-style-type: none"> <li>• Information meetings on fundraising issues were held for businessmen and the participants of 19 teams from business incubators were trained on fundraising topics</li> </ul>
Attraction of SME-oriented private equity funds and venture capital funds for start-up financing	<ul style="list-style-type: none"> <li>• Venture funds and startups were identified for future cooperation</li> </ul>
Helping SMEs to increase access to finance through commercial banks and microfinance organizations	<ul style="list-style-type: none"> <li>• Enterprise Georgia added two new incentive programs for the hotel industry and the film industry</li> <li>• Discussions were held between different parties to identify obstacles to SMEs' access to finance</li> </ul>
Improvement of SMEs' finance through grants	<ul style="list-style-type: none"> <li>• Amendments to the law of grants have been elaborated and adopted</li> </ul>

IFRS = International Financial Reporting Standards, SMEs = small and medium-sized enterprises.

Source: SME Development Strategy of Georgia 2016–2020.

<sup>56</sup> [http://www.economy.ge/uploads/files/2017/ek\\_\\_politika/eng\\_sme\\_development\\_strategy.pdf](http://www.economy.ge/uploads/files/2017/ek__politika/eng_sme_development_strategy.pdf)

According to the annual progress report<sup>57</sup> of the SME development strategy action plan 2016–2017, all six priority actions of the second strategic direction were fulfilled. At the same time, according to the Midterm Evaluation of Georgia's SME Development Strategy 2016–2020, although some activities aimed at increasing SMEs' financial literacy have been carried out, no strategic framework indicating SMEs' financial literacy exists. Moreover, more activities to inform SMEs about the advantages of International Financial Reporting Standards (IFRS) and about the alternative financing tools are considered to be the important actions government has to take.

The second direction is export promotion and SMEs' internationalization. To fulfill this goal, the following priority actions were planned and relevant activities were implemented (Table 3.13):

**Table 3.13: Priority Actions and Activities under Strategic Direction—  
Export Promotion and SMEs' Internationalization**

Priority Action	Activity
Raising awareness of prospects offered by the Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union and its requirements	<ul style="list-style-type: none"> <li>• Establishment of information centers to increase access to information about the DCFTA</li> <li>• Training and awareness-raising events</li> <li>• International exhibitions, international trade missions, and business forums were conducted</li> <li>• Seminar in standardization and metrology was conducted for SMEs</li> <li>• Meetings with farmers and entrepreneurs were held, where the DCFTA obligations and challenges towards them were discussed</li> <li>• The export managers of Enterprise Georgia beneficiaries were trained; the objective of the training was to diversify export markets</li> </ul>
Support businesses to adapt to DCFTA requirements	<ul style="list-style-type: none"> <li>• Identifying competitive products for export markets</li> <li>• Consulting with representatives of private sector</li> <li>• Introduction of international food safety standards</li> <li>• Support businesses to implement ISO 22000 standards and gain ISO 22000 certificate</li> <li>• Identifying needs and problems of the enterprises according to export readiness</li> <li>• DCFTA information centers were opened</li> </ul>

*continued on next page*

<sup>57</sup> [http://www.economy.ge/uploads/files/2017/ek\\_\\_politika/eng\\_sme\\_development\\_strategy\\_ap\\_annual\\_pr\\_2017.pdf](http://www.economy.ge/uploads/files/2017/ek__politika/eng_sme_development_strategy_ap_annual_pr_2017.pdf)

**Table 3.13: Continued**

Priority Action	Activity
Promotion of export of SMEs	<ul style="list-style-type: none"> <li>Identifying top-priority markets</li> <li>Identifying top-priority products for export market</li> <li>Developing export readiness tests to assess companies' export readiness</li> <li>Organize trade sessions and trade missions</li> <li>Supported beneficiaries for stimulating exports</li> </ul>
Help SMEs to establish international trade relations	<ul style="list-style-type: none"> <li>Organize an event: networking opportunities for SMEs under EEN and Horizon 2020</li> </ul>
Responsible Business Conduct (RBC) promotion	<ul style="list-style-type: none"> <li>Conducted research on business and human rights</li> <li>Discussions on Business partnership for gender equality were carried out</li> <li>Masterclasses on Employing people with disabilities in business sector were organized</li> </ul>
Support the establishment of FDI–SME linkages <sup>a</sup>	<ul style="list-style-type: none"> <li>Business forums were organized</li> <li>Foreign investors were identified for future cooperation</li> <li>Georgian enterprises and foreign investors were connected</li> <li>Foreign investors were informed about Georgian companies</li> </ul>

FDI = foreign direct investment, SMEs = small and medium-sized enterprises.

<sup>a</sup> We are in active communication with the Ministry of Economy and Sustainable Development and will have an in-depth discussion about this topic soon.

Source: SME Development Strategy of Georgia 2016–2020.

According to the annual progress report<sup>58</sup> of the SME development strategy action plan 2016–2017, all six priority actions of the fourth strategic direction were fulfilled. At the same time, according to the Midterm Evaluation of Georgia's SME Development Strategy 2016–2020, trade barriers for SMEs related to financing still exist and there is a need to identify trade barriers and to cultivate further SME internationalization.

To increase SMEs' access to finance, the Ministry of Economy and Sustainable Development of Georgia is going to set up a credit guarantee mechanism, which is a guarantee fund that will be a guarantor for loans for SMEs to be received from commercial banks (Agenda.Ge 2018). The credit guarantee will be a risk-sharing mechanism between banks, SMEs, and the state. The credit guarantee mechanism will be enforced in the first quarter of 2019.<sup>59</sup>

<sup>58</sup> [http://www.economy.ge/uploads/files/2017/ek\\_\\_\\_politika/eng\\_sme\\_development\\_strategy\\_ap\\_annual\\_pr\\_2017.pdf](http://www.economy.ge/uploads/files/2017/ek___politika/eng_sme_development_strategy_ap_annual_pr_2017.pdf)

<sup>59</sup> [http://gov.ge/print.php?gg=1&sec\\_id=526&info\\_id=69911&lang\\_id=ENG](http://gov.ge/print.php?gg=1&sec_id=526&info_id=69911&lang_id=ENG)

## 3.8 Recommendations

Based on the research outcomes, it can be concluded that the economic activity of SMEs is increasing in Georgia. However, a major barrier to SMEs' development is access to finance. The study analyzed the current situation regarding SMEs' access to finance and we propose the following policy recommendations and immediate actions with regard to existing government policies.

The government can improve SMEs' access to finance through heeding the following policy recommendations:

- **Land market liberalization:** The restriction on foreign ownership and management of agricultural land should be abandoned. In addition, a land registration process should be finalized and the process of privatization of state agricultural land should be accelerated (in Georgia, the state owns 75.1% of cultivable agricultural land).
- **Establishment of a well-functioning monitoring and evaluation system:** The government has a wide range of programs to support SMEs' development and to increase their access to finance. However, the system for the monitoring and evaluation of these programs remains weak. In order to increase the efficiency of government programs, it is necessary to increase the competencies of public officials in monitoring and evaluation and establish robust mechanisms of accountability and continuous learning (PMC Research Center 2019).
- **Regulatory impact assessment:** A regulatory impact assessment system has not been established in Georgia. In order to develop a sustainable SME policy, impact assessments of new regulations for the private sector should be conducted.

The government could improve access to finance through the following immediate actions regarding existing government policies:

- **Insurance:** The government, in cooperation with insurance companies, should expand the coverage of agroinsurance. Insurance should cover all agricultural products (currently, honey production and livestock are not insured).
- **Inclusion of financial institutions, other than commercial banks, in government programs:** Currently, microfinance organizations are not eligible to participate in government-initiated programs. These programs require financial institutions to have a current account and microfinance organizations do not have these.

- **Assess financial literacy of SMEs:** There has been no research analyzing SMEs' level of financial literacy in Georgia. In order to achieve the goals set out in the SME Development Strategy, the government should assess SMEs' financial literacy, identify major challenges, and provide necessary actions based on the assessment.
- **Promote formal relationships, such as contract farming:** In order to increase SMEs' involvement in value chains and to promote formal relationships between chain participants, government programs should require contracts or consider them an advantage for granting beneficiaries.
- **Training for farmers:** The government could support SMEs by conducting training aimed at increasing SMEs' awareness of market requirements, government programs, and financial products and services such as factoring, leasing, and private equity to increase sources of value chain financing.
- **Trade (export) financing:** Government programs finance almost all parts of the value chain, except trade. The government promotes exports through only technical assistance and helps SMEs to participate in international exhibitions and develop connections with foreign partners. In order to increase Georgia's SMEs' involvement in global value chains, the government should elaborate a trade financing program.
- **Support entrance of international companies into Georgia:** Involvement of Georgia's SMEs in global value chains increases their capacity and access to finance. The entrance of international companies into Georgia will help SMEs to get involved in global value chains. For example, the development of the hazelnut sector was boosted by opening the Ferrero Hazelnut Company in Georgia.

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### Appendix A.3 | Methodology

In this document, SMEs’ access to finance barriers and involvement in domestic and global value chains were assessed using desk and field research tools. Desk research included a literature review and statistical data analysis. Field research considered interviews with relevant stakeholders. Interviewees included representatives of government, financial institutions, donor organizations, and field experts.

#### Field Research—Conducted Interviews

Respondent	Organization	Position
Mariam Guniava	NBG	Head of financial education division, consumer protection and financial education department
Diana Togoevi	NBG	Specialist, financial education division, consumer protection and financial education department
Lasha Gzirishvili	NBG	Head of department, consumer protection and financial education department
Nikoloz Kavtaradze	Agricultural Projects’ Management Agency (APMA)	Project: Cofinancing of agro processing and storage enterprises
Severian Gvinepadze	EBRD	Principal manager, advice for small businesses, Georgia
Sandro Museridze	EBRD	Associate banker, SME F&D regional network
Kateryna Poberezhna	EBRD	Coordinator of advisory services for local agribusinesses in Georgia/DCFTA adaptation program
David Kapanadze	Bank of Georgia	Head of SME business banking department
Shota Gongladze	TBC Bank	Agro business development coordinator
Kakha Gabeskiria	Crystal (Microfinance Organization)	Chief business officer
Keti Gogotchuri	Georgian Farmers’ Association	Project manager
Shalva Japaridze	Georgian Farmers Distribution Company	Deputy director
Rati Kochlamazashvili	ISSET Policy Institute	Deputy head of agricultural policy research center
Mikheil Skhiereli	Policy and Management Consulting Group (PMCG)	Associated consultant governance, innovation, and investment policy
Irakli Barbakadze	ISSET Policy Institute	Researcher

DCFTA = Deep and Comprehensive Free Trade Agreement, EBRD = European Bank for Reconstruction and Development, F&D = finance and development, NBG = National Bank of Georgia, SME = small and medium-sized enterprise.

# Leveraging SME Finance through Value Chains in Kazakhstan

Kassymkhan Kapparov

## 4.1 Introduction and Overview of the Role of SMEs in the Economy and SME Finance

### 4.1.1 | Breakdown of Economy and Growth Performance by Sector

Kazakhstan has been successfully building its market economy since gaining independence in 1991. The constitution has established private property rights, and the development of small enterprises was officially announced as a priority for economic policy. Twenty-eight years later, we can now see that the bet on development of the private sector has paid off, although the potential for further development of small enterprises remains significant.

Its rich mineral resource base allowed Kazakhstan to develop the oil and gas and mining sectors. This was accomplished through large-scale privatization of the big industrial enterprises and attracting foreign investments. Kazakhstan is an oil economy: it possesses more than 3% of the world reserves of oil. The country increased the production of crude oil and gas condensate from 1 million barrels per day in 1993 to 1.7 million barrels per day in 2016, with oil exports reaching 70 million tons (USEIA 2017).

Oil production is concentrated around the three largest projects: Karachaganak, Kashagan, and Tengiz. The two largest projects, Tengiz and Karachaganak, accounted for 50% (Tengiz 35%, Karachaganak 15%) of the country's production in 2016 (Energy Intelligence Group 2017). High concentration can also be seen in other mineral resource extraction sectors—mining, coal production, agriculture (grain and wheat production)—as well as in the transport, construction, and banking sectors. Large private industrial and financial conglomerates are in fact a legacy of Soviet central planning and therefore have closer ties with other conglomerates in the former Soviet Union countries than with local companies in Kazakhstan. In addition, this small number of large companies mostly procures sophisticated goods and services that are not produced in Kazakhstan.

Kazakhstan has performed well in attracting foreign direct investment (FDI) into its economy. By 2016, the country had attracted \$150 billion of FDI and its stock to gross domestic product (GDP) level reached 55%, higher than in most neighboring countries (OECD 2017). However, most of the foreign investments—70% of total FDI stock—have been directed into natural resource extraction. The challenge is still to attract investment into other sectors and activities, as well as to retain current foreign investors.

Due to the period of high oil prices in the 2000s, the Government of Kazakhstan followed a resource nationalism policy to increase its role in the economy. As a result, the economy of Kazakhstan is now dominated by state-owned enterprises (SOEs). In the early 1990s, 87% of the workforce was employed by SOEs. Many of the country's leading sectors are dominated by companies owned by Kazakhstan's national holding Samruk-Kazyna, including the extractive sector, transport and storage, and information and telecommunications. The banking system is dominated by privately owned entities; however, the state, through fully- and quasi-state-owned entities, is both the largest depositor and the largest borrower (IFC 2017).

Currently Samruk-Kazyna, the largest holding company of the SOEs, and its subsidiaries account for an estimated 30% of total employment (IFC 2017). In 2015, there were still over 27,000 registered state-owned legal entities, of which over 1,000 employed more than 250 people. The government has set a target to decrease the share of SOEs' gross value added to GDP to 15% by 2020, partially through a new privatization program.

The banking sector in Kazakhstan has been slowly recovering from the financial crisis of 2007, mostly due to state support (see Table 4.1 for the main indicators of the banking sector). Hence, for the last 10 years the private sector has lost the possibility of borrowing from the banking system. In order to support economic activity, in 2010, the government introduced the state program Business Roadmap 2020 to finance small and medium-sized enterprises (SMEs).<sup>1</sup> However the devaluation of the tenge in 2015 led to increased currency risks that froze SMEs' investment plans and suspended long-term lending by banks.

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<sup>1</sup> Decree of the President of the Republic of Kazakhstan N925 from 17 February 2010.

**Table 4.1: Overview of the Banking Sector in Kazakhstan**

Total loans, \$ billion	44
As % of GDP	35
Corporate loans (excluding SMEs), \$ billion	20
Loans to SMEs, \$ billion	15
As % of total loans	32
Retail loans, \$ billion	9

GDP = gross domestic product, SME = small and medium-sized enterprise.

Sources: NBK (2017a), NBK (2017b).

Nonperforming loans (NPLs) with a debt of more than 90 days in the banks' portfolio for SME loans in 2016 went down to 8.8% (6.7% for total business loans). This decrease from 2015 was due to the fulfillment by commercial banks of the requirements of the National Bank of Kazakhstan (NBK), according to which the maximum level of NPLs should be no more than 15% of the total loan portfolio in 2015 and no more than 10% in 2016.

Kazakhstan joined a Customs Union with the Russian Federation and Belarus in 2010 and later the Eurasian Economic Union in 2015. This led to an increase in competition in the domestic market for which most of the local SMEs were not ready. In addition, the sharp decline in oil prices in 2014 led to an increased budget deficit and reduced state support for the private sector.

Summarizing, SME development in Kazakhstan is facing a number of significant challenges, including the following:

- The largest producers in the country have restrictively high standards for most of the manufacturing goods and services they consume and are mostly oriented to global markets.
- In many sectors, the SOEs are competing with the private companies and introducing distortions to the market economy.
- Financing of the SME sector is limited due to the inactivity of the banking sector.
- Economic integration brings more competition from Russian Federation companies that are more established and have larger economies of scale.
- There is high dependence of local economic activity on global oil prices.

Thus, over the past 27 years in Kazakhstan, development of the SME sector has faced numerous challenges, including the lack of access to bank lending, devaluation, increased competition from foreign companies and products due to the opening of the domestic market, the concentration of resources in the hands of the state, and the ultimate dependence of business activities on oil prices.

### 4.1.2 | Role of SMEs in the Economy by Sector

**Definition of SMEs in Kazakhstan.** According to Article 24 of the Entrepreneurial Code of the Republic of Kazakhstan (hereinafter, the Entrepreneurial Code), depending on the average number of employees and average annual income, business entities are divided into small enterprises, including micro-businesses; medium-sized enterprises; and large enterprises (Code of the Republic of Kazakhstan 2015). These categories are used for the purposes of state statistics, state support, and the application of other laws.

In terms of state statistics, only the criterion of average number of employees is used. The average annual number of employees of business entities is determined by taking into account all employees, including employees of branches, representative offices, and other separate divisions of the subject, as well as the individual entrepreneur.

With reference to state support, two criteria are used to define the size of the firm: average number of employees and average annual income. The average annual income is the sum of the total annual income for the last 3 years, divided by three. This also applies to business entities that, in accordance with the tax legislation of Kazakhstan, apply a special tax regime based on a patent or a simplified declaration. It is important to note that state support programs for private entrepreneurs may provide other criteria.

Small enterprises include individual entrepreneurs without a legal entity and legal entities with an average of no more than 100 employees and an average annual income of no more than 300,000 times the monthly calculated indicator (see Table 4.2 for all enterprise size criteria).

A micro-business is defined as a small enterprise with an average of not more than 15 employees or an average annual income of not more than 30,000 times the MCI.

**Table 4.2: Official Criteria for Defining the Size of an Enterprise, 2018**

	Micro	Small	Medium-Sized	Large
<b>Kazakhstan: national statistical definition of SMEs</b>				
Number of employees	<15	<100	100–250	>250
<b>Kazakhstan: for state support purposes</b>				
Number of employees	<15	<100	100–250	>250
Annual turnover in \$ million <sup>a</sup>	<0.21	<2.14	2.15–21.5	>21.5

SME = small and medium-sized enterprise.

<sup>a</sup> Average KZT/\$ rate for 2018 is KZT344.71 = \$1.

Source: Code of the Republic of Kazakhstan (2015).

**SME Statistics.** Data on SMEs are produced by the Statistics Committee of the Ministry of National Economy of Kazakhstan. The data on the number of enterprises are collected using the Business Register, which is based on the databases operated by the Ministry of Justice and the State Revenue (Tax) Department of the Ministry of Finance.<sup>2</sup>

In December 2013, the criteria for defining the size of a firm changed. According to the new methodology, the number of employees became the sole defining indicator of the size of the enterprise for statistical purposes. In addition, starting from 2014, the number of employees in small enterprises increased from 50 to 100 people (Code of the Republic of Kazakhstan 2015). As a result, statistical data on SMEs in Kazakhstan before and after 2014 became largely noncomparable.

### 4.1.3 | The Current State of the SME Sector in Kazakhstan

There are 12 SMEs per 1,000 citizens in Kazakhstan. This number is comparable to the Russian Federation. However, developed countries on average have 30 SMEs per 1,000 citizens.<sup>3</sup>

<sup>2</sup> Statistics Committee of the Ministry of National Economy of Kazakhstan. [http://stat.gov.kz/faces/respondentsPage/respondentsStatForm2018?\\_adf.ctrl-state=x0zab5w8\\_4&lang=ru&\\_afzLoop=1179306199144259#%40%3F\\_afzLoop%3D1179306199144259%26lang%3Dru%26\\_adf.ctrl-state%3De7fg309kt\\_174](http://stat.gov.kz/faces/respondentsPage/respondentsStatForm2018?_adf.ctrl-state=x0zab5w8_4&lang=ru&_afzLoop=1179306199144259#%40%3F_afzLoop%3D1179306199144259%26lang%3Dru%26_adf.ctrl-state%3De7fg309kt_174).

<sup>3</sup> Statistics Committee of the Ministry of National Economy of Kazakhstan. Main indicators of the number of legal entities, subjects of individual entrepreneurship, branches and branches of foreign legal entities in the Republic of Kazakhstan as of 1 January 2018.

The role of the SME sector in the economy of Kazakhstan is relatively small. SMEs contributed 26% of GDP in 2017. This percentage is relatively low, especially when compared to OECD countries, where SMEs contribute more than half of the country’s GDP. In 2016, SMEs made up 96% of all enterprises registered in Kazakhstan. The SME sector employs over 3 million people, or a third of the total workforce.

In 2017, there were over 383,000 registered enterprises in total, of which only one third—133,000 enterprises—were actively doing business (reported production or sales in their statistical reports) (Statistics Committee of MNE RK 2018). This is mostly relevant to small enterprises, as in most cases they prefer to put business operations on hold rather than shut down the company, in order not to have a mandatory tax audit conducted by the State Revenue Department (see Table 4.3 for more detailed information).

**Table 4.3: Number of Firms by their Status and Size, 2016**

	Total Registered	Active Enterprises	% of Active Enterprises
Large enterprises	2,436	2,302	95
Medium-sized enterprises	6,502	5,763	89
Small enterprises	374,912	125,523	34
Total	383,850	133,588	35

Source: Statistics Committee of MNE RK (2018).

The distribution of enterprises by size is skewed toward small enterprises, which constitute 94% of all enterprises with active status. Medium-sized enterprises account for 4% and large enterprises for the remaining 2%.

Labor productivity in SMEs is 30% lower than the average level in the economy. In 2017, labor productivity in SMEs per employee amounted to \$13,000. There are several factors that can explain this situation. Firstly, three-quarters of the total goods and services produced by SMEs originate from the services sector, which has low productivity and low incomes (Halyk Finance 2019). Secondly, average labor productivity numbers are affected by the high labor productivity in resource extraction sectors that are highly capital-intensive. These sectors—including oil and gas and mining—generate 20% of GDP, while employing only 2% of the working population. As a result, the productivity of almost 3 million self-employed people is about six times lower than that of those who are formally employed (OECD 2018b).

## 4.2 Status of Financial Inclusion for SMEs

### 4.2.1 | Credit

The Asian Development Bank (ADB) defines financial inclusion as “ready access for households and firms to reasonably priced financial services” (ADB 2015b: 71). Banks remain the main source of funding for SMEs in Kazakhstan. At the same time, SMEs are the main borrowers from banks and account for over 80% of their business loans portfolio (EBRD 2017a). In part, this result is due to the fact that large businesses can attract cheaper funding than is available from local banks due to their ability to attract equity and debt financing in foreign and domestic markets.

Lending to SMEs in Kazakhstan has been growing since 2014. Over the past 3 years, the SME loan portfolio grew by 73.7%, while new lending to SMEs increased by 65.5% over the same period. In this regard, the share of loans to SMEs among the total volume of commercial loans reached 33.6%, and new loans grew by 25.7%. Interest rates for SMEs have steadily increased over the past 2 years from a record low of 11.5% in 2014. In 2016, they reached 14.0%, which is lower than that of large enterprises, which stood at 14.5% (OECD 2018a).

Although almost all SMEs have an account at a formal financial institution, the share of firms using bank loans remains relatively low. This applies to the share of firms using banks to finance investments (16%), firms using banks to finance working capital (13%), and firms with a bank loan or line of credit (20%) (OECD 2018a). The main reasons for the low use of credit remain the restrictively high rates for loans and high requirements for collateral levels, usually in the form of real estate.<sup>4</sup>

The geographic outreach of the banking sector in Kazakhstan is also low: the country has a ratio of 130 bank branches per million inhabitants, compared with 470 in Germany or 440 in Ukraine (OECD 2013a). Few banks have an extended network of local branches, especially in regions like Akmola, Kyzylorda, and North Kazakhstan, and most of them concentrate their operations in major cities. Transaction costs increase for SMEs as they have high commuting times to reach the nearest local bank branch.

<sup>4</sup> NBK website: <http://nationalbank.kz/?docid=786&switch=russian> (accessed 10 September 2018).



According to the European Bank for Reconstruction and Development (EBRD), there is a pronounced direct correlation between the size of a company and its ability to access bank loans. As a result, SMEs, to which the overwhelming majority of companies belong in most emerging markets and in developed countries, are more likely to face a shortage of loans. Small enterprises in most cases do not have enough collateral for lenders; nor can they show the required level of transparency of their operations (EBRD 2017a).

The heads of virtually all banks surveyed in the Banking Environment and Performance Survey (BEPS) II expressed serious concerns about the solvency of SMEs that are applying for loans. The survey also suggests that the banks' own problems with financing, although important, are not the only explanation. The BEPS data also show that for companies that lack transparency, the probability of being confronted with credit restrictions is constantly much higher than for companies that are relatively transparent (EBRD 2017b).

#### 4.2.2 | Kinds of Financial Institution Involved

SMEs in Kazakhstan are highly dependent on the banking sector to meet their financing needs. However, an alternative source of finance that is becoming increasingly relevant in the country is microfinance. As of January 2019, 157 microfinance organizations (MFOs) were registered in Kazakhstan (NBK 2019). They provided T226 billion (\$0.59 billion), of which loans for SMEs accounted for only T4 billion (\$10 million). One of the reasons for the remarkable growth in MFOs is that their regulations are not as tight as those for commercial banks. For example, licensing is not required for those MFOs that do not attract deposits from the population. The main clients of microfinance institutions in Kazakhstan are nonbankable micro- and small enterprises, as well as retail borrowers.

In February 2018, ADB signed a loan agreement with KMF, the largest local microfinance organization. Under the agreement, ADB will provide a loan of T72 billion (\$200 million) for SME funding in all regions of the country. The Government of Kazakhstan and its SME funding operator (Damu Fund) have guaranteed the loan. The loan was given under the Supporting Resilience of Micro, Small and Medium-Sized Enterprise Finance Project.<sup>5</sup>

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<sup>5</sup> <https://www.adb.org/projects/documents/kaz-49076-005-pra-1>.

Among nonbanking sources of financing, leasing has the largest market and is growing steadily. In the 6 years since 2010, leasing and rental grew 2.8 times. The factoring market is also developing dynamically: initially launched by independent factoring companies, it has entered the sphere of interest of commercial banks (OECD 2018a).

There are 32 insurance companies registered in Kazakhstan, of which 22 are members of the state-owned Insurance Guarantee Fund. The assets of the insurance companies are relatively low, at 2% of GDP. The average insurance premium amount is \$60 (NBK 2017b). According to the World Trade Organization (WTO) accession requirements for Kazakhstan, foreign insurance companies will be allowed to establish branches 5 years after accession—i.e., not before 2020.

The Kazakhstan Stock Exchange (KASE) has been operating since 1993. After the pension reform and the creation of private pension funds, KASE experienced rapid growth in trade volumes. However, following the government's 2013 decision to consolidate all pension savings into a single state-owned fund, the number of listed companies dropped from 354 in 2010 to 142 in 2017. Currently, the main operations of KASE concern foreign exchange (52%) and repurchase agreement transactions (46%), whereas government and corporate securities remain negligible (1%). Stock market capitalization is at \$47 billion and corporate bond market capitalization \$24 billion. The NBK owns 50.1% of KASE shares.

SMEs and entrepreneurs need to have local access to finance, especially in the initial stages of their development, through equity finance, microfinance, and local financial institutions like credit cooperatives. These associations are also close to potential borrowers, have privileged information on their creditworthiness and operations, and can benefit from informal social pressure to avoid moral hazard. Credit cooperatives and microcredit institutions are key local players able to provide funds to companies, and should have connections with local banks and institutions. Kazakhstan has credit cooperatives in selected sectors, such as agriculture, but they have limited financial impact compared to bank finance and government-supported programs.

From 2020, foreign banks will be allowed to establish branches in Kazakhstan. This was a WTO accession requirement for the country. This could increase the supply of financial products available for SMEs and foster competition in the local market. Overall, it is expected that the entrance of new banks will have a positive effect on financing of the SME sector, especially for SMEs that sell goods and services to other countries (EBRD 2017a).

### 4.2.3 | Financial Technology for SME Funding

New forms of innovative finance, such as peer-to-peer lending and crowd-sourced equity funding, can increase the financing options available to SMEs. These lending instruments are not currently available in Kazakhstan, as there is no legislative base in place. However, a number of countries have already successfully utilized this tool for SME financing, while their governments continue to stimulate crowdfunding activities, mainly through changes to financial regulation.

## 4.3 Financial Knowledge and Skills of SME Entrepreneurs

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### 4.3.1 | Assessments of Financial Literacy

Financial literacy is a crucial factor in ensuring access to finance. Financial literacy is the ability of individuals to make informed judgments about financial products and behavior and to take part in financial decisions. Financial literacy helps improve access to finance through a better understanding of financial products. Low financial literacy is a significant obstacle for SMEs to access funding, as they are usually considered high-risk borrowers due to their poor financial reporting and weak management skills. There is no official financial literacy assessment available in Kazakhstan.

SMEs' financial literacy implies the ability to translate knowledge and skills into the business. There are several qualities of financial literacy for SMEs:

- An adequate level of personal entrepreneurial competencies, personal finance skills, and business management skills.
- An appropriate level of understanding of functional financial management systems.
- An appropriate level of understanding of SME lifecycle funding and other financial service requirements.
- An understanding of legal, regulatory, and tax issues as they relate to financial matters.
- An understanding of the range of legal recourses when necessary—namely, in case of bankruptcy or other situations of financial distress.

### 4.3.2 | Financial Education Strategy

In Kazakhstan, there has never been a comprehensive national financial strategy; neither is there a strategy that focuses on the financial literacy of SME and entrepreneurs. SMEs' financial education has been conducted mainly by financial institutions (banks, insurance companies, etc.). The Damu Fund provides free financial education for SMEs and its courses are mandatory for all of its borrowers. EBRD has been delivering trainings on how to run small business and mentoring opportunities as part of its Women in Business program. Of course, these initiatives are not addressing the problem in full, and the coverage of these programs is limited.

## 4.4 Barriers to SME Finance

### 4.4.1 | Supply Side

In 2011–2014, SME credit rates were on average 1 percentage point higher than on corporate loans. In 2015–2016, amid state support, the reverse process occurred: interest rates for SMEs were almost 2 percentage points below corporate ones, although, given the lack of growth in new lending, the lower level of interest rates apparently did not play a significant role in expanding lending to SMEs. At the end of 2017, interest rates on corporate loans and SME loans leveled and stood at about 14%. The real interest rate adjusted for inflation has averaged 6% since 2010.

There are two key reasons for high market interest rates: relatively high inflation and, consequently, higher rates for attracting money (deposits, bonds, etc.); and a relatively high credit risk among borrowers (legal entities and individuals). With high inflation, depositors and creditors are not interested in placing their money on deposit and into bank bonds if they do not offer interest rates higher than inflation. In turn, banks as financial intermediaries will not be able to put the credit rates below the cost of attracting deposits.

Another factor is that SMEs usually have limited collateral to secure the loan, or no collateral at all in the case of newly established business. Due to increased requirements for loan provisions in Kazakhstan, local banks have higher collateral requirements for SMEs, especially for newly established businesses.

In addition, the high concentration of the banking sector, with the largest bank (Halyk Bank) representing half of total assets, does not encourage competition among banks and with SOEs.

The poor outreach of the banking sector remains a constraint, especially for SMEs, which generally report more difficulty than large companies in obtaining loans from banks. Banks prefer larger commercial clients, which are more profitable and can offer more guarantees.

In addition, after the financial crisis of 2008, there was a period of high levels of default on loans in Kazakhstan. As a result, to receive income from their activities, banks were forced to charge a higher interest margin due to the system credit risk of domestic borrowers. This led to much higher interest rates on bank loans compared with developed countries. That is why the interest rates on bank loans over the past 15 years have not been significantly below current levels, even in periods of favorable economic conditions in Kazakhstan and rapid growth of loan portfolios of banks (2006–2007).

There is an issue of information asymmetry when it comes to lending operations for SMEs. A credit registry could potentially help overcome this issue. In Kazakhstan, there is a credit registry for the credit history of firms called The Strongest, and 14% of SMEs have an active credit history.<sup>6</sup> Currently, there are only eight companies that have obtained The Strongest certificates.<sup>7</sup> However, SMEs are not forced to have their reports audited: there is no such requirement by law and no additional incentives, such as through participation in public procurement.

For farmers, there are several barriers to face when looking to access financing from commercial banks:

- Rural farmers and SMEs face long commuting times to reach their nearest bank branch, and multiple trips to gather information, sign forms, and go through the general loan approval process. The insufficient network of regional and local centers such as extension centers or local financial agencies also hinders the transfer of information and competencies regarding financial instruments and offers.
- High transaction costs also impact banks, which face increased marketing and sales costs in order to reach target clients. As a result, many banks choose to focus their limited resources on cities and on larger firms that require bigger loans. High transaction costs disproportionately impact the financing decisions of SMEs and individual farmers in comparison with larger firms.

<sup>6</sup> <https://kursiv.kz/news/otraslevye-temy/2015-11/pervoe-kreditnoe-byuro-zapuskaet-reyting-dlya-biznesa>.

<sup>7</sup> <http://www.thestrongest.kz/ru/strongest-companies/>.

- Agribusiness is an activity with a strong risk exposure: production outputs are highly variable because of weather conditions, seasonal fluctuations, and volatile commodity prices. Investment level is consequently undermined by risk default: delinquent loans are significantly higher in agribusiness than in other sectors.
- The low return on investment in the agribusiness sector means that private banks do not see the sector as attractive relative to other industrial sectors in the economy. The structurally low agribusiness return on investment is further worsened by the low productivity of agriculture in Kazakhstan. Agribusinesses are plagued by low absolute productivity and low productivity growth rates. The use of seeds and fertilizers is insufficient and agricultural machinery is outdated.

As a result of these factors, banks compensate for the risk linked to the variability of production with high nominal interest rates for lending or high collateral.

EBRD indicates that, in Kazakhstan, there is a relatively high proportion of companies facing credit constraints.<sup>8</sup> In 2013–2014, this figure reached 76%—that is, double the figure in 2005 (38%). The following categories of enterprises are more often confronted with credit restrictions: small enterprises, companies that are not exporters, and companies whose financial statements are not audited by auditors (EBRD 2017a).

The results of the Business Environment and Enterprise Performance Survey (BEEPS) show that a significant proportion of companies complain about cumbersome loan procedures and strict requirements for collateral. These problems are mostly caused by the increased requirements for reporting and the provision level on loans. The regulator introduced these requirements after the financial crisis of 2008 in order to minimize new NPL accumulation. As a result, banks require high collateral coverage in the form of real estate or equipment, especially from SMEs, which usually lack audited financial statements (EBRD 2017b).

Based on observational data, EBRD makes the assumption that the effective establishment of relations between companies and banks in many transition countries is still hampered not only by changes in banking systems, but also by structural factors (EBRD 2017a).

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<sup>8</sup> Companies facing credit restrictions are companies that need additional borrowing, but have either been rejected when applying for bank loans or who dare not apply for such loans.

Last is the lack of incentives for banks to lend to SMEs. Currently, banks are caught up in a situation where they have enough liquidity but the post-financial crisis regulation is much tighter when it comes to provision. For banks, it has become prohibitively expensive to work with SMEs. There are administrative costs for banks to maintain the regional network and assess the risks of each possible client. In addition, there is a trade-off between providing loans to SMEs to get slightly higher returns with higher risks, and market operations with the central bank, with stable returns on the base interest, which does not increase the NPL level. There is low appetite for risk from the banks when it comes to lending to SMEs. As a result, there is little competition for SME loans, and instead banks compete for consumer loans and credit cards. When asked about the reason for the low level of lending for SMEs, banks usually argue that they do not make “good enough” clients, meaning companies with collateral or audited reports.

#### 4.4.2 | Demand Side

The overarching issue with the demand side of SME financing in Kazakhstan has several dimensions.

Firstly, there is very small number of medium-sized enterprises in general. Most of the medium-sized companies are state-related or highly dependent on state regulation. Current tax policy favors small enterprises and does not stimulate the consolidation of business. This, in turn, leads to a lack of credit history and audited reporting among potential local business borrowers. Without such incentives, SMEs are not interested in providing more information for the credit registry, especially if they have no immediate need to attract external funding. There is a problem with SMEs’ intention to register, and how many SMEs see bank loans as a preferential funding source.

#### 4.4.3 | Institutional Aspects

Access to finance is not the most important barrier for firms in Kazakhstan. Only about 10% of firms have reported it to be their major problem. More firms have reported that corruption, informal sector practices, workforce quality, and tax rates play a more significant role (World Bank 2017).

The business climate in Kazakhstan in general is relatively favorable for SME development. The country has achieved a steady improvement in its overall regulatory environment for business over the last decade. In 2018, Kazakhstan ranked 28th in the world in the World Bank’s Ease of Doing Business Index.

The current ranking is a significant improvement from 58th place in 2011, and is higher than the Russian Federation, which ranked 31st in 2018 (World Bank 2018).

The growth of SME lending is limited due to the weak credibility of SME reporting, as SMEs are not required to report in accordance with International Financial Reporting Standards.

In addition, the state remains dominant in many sectors of the economy despite the extensive privatization conducted in the 1990s. The 100% state-owned welfare fund Samruk-Kazyna controls a large share of the economy through its holdings in enterprises such as KazakhTelecom (telecommunications) and KazMunaiGaz (the national oil and gas company). Samruk-Kazyna is estimated to hold stakes equivalent to 60% of the country's GDP (UNECE 2012).

#### **4.4.4 | Gender Issues**

In Kazakhstan, gender barriers are mostly relevant to the rural population, where women lack access to financial services due to the fact that they do not have regular employment, pension accounts, bank accounts, credit history, financial education, and business knowledge and skills. There are no legal barriers for female entrepreneurs starting or running a business. On the other hand, there is no national state program to support women-led businesses.

## **4.5 Status of Domestic and Global Value Chains in Kazakhstan**

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### **4.5.1 | Definition of the Global Value Chain**

The global value chain (GVC) refers to the full range of cross-border, value-added business activities that are required to bring a product or service from conception, design, sourcing raw materials, and intermediate inputs stages to production, marketing, distribution, and supplying the final consumer (ESCAP 2007).

The value chain concept has evolved with trade and has become more complex as goods and services have become more sophisticated. According to the United Nations Conference on Trade and Development (UNCTAD 2013), 80% of world trade now involves GVCs. This is largely attributed to the increased import content of exports, which increased from 20% in 1990 to 40% in 2010, and is set to reach 60% by 2030.



There are four basic types of GVC:

- (i) International supply markets, where transactions are made based on arm's length relationships between buyers and sellers across borders, requiring minimal coordination and cooperation (e.g., commodity markets).
- (ii) Producer-driven networks, where the lead firm (such as an automobile or consumer electric appliance assembler) plays a central role in exercising control over the international network of subsidiaries, affiliates, and suppliers.
- (iii) Buyer-driven networks, where large retailers, marketers, and brand manufacturers (such as Levi's in the apparel industry and Walmart as a multinational retailer) source from the decentralized network of suppliers across borders.
- (iv) Integrated firms, where hierarchical governance systems are implemented throughout the international networks, and which produce all major goods and products in-house, characterized by vertical integration and strong managerial control. This type has become rare these days, but can still be found, for example, in the American automobile industry (ADB 2015a).

### **Belt and Road Initiative and GVCs in Kazakhstan**

The Belt and Road Initiative (BRI) launched by the People's Republic of China (PRC) in 2013 can become an important factor in promoting GVCs in Kazakhstan. Currently, over 80 countries are taking part in the initiative with the broader aim of enhancing policy coordination, connectivity, trade, financial integration, and people-to-people contacts, and so forging greater international economic integration.

In 2015, the PRC announced the transfer of 51 industrial production sites from the PRC to Kazakhstan. As of 2017, 12 sites, mainly from the processing industry, had been transferred. In addition, five agreements had been signed aimed at creating cluster cooperation zones in transport infrastructure, trade, processing industries, construction, agriculture, and other areas (Vakulchuk and Overland 2019). However, so far most of the progress has been seen in one sector, transport infrastructure, with agriculture being the sector with the highest potential for development.

In May 2016, Gulmira Isayeva, Kazakhstan's deputy agriculture minister, announced that companies from the PRC were in talks to invest \$1.9 billion in 19 agricultural projects as part of the BRI, although the announcement emphasized that the PRC companies would not be allowed to own Kazakh land. More recently, on 11 July 2017, Kazakhstan and the PRC signed seven agreements worth a total of \$160 million at the Kazakh–Chinese Agriculture Investment Forum in Astana (Bizhanova 2018).

The main question with the BRI projects in Kazakhstan remains how the large-scale projects will influence the development of SMEs and to what extent local SMEs will be involved. There is a global practice when the PRC companies implement PRC-funded projects with non-existent local content and knowledge transfer—for example, the \$1.5 billion project for the construction of the light rail transport system in Astana that is being implemented by a PRC construction company. State policy should address this issue and find means to use BRI projects to promote SME development and to increase the participation of SMEs in global value chains related to the BRI.

BRI projects aimed at infrastructure development also contribute to better connectivity between Kazakhstan and the PRC, as well as among Central Asian countries. This can create an opportunity for international development organizations to provide support for SMEs' participation in BRI projects and GVCs. Coupling these hard investments with soft investment in trade facilitation, policy regulation, and better information flow could contribute to SMEs' participation in global and regional value chains.

#### **4.5.2 | SME Participation in Value Chains in Kazakhstan**

SMEs in Kazakhstan are mostly focused on the domestic market. As a result, they are heavily dependent on the local economy and the income of the local population. Large companies consume high-tech services and goods that are mostly imported. The number of medium-sized enterprises is relatively small. Hence, SMEs mostly focus on public procurement and retail sales. Limited access to financing does not allow SMEs to invest in technological development in order to become a supplier for large companies and to compete in other countries' markets.

The participation of SMEs in international trade operations is one-sided: imports are widely developed, but exports are poorly represented. SME exports account for about one-fifth of total exports (\$6 billion in 2016) and are highly dependent on the volume of total exports. SMEs act as intermediaries in the commodity trade; hence SME exports are mainly concentrated in oil and grain production regions. SME exports therefore reflect the overall specialization of the economy in commodities. At the same time, SMEs account for more than 60% of the imports of goods. However, SMEs mostly import finished goods for domestic consumption, and few intermediate goods for further production and export of finished products.

The fragmentation of global supply chains is an opportunity for SMEs to unite in the supply chains of large firms and thus capture positive flows from the transfer of technology, skills, and know-how. For local companies, one opportunity would be to link into global supply chains that target the neighboring markets of the Russian Federation and the PRC, not only in terms of logistics and the supply of raw materials, but also in creating an export-oriented production base in Kazakhstan.

However, in developing countries, the development of such ties can take a long time due to market inefficiencies. These include the fact that local SMEs require more technological upgrades to meet the needs of foreign partners, may not be of the appropriate size or be able to work properly on the network, and may not have information about the available opportunities. In these cases, it is possible for the government to intervene and support the simplification of business relationships between existing value chains and SMEs.

In general, clusters and supply chains are not highly developed in Kazakhstan, so the key questions relate to which sectors and/or clusters are important and how something new can be developed—for example, new clusters or supply chain organizations.

ADB's research on SMEs in Kazakhstan conducted in 2015 revealed the following obstacles for SMEs on the way to becoming part of a GVC (ADB 2015a: 47):

- Firms in Kazakhstan felt strongly disadvantaged about their capacity to meet international product or quality standards.
- Firms have faced difficulties in the business environment.
- Primary and services sectors, importers, and micro-firms have had trouble finding skilled workers and professionals. The manufacturing sector seems to have had fewer issues with skilled labor.
- The primary and services sectors, again, felt that the institutional support they received was weak. Importers and those without trade seemed to have the same feeling toward inadequate institutional support.
- It is not surprising that micro-firms had less capability to deal with international product and quality standards and nontariff barriers.
- Younger firms felt there were many disadvantages in their business sector (or toward their own capability perhaps, due to a lack of confidence as newcomers to the market).

### 4.5.3 | Agricultural Supply Chain

#### Current Situation: Products Actually Involved

Kazakhstan's agricultural supply chain is underdeveloped, and so are agriculture and farming. Farmers sometimes directly transport their produce to open markets (bazaars) where consumers buy directly from them. In other cases, farmers sell their produce to retailers. Agricultural farms produce the raw material base: dairy products, grains, vegetables, fruit, etc. that need further processing are transported to processing plants that make various kinds of finished products from the basic raw materials. Wholesalers or intermediaries take care of the logistics operations, like packaging, distribution, transportation, and delivery to retailers and consumers (Rana 2014). There are some peculiarities that characterize the functioning of food supply chains in Kazakhstan. Buyers provide inputs and assistance to farms, including investment assistance, trade credit, bank loan guarantees, and management advisory services. At the same time, FDI has brought about food retail chains and the internationalization of agribusiness markets. Agribusiness in Kazakhstan is influenced by three main forces:

- (i) an emergence of vertical integration financed by the private sector;
- (ii) a massive extension of state financing loans to agriculture-related projects; and
- (iii) the emergence of a modern food retail sector in metropolitan areas.

These forces will lay the path for agribusiness from most fragmented to modern industrial facilities. This can happen when producers, processors, and retailers develop and implement a system to coordinate the production and supply of farm products, their processing, and distribution, with demand signals along the supply chain (Rana 2014).

#### Prospects for Development: Products Potentially Involved

Kazakhstan's agricultural sector contributes significantly to its economy, though its role is dwarfed by the size of the oil exports. The country is the 15th largest producer of wheat in the world, growing more than 11 million metric tons annually. Wheat is Kazakhstan's largest export commodity and accounts for 55% of total agrifood exports. About 30% of the labor force is employed in the agricultural sector, which contributes about 5% to its GDP (Statistics Committee of MNE RK 2019).

Kazakhstan's agricultural sector comprises grain, vegetables, dairy, poultry, fodder, and livestock. Kazakhstan is among the top 10 largest grain producers in the world, including high-quality wheat with rich protein content. Almost half of the agricultural output pertains to livestock-related activities. Traditionally, farmers raise sheep, cattle, and horses. Pigs and camel herding are also developed in some parts.

The meat industry accounts for nearly 30% of all food products in Kazakhstan. Nevertheless, local meat production does not cover its consumption: the shortage of meat is covered by imports, including imports of beef, pork, and poultry.

There is also a milk shortage in the country. Milk consumption varies greatly by region. For example, the average per capita consumption of milk in the South Kazakhstan oblast is less than 200 kg compared to an average of 260 kg. A large proportion of dairy products is imported. Also, local dairy products are not competitive in price. As a result, the local market is full of imported goods, especially food products like cheese and butter. The main problem is a shortage of indigenous quality raw materials. There is a need for significant investment in local dairy farms. For example, one of the largest producers of dairy products in the country, FoodMaster (part of the French Lactalis group), controls the entire supply chain of dairy products from milk to the distribution of final products. It has two dairy farms (in Almaty and Pavlodar oblasts) and three processing plants (in Issyk, Shymkent, and Pavlodar), which process products including milk, kefir, sour cream, yogurt, cheese, and ice cream. The company's products are being exported to the Russian Federation and Central Asian countries. The positive impact of such a supply chain on local SMEs is the transfer of know-how, building up local expertise, and quality control standards.

The food processing industry is not developed and is inadequate to meet the demand for processed food products. Most imported products are processed food, and exports are predominantly unprocessed staple commodities. The food processing industry has special support from government and international financing organizations. The major segments of the food processing industry include soft drinks, flour and cereals, plant and animal oil production, meat processing, dairy, and fruit and vegetable processing. The Ust-Kamenogorsk Poultry Factory, located in northeast Kazakhstan, is a vertically integrated broiler factory that markets and distributes frozen and cooked chicken, chicken sausages, and smoked chicken. It accounts for almost 50% of the chicken produced in Kazakhstan. However, the share of imports in local consumption of poultry remains high.

Kazakhstan is self-sufficient in vegetables in general; however, there is a shortage in fruit production due to the harsh climate in most of the country. Therefore, the state now encourages the construction of greenhouses. The number of greenhouses in Kazakhstan is steadily increasing, but the needs are far from being covered. In addition, some of the high-quality fruit and vegetables from greenhouses are exported to other countries, primarily to the Russian Federation.

Kazakhstan can develop its own local production of fruits and vegetables, but that will require a large amount of direct subsidies from the state, which will be difficult once the WTO rules on agricultural subsidies come into power in 2020. Nevertheless, the Central Asian countries with a milder climate can become a source for cheaper fruits and vegetables, and other products that do not grow in Kazakhstan due to the climate. Processing these goods and making high-added-value products from them (such as jam, frozen fruits, juices, etc.) can be a more productive way of subsidizing the agricultural sector and will help to increase labor productivity in the agricultural sector. Currently, food processing and food retailing in Kazakhstan contribute to more than 12% of GDP (OECD 2013b).

## 4.6 Value Chain Financing Analysis

A lack of access to finance for agribusiness firms is one of the main impediments to improving the sector's competitiveness. Agribusinesses continue to face hurdles in accessing credit, these being similar to the challenges faced by other companies. This reduces their capacity to invest in working capital and fixed assets such as fertilizers and machinery, thus further dampening the sector's productivity. Moreover, the low return on investment of agribusiness compared to that of other sectors, especially extractive industries, adds another layer of difficulty for agribusiness firms' access to financing in an already challenging credit environment.

Access to finance in Kazakhstan is largely driven by the role of nonbanking financial SOEs in many sectors. SOEs (such as the Damu Fund and KazAgro) are mostly financed from the government budget; they deliver credit programs through which they provide direct loans to companies and subsidize interest rates. In addition, both SOEs and private companies benefit from selected government subsidies and credit programs. The influence of SOEs and public lending is central in Kazakhstan and calls for the highest transparency and efficiency of existing public funds.

Currently, commercial banks, KazAgro, and rural credit cooperatives are the main sources of agribusiness financing. Despite a moderate share of loans, microcredit financial institutions in Kazakhstan are key complementary players in providing microfinance and capacity to small farms not reached by other sources.

KazAgro aims to implement the government's policy of supporting development of the agro-industrial sector. KazAgro's market dominance has compensated for the lack of credit. KazAgro is a central finance provider in agribusiness that sustains credit supply in the agri-financing system, as banks are reluctant to increase their lending to the sector.

The KazAgro holding is the main agricultural SOE, composed of seven subsidiary companies in which it has close to 100% equity:

- KazAgroFinance
- Agrarian Credit Corporation
- KazAgroGarant
- Food Contract Corporation
- Financial Support Fund
- KazAgroProduct
- KazAgroMarketing

Five of these companies provide direct finance to agribusiness companies: KazAgroFinance, Agrarian Credit Corporation, KazAgroGarant, Food Contract Corporation, and the Financial Support Fund. KazAgroFinance leases equipment and machinery to agribusiness companies and finances direct credit for working capital. KazAgroGarant issues concessional loans, as well as credit guarantees. In addition to purchases and interventions in the grain market, the Food Contract Corporation has developed lending activities for grain and cotton producers. The Financial Support Fund provides credit to rural micro-producers, including seasonal loans.

## 4.7 Policies to Promote SME Finance in Kazakhstan

The state plays an important role in providing SMEs access to lending by placing funds in commercial banks, which, in turn, provide preferential loans to enterprises during periods of a lack of liquidity in the market. The largest allocation of state funds for SME lending occurred in 2009, when the interest rate for SMEs was limited to 11.5%. In 2014–2015, interest rates for manufacturing SMEs were limited to 6%. As a result of these measures, an unusual situation arose in the market, when in 2009, 2015, and 2016 the interest rates for SMEs were lower than the total average interest rates of business loans.

Since 2010, the government has provided soft lending, subsidizing interest rates and loan guarantees for SMEs as part of the Business Roadmap 2020 program and as part of the Damu Entrepreneurship Development Fund. Loan guarantees—a new financial instrument in Kazakhstan—have increased from three guarantees in 2010 to 2,600 at the beginning of 2017 (OECD 2018a).

Currently, direct state support of SMEs in Kazakhstan is modest in size. For example, the Damu Fund has supported around 5% of the total number of existing SMEs. The government plans to consolidate budget expenses in the near future and even cut them in relative terms. The reason for this is that government support for SMEs in Kazakhstan has been driven by two main factors: the need to support the emergence of new small firms and support for the SME sector after the banking sector crisis in 2008. Government SME support strategies are pursuing several goals: maintaining current levels of employment, and increasing productivity and competitiveness.

In order to support SME development, the government has been subsidizing part of the interest rate for SME loans with a rate of not higher than 19%. The Damu Fund was created to serve as an operator for state programs in the field of entrepreneurship development. The Damu Fund has a market share of 8% of all loans for business purposes, up from 5% in 2014. The Damu Fund's SME support program does not cover trade and construction, which accounted for half of all loans to businesses. Hence the Damu Fund's share increases to 16%, which shows the increasing importance of state support in SME sector development.

The state program for productive employment and mass entrepreneurship has provided microcredits since 2015: on average, the total annual funding budget is from T10 billion to T30 billion. Interest rates on microloans on average equal the inflation rate, and loans are usually provided for between 5 and 7 years.

Government support for SMEs is carried out through various development programs. As a response to the financial crisis of 2008–2009, the state program Business Roadmap 2020 was developed. This program is being implemented in four areas: supporting new business initiatives, improving the business sector, curtailing entrepreneurs' currency risks, and increasing entrepreneurial capacity. The period of the program covers 2010–2020. In 2017, expenses for implementation of the program were around T17.4 billion, which was significantly below what it was in 2016 (T56.6 billion). In the current and following year, costs are not expected to exceed T9 billion as provided by the program; currently, as the end of the program is approaching, its extension is being discussed. It is hard to say what is the cause of the reduction in spending on this program. It is possible that the regions will seek funding sources themselves, and development institutions will attract funds on the open market or through budgetary loans.



ADB has been actively involved in government efforts for SME development. In particular, in 2011, ADB provided a \$500 million loan to the Damu Fund under Kazakhstan government guarantees. The loan was disbursed in three tranches (2011, 2014, and 2015), and the financing of SMEs has not had industry restrictions. The loan funding was used to finance 2,000 projects worth T210 billion.

Government policy instruments to foster SME access to finance include the following (OECD 2018a):

- Government loan guarantees
- Special guarantees and loans for start-ups
- Subsidized interest rates
- SME banks

The gender issues in SMEs' development has been addressed by several initiatives, among which EBRD's Women in Business program can be mentioned as one of the most successful. This program was launched in 2015; since then, more than 20,000 loans have been disbursed to SMEs headed by women for a total amount of T26 billion. The Ministry of National Economy has been a partner of this program by providing guarantees for loans.<sup>9</sup> ADB has also developed a Gender Action Plan for its lending partners in Kazakhstan, in which it has set the goal of increasing the volume of lending to women-owned businesses and directing at least \$50 million to finance women-owned businesses.<sup>10</sup>

#### 4.7.1 | SME Funding through Public and Private Equity Funds

The first public venture fund in Kazakhstan was created in 2004 and was called the National Innovation Fund; later it became the National Agency on Technological Development, and is currently called QazTech Ventures, a 100% state-owned venture fund. In 2011–2018, the National Agency on Technological Development gave 316 innovative grants, amounting to T11.5 billion (\$30 million at 2019 exchange rate). The difficulty in developing venture funding using the public funds was the perception of giving public money for free, and defining who would be responsible for the success or failure of such an investment. When it comes to budget, there are many controlling agencies that oversee the use of public funds.

<sup>9</sup> <https://kursiv.kz/news/vlast-i-biznes/2018-10/programma-ebrr-zhenschiny-v-biznese-tri-goda-na-rynke>.

<sup>10</sup> <https://www.adb.org/sites/default/files/project-document/202751/49076-005-gap.pdf>.

Another equity management fund is Kazyna Capital Management (KCM), which invests as a limited partner in different equity funds in various sectors. Over the years, KCM has invested over \$400 million in 12 funds. One of these funds is the Kazakhstan Growth Fund, a \$80 million joint fund with EBRD with a focus on investing in the manufacturing and services sectors. Another KCM portfolio fund is the \$100 million Almex Baiterek Agriculture Equity Fund, which is partially publicly funded.

Current main strategy documents of ADB operations in Kazakhstan offer the following guidance regarding SME funding through private equity funds:

- ADB's Country Partnership Strategy for Kazakhstan for 2017–2021, in its first pillar “Strengthening foundations for economic diversification,” states that, “ADB *will consider investing in equity funds* [italics added] and private companies and offer continued support for trade finance to local banks, aiming to close market gaps and promote international trade activity of companies in Kazakhstan” (ADB 2017:9). As of the time of writing of this paper there were no concrete steps taken in this direction.
- Country Operations Business Plan for Kazakhstan for 2019–2021 makes no mention of private equity investment plans for Kazakhstan until 2021 (ADB 2018).

There are some constraints related to equity fund operations in developing countries. One of the main constraints is the limitation of the local investment pool and the need to define the exit strategy.

## 4.8 Conclusions and Recommendations

### Recommendations to the Government of Kazakhstan

Based on the research conducted, a set of recommendations has been developed for the Government of Kazakhstan. Recommendations are mostly focused on the macro situation with SME development in the country:

- (i) Include in the SME support policy measures to stimulate SMEs to register with the credit registry. Existing credit risk databases include a very limited number of SMEs and are effectively non-existent. The policy to promote credit risk databases can target SMEs of a certain size—for example, those over 50 employees. Being registered with the credit registry could be a requirement

for getting access to SME support tools—for example, participating in public procurement and having access to credit guarantees and loans with subsidized interest rates. Such measures can help SMEs to build their credit history and have access to finance in the long term.

- (ii) In order to facilitate the promotion of export-oriented SMEs, the government can introduce incentives for SMEs to participate in GVCs. This can be done through providing long-term financing for SMEs with offtake agreements with global companies. Another tool could be subsidizing the interest on trade credits for such SMEs. The existing state fund KazakhExport, which aims at promoting non-mineral export, is mostly focused on working with medium-sized companies and does not currently provide flexible services to small enterprises.
- (iii) The credit guarantee mechanism should be promoted further. Currently, it is part of the 100% state-owned Damu Fund. Given the important role of this mechanism in promoting the development of SMEs and the possible decrease in public funding available for the Damu Fund, it is recommended to spin off this activity into a separate entity, the Kazakhstan Credit Guarantee Fund. Such an entity should actively engage with international donors and international financial institutions, and work on a commercial basis. Examples of such credit guarantee funds are the Credit Guarantee Fund<sup>11</sup> in Turkey and the Credit Guarantee Fund Tajikistan.<sup>12</sup> The goal of such a transformation should be to increase the share of private and international funds and to decrease the share of public funds. This will also lead to more transparent and effective operations of such funds.
- (iv) One possible solution could be the ongoing privatization of SMEs that can support the establishment of new ones. These new private businesses would have higher quality assets that they can use as collateral for securing bank loans.
- (v) Create favorable conditions for micro-business development. Design a separate state support policy for micro-businesses with fewer than five employees. Currently, the SME support policy targets a heterogeneous group of firms with employee numbers ranging from 1 to 100, and in some cases up to 250 people. State policy to support micro-business could include easy business registration and simple taxation, with the focus on easing tax administration and offering tax holidays for prioritized areas and regions (for example, rural areas).

<sup>11</sup> <https://aecm.eu/kgf-credit-guarantee-fund/>.

<sup>12</sup> <http://www.cgft.com/about-cgft/credit-guarantee-fund-tajikistan/>.

- (vi) Prioritize the development of medium-sized enterprises. This would be a major step toward creating a diversified complex economy. In order to promote the consolidation of fragmented small businesses, the tax regime for medium-sized enterprises should be changed to be more favorable than that of small enterprises. Medium-sized enterprises have more resources and expertise to become part of GVCs and to export their goods and services. Public procurement could be used as an additional incentive tool to promote the development of medium-sized enterprises. For example, thresholds (procurement lot size) for small enterprises can be introduced, above which only medium-sized and large enterprises can be considered as suppliers.
- (vii) There is a need to develop a comprehensive national financial education strategy with a focus on SMEs' needs. In order to do that, the government needs first to map all the main initiatives carried out by public and private stakeholders in the country (including the Damu Fund, banks, Atameken chamber, business incubators and accelerators, business programs at universities, and others). All of these stakeholders should be part of implementing the national strategy in order to increase the effectiveness of the program and to cover all target groups.
- (viii) There is a great need for a general national financial education strategy that will cover the population. This strategy should also address the issue of financial education for SMEs and entrepreneurs. Push and pull factors should be combined when designing the national strategy. The government's role should not be focused on providing free-of-charge training and the dissemination of educational information; rather, it should focus on organizing, stimulating, and coordinating society's efforts to make financial sectors and their services more available to larger numbers of those who will use them responsibly. Working closely with the main stakeholders—financial institutions and nongovernment organizations—should be at the core of the new strategy to ensure buy-in from a wider range of population groups.

### Recommendations to International Donors

In addition to recommendations for the government, there is a set of recommendations for international donor organizations working in Kazakhstan. These recommendations are mostly focused on fine-tuning the funding schemes for SME development in the country.

- (i) Launch a new program for local banks to finance trade loans for SMEs aimed at promoting regional trade. The improved connectivity due to BRI-related infrastructure development and the economic liberalization in Uzbekistan create an opportunity for regional trade development. ADB could become a main driving force behind the emerging boom in regional trade by funding trade operations for

SMEs in Kazakhstan. Given the short time period of trade finance operations, ADB could see a significant impact from limited funding. Moreover, starting such a program could be a relatively quick operation, as most of the local banks have such trade facilitation services in place. The new program could target the SMEs that focus on the development of trade with Central Asian countries and BRI-related projects.

- (ii) Start a private equity fund in Kazakhstan targeting export-oriented medium-sized companies. Kazakhstan could become the first country in Central Asia where ADB launches a private equity fund. ADB has extensive expertise in equity funding, including operations in developing countries. Kazakhstan has experience of creating a joint private equity fund between EBRD and the Baiterek state fund. ADB could invest in a number of such private equity funds, each focused on a certain sector with significant export potential, such as agriculture, transport and logistics, manufacturing, and services. Private equity funds in Kazakhstan could become a starting point and a testing ground for the use of this financial instrument across the Central Asian region. There is more possibility of creating a competitive industry and competitive enterprises with international management, which will attract not only donor funds, but also public funds: that is why this chapter suggests 10% from the managing partner, 20% from a donor organization, and the rest from public funds. In this way, the donor will have to choose an international fund manager, and the manager will choose the right company to invest in. ADB has experience with creating and investing in equity funds worldwide. ADB first invested in private equity funds in 1983, primarily to promote SMEs in developing countries. Between then and 31 December 2007, approved investments in private equity funds totaled 75, with a combined value of \$900 million.
- (iii) Diversify the channels for SME funding through cooperation with microfinance organizations (widen the practice further) and private equity funds, and support the development of crowdfunding platforms and the crowd-sourced equity funding sector. Currently, SME funding is supported mostly through securing guarantees from the government and disbursing funds using the Damu Fund, which has a regional network and access to SMEs. This scheme ensures that funds are disbursed fully and in time. However, in the long run, it is advisable not to rely only on one channel to provide support for SMEs.
- (iv) ADB could discover options to provide local banks with financing for trade loans for SMEs aimed at promoting regional trade. Another tool that international donors can support is insurance for exports operations for Kazakh companies through the existing state entity KazakhExport.

The gradual opening and liberalization of Uzbekistan creates a positive momentum for such regional trade facilitation schemes.

- (v) One possible solution is to focus on funding export-oriented SME companies that are already a part of, or can potentially become a part of, the GVC. In this case, the exit strategy would be to sell such a company to the larger global companies that are part of this GVC. Another approach for Kazakhstan is to focus on SMEs in Kazakhstan that can be part of the larger BRI projects targeting the PRC market. Such companies could go public using the Astana International Financial Center that operates under the common law. Of course, equity funding would be focused on investing in more mature medium-sized firms with stable export operations. This would create an additional incentive for local companies to grow and consolidate operations in one legal entity instead of maintaining a number of small firms.

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# Leveraging SME Finance through Value Chains in the CAREC Landlocked Economies: The Case of the Kyrgyz Republic

Kanat Tilekeyev

## 5.1 Introduction and Overview of SMEs' Role in the Economy of the Kyrgyz Republic and SME Finance

### 5.1.1 | Economy

The Kyrgyz Republic is one of the smallest countries in Central Asia. The population is a multi-ethnic society of 6.2 million people, with a prevalence of ethnic Kyrgyz (70%). The second and third ethnicities are located in two different regions in the country: Uzbeks (15%) are concentrated in the south, while Russians (7%) mainly live in the north in the capital. The Kyrgyz Republic is one of the poorest countries in Europe and Central Asian region, with a gross national income per capita of \$1,130 in 2017 (Atlas method).

The Kyrgyz Republic's economy shows certain recovery from the economic crisis, experiencing economic growth of 4.5% in 2017. Joining the Eurasian Economic Union (EEU) did not bring the expected growth of exports to the Russian Federation and Kazakhstan, but led to keeping labor migration on the high scale. Remittance levels have reached one-third of gross domestic product (GDP). The Kyrgyz Republic has a declining share of agriculture in GDP, with 34% in 2000 and 13% in 2017 (Table 5.1). At the same time, employment in the agricultural sector fell from 53% to 29%. While long-term economic growth in the country varies from 4% to 4.5%, agriculture grew 2% on average over the last 15 years. Growing sectors in the economy are construction, trade, transport, and communication. Declining sectors are manufacturing and energy, gas, and water. It should be noted that the long-term trend of the rate of the growth of the economy lies in the range between 4% and 4.5% with the high volatility caused by the different growth rates of such sectors like construction, agriculture, and manufacturing (Figure 5.1).

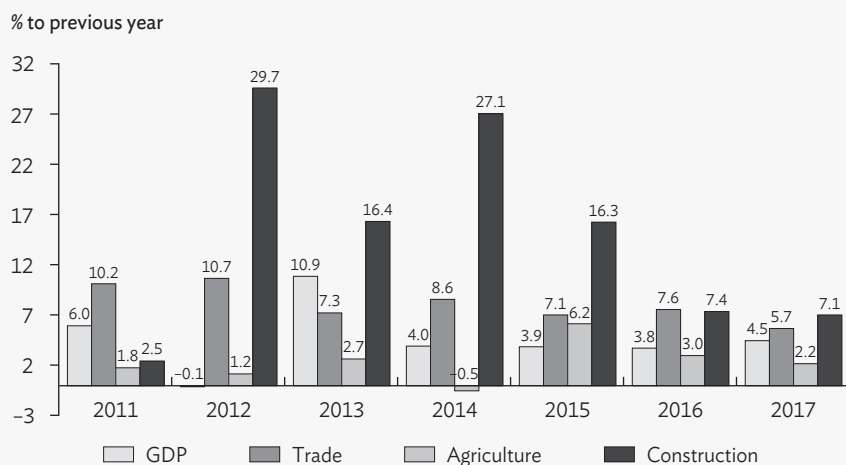
**Table 5.1: Main Sectors of the Kyrgyz Economy in GDP, 2000–2017 (%)**

	2000	2004	2008	2012	2015	2017
Agriculture	34	30	23	17	14	12
Manufacturing	18	15	13	12	16	15
Energy, gas, and water	6	3	1	3	2	2
Construction	4	2	5	6	8	8
Trade	12	16	16	16	19	18
Transport	2	3	4	5	4	4
Communication	1	3	4	4	4	4
State, education, and health	9	10	11	15	13	15
Net taxes	7	10	13	13	12	13
Other sectors	5	7	8	9	8	9

GDP = gross domestic product.

Source: National Statistical Committee.

**Figure 5.1: Growth of GDP and Value Added for Main Sectors in the Kyrgyz Republic, 2011–2017 (% to the previous year)**



GDP = gross domestic product.

Source: National Statistical Committee.

### 5.1.2 | SME Definition

According to the Kyrgyz Republic’s legislation, there is no unified definition of small and medium-sized enterprises (SMEs). Therefore, a combined approach is used by the National Statistical Committee (NSC) of the Kyrgyz Republic to fully represent the different types of business activities in the Kyrgyz Republic. The basic classification of types of enterprises is defined by Government Decree #78 for the two different types of economic sectors (Table 1.2).<sup>1</sup>

**Table 5.2: Classification of SMEs by Number of Persons and Turnover in the Kyrgyz Republic**

	Production Agriculture, construction, mining, processing industry, production and distribution of energy, gas, and water	Service Trade and repair services, transport and communication, finance, education, healthcare, and other services
By number of workers		
Extremely small enterprises	Up to 14 persons	Up to 6 persons
Small enterprises	15 to 50 persons	7 to 15 persons
Medium-sized enterprises	51 to 200 persons	16 to 50 persons
Big enterprises	201 persons and more	51 persons and more
By annual turnover		
Extremely small enterprises	Up to Som150,000 (\$2,100)	Up to Som230,000 (\$3,300)
Small enterprises	Som150,001–Som500,000 (\$7,100)	Som230,001–Som500,000 (\$7,100)
Medium-sized enterprises	Som500,000–Som2 million (from \$7,100–\$28,700)	Som500,000–Som2 million (from \$7,100–\$28,700)
Big enterprises	Som2 million or more (more than \$28,700)	From Som2 million or more (more than \$28,700)

Note: The som is the national currency of the Kyrgyz Republic. The average exchange rate in 2017 was Som68.87 per \$1.00 (Source: National Statistical Committee).

Source: Decree of the Government of the Kyrgyz Republic “On the basic scheme of the classifier of types of enterprises” #78 of 17 February 1998, in the version of Decree #590 on 29 August 2002.

<sup>1</sup> Decree of the Government of the Kyrgyz Republic “On the basic scheme of the classifier of types of enterprises” #78 of 17 February 1998, in the version of Decree #590 of 29 August 2002.

This classification referred to the activity of formally registered legal entities and did not cover individuals' entrepreneurial activity or farmers. The NSC uses the approach of counting economic activities not only for companies (corporations), but also for households. Normally households are consumers, but some also carry out productive activities in the form of unincorporated enterprises created to produce goods and services both for sale and for own use.<sup>2</sup> This sector includes:

- private rural household activity on a home plot of land,
- individual entrepreneurial activity without hired labor, and
- individual peasant farms

In important growing sectors, such as trade, construction, and services, the share of individual entrepreneurs is significant. Micro-SME businesses use the advantage of the simplified taxation system based on regular patent payments (Engelschalk and Loeprick 2015). Working on a patent is easy and does not require providing bookkeeping, and rates are flat and low.<sup>3</sup> Moving from an individual entrepreneur threshold increases the tax burden, which makes micro operations the most popular form of business operations in the country.

In agriculture, 95% of all output is produced by peasant farms and rural households. Peasant farms pay only land tax and social tax (equal to land tax) and a small fee on livestock. In total costs, the estimated tax burden on farmers is close to 1% of the output value. Moving from peasant farm status (agricultural cooperative or agroprocessing) also increases the tax burden. Thus, the definition of small and medium-sized businesses includes individual entrepreneurs and peasant farms, in addition to SMEs.

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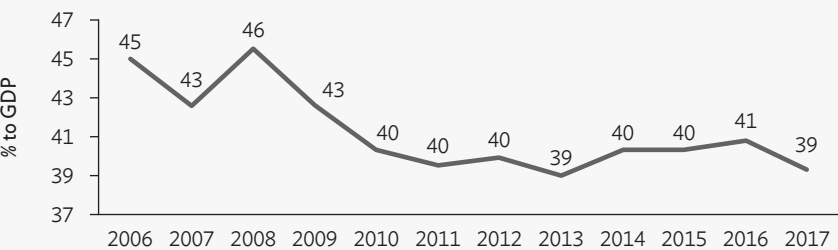
<sup>2</sup> A privately owned business, often owned by one person who has unlimited liability as the business is not legally registered as a company. <https://www.collinsdictionary.com/dictionary/english/unincorporated-business> (accessed October 2018).

<sup>3</sup> A patent is a form of the special tax regime, when tax obligations paid on the base of the fixed sum for the entrepreneurial activity implemented by individual. Paying the patent means that there is no other tax applied. Limitation for the patent is the annual turnover of Som8 million per year (\$114,000). Excerpts from the Tax Code No. 230 from 17 October 2008.

### 5.1.3 | SMEs’ Role in the Economy

The role of the SME sector in the Kyrgyz Republic is substantial. It reached 45% of GDP at maximum in 2006 and 2008. Then the share of SMEs in the national economy declined to the level of around 40% and stabilized at that level after 2010 (Figure 5.2).

**Figure 5.2: SME Share in the Economy, 2006–2017 (% of GDP)**



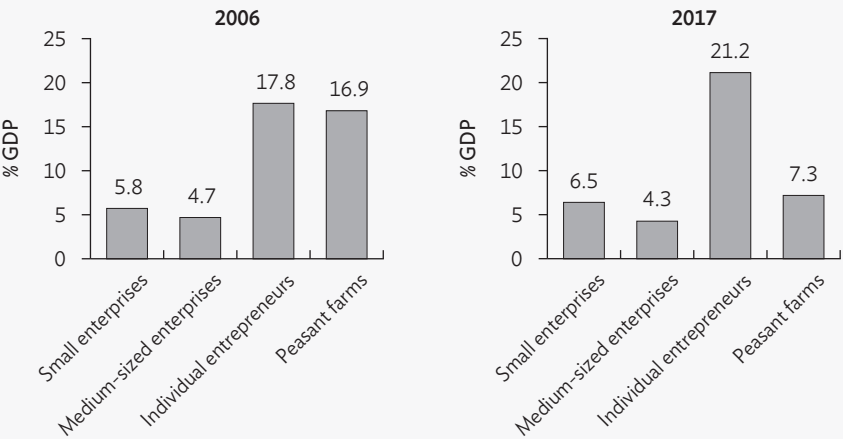
GDP = gross domestic product, SME = small and medium-sized enterprise.  
Source: National Statistical Committee.

Four types of entrepreneurs form this contribution to the economy—SMEs (firms), individual entrepreneurs, and peasant farms. The contribution of different types of SMEs to GDP changed over time (Figure 5.3). The share of peasant farms in GDP declined from 16.9% to 7.3%. The trend is explained by the low growth rate of the agricultural sector (Table 5.1). Individual entrepreneurs’ contribution to the SME sector increased (from 17.8% to 21.2%) as well as small enterprises (from 5.8% to 6.5%). The share of medium-sized enterprises declined from 4.7% to 4.3%.

The share of agriculture in SMEs consists not only of that of peasant farms; it also includes a proportion of agricultural SMEs (2.2% of total output in 2016). In addition, 29.3% of individual entrepreneurs worked in the agricultural sector in the same period (NSC 2017a). Thus, the consolidated share of agriculture in the SME share of GDP consists of 13.5% of the total 39.3% in 2017.

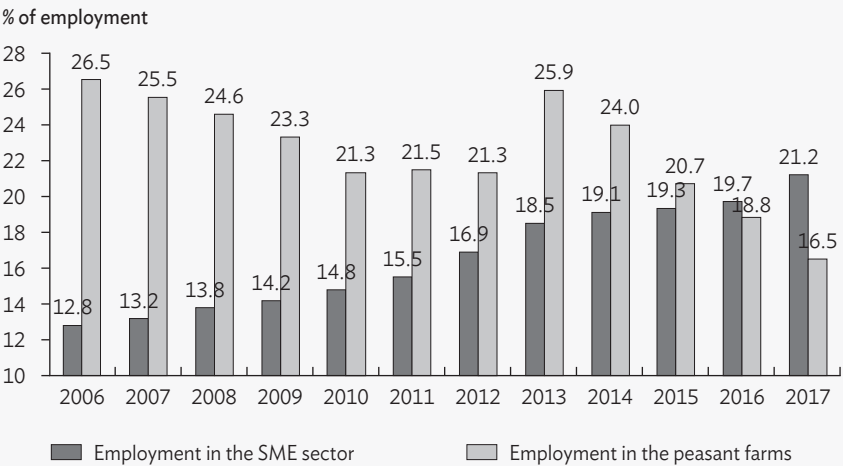
Employment in SMEs increased from 12.8% to 21.2% of all labor markets during 2006–2017 (Figure 5.4). Most of the growth happened between 2010 and 2013. During the last 3 years, the indicator stabilized around 20%. The growth of employment in SMEs, which is mainly the growth of self-employment, consists primarily of the growth of the share of individual entrepreneurs in the SME sector (Figure 5.3).

**Figure 5.3: SME Sector Contribution by Type of Entrepreneurs in the Kyrgyz Republic, 2006 and 2017 (% of GDP)**



GDP = gross domestic product, SME = small and medium-sized enterprise.  
Source: National Statistical Committee.

**Figure 5.4: Employment in the SME Sector in the Kyrgyz Republic, 2006–2017 (%)**



SME = small and medium-sized enterprise.  
Source: National Statistical Committee.

It should be noted that employment in agriculture—in peasant farms—is also a significant share of the labor market. Peasant farms are a source of 387,500 jobs (16.5% of employment), mainly farmers themselves and non-paid family workers. The trend of employment in agriculture predictably declined from 26.5 in 2006 or 10 points. The decline not only demonstrates the outflow of the rural population toward alternative employment opportunities in other sectors, but reflects increased outflow of labor migration, mainly to the Russian Federation.<sup>4</sup> Thus, the total combined employment in the SME sector, including farmers, is 37.7%.

### 5.1.4 | Finance to SMEs

According to the national legislation of the Kyrgyz Republic, there are two main types of financial institutions that can operate on the finance market:

- Banks
- Nonbanking financial institutions (credit unions and microcredit organizations)

The regulatory framework of the banking sector is defined by the Law of the Kyrgyz Republic No. 206 of 16 December 2016, “On the National Bank of the Kyrgyz Republic, banks and banking activity.” It defines the main rules of the banking activity for commercial banks, the requirements, and principles of working with clients. The law also defines that the major regulatory role in the financial system belongs to the National Bank of the Kyrgyz Republic. The law provides the rules of the work, including currencies, mandatory requirements for limits, licensing, audit roles, and other activities for creating a clear and transparent financial system in the republic.

Nonbanking financial institutions include credit unions and microfinance organizations. Credit unions operate according to the Law of the Kyrgyz Republic No. 117 of 28 October 1999, “On the credit unions.” It defines the main rules of the activity and provides a regulatory framework for the activity—collecting shares, management, reserves, limitation of the credit, and auditing. The main limitation of the credit union activity is that credit is distributed among union members only.

Microfinance organizations’ work is regulated by the Law of the Kyrgyz Republic No. 124 of 23 July 2002, “On the microcredit organizations in the Kyrgyz Republic.”

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<sup>4</sup> According to the information of State Service on Migration under the Government of the Kyrgyz Republic, the number of labor migrants from the Kyrgyz Republic in the Russian Federation reached 640,000 people in 2018. <http://ssm.gov.kg/> (accessed November 2018).

It provides definitions for the main types of microcredit organizations: microfinance company, microcredit company, and microcredit agency. A microfinance company is a joint stock company which can lend money and attract deposits. It is a commercial organization which can only lend to clients. A microcredit agency is a noncommercial organization that provides loans to clients with interest rates, but without the right to make a profit. The law regulates the main lending activity and mandatory obligations and rules—lending to clients, licensing criteria, reserves, and modality of main operations. All activities should be done according to the permission of the National Bank described in the license on financial activity.

The regulatory work of the National Bank role in the financial system is significant. In general, the legal framework is assessed as satisfactory. It is recommended that efforts be improved for enhancing the regulatory environment for financial institutions, including risk-based supervision, bringing the framework to international standards, improving loan management, and equal regulation for all institutions (IMF 2018).

Finance provided by banks and nonbanking financial institutions to entrepreneurs and the general population has increased over time in the Kyrgyz Republic (Figures 5.5 and 5.6). There are no collected separate statistics for SME finance. It is based on the complicated SME definition problem and the prevalence of individual entrepreneurs. Selected interviewed representatives from financial institutions report that in commercial banks, the share of SME borrowers reaches 60%–70%, while for microfinance institutions, it reaches up to 80%.<sup>5</sup> However, there are some other problems that constrain the access of entrepreneurs to finance: low deposit base, insufficient financial literacy, and national currency exchange rate stability.

Supply of credit to the economy increased in absolute terms by 9.5 times between 2006 and 2017 (Figure 5.5). In proportion to GDP, it increased two times—from 10% to 21%.

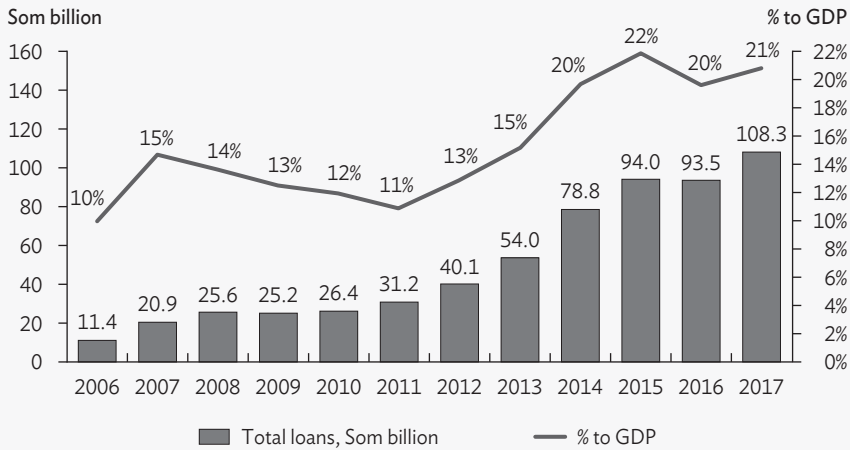
An alternative source of finance for SMEs, especially for individual entrepreneurs, that has developed is microcredit provided by microcredit organizations.

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<sup>5</sup> During report preparation, the author interviewed representatives of commercial banks (Tolubai, FINCA, Capital Bank, Bakai Bank, KICB) and microfinance organizations (FNT Credit and First Microfinance Organization) to cover the gaps in information. This assessment is based on a qualitative approach and is not statistically representative.

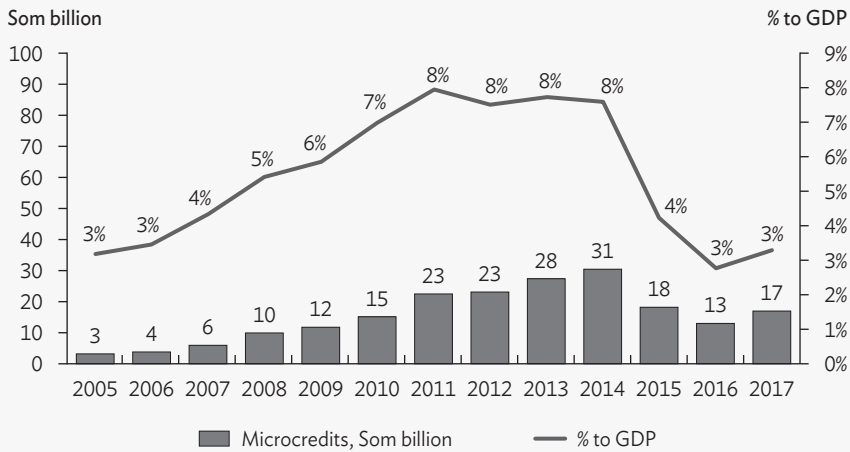


**Figure 5.5: Total Volume of Loans (Som billion) and Share to GDP (%) in the Kyrgyz Republic, 2006–2017**



GDP = gross domestic product, Som = Kyrgyz som.  
Sources: National Bank of the Kyrgyz Republic, National Statistical Committee.

**Figure 5.6: The Volume of Microcredit (Som billion) in the Kyrgyz Republic, 2006–2017**



GDP = gross domestic product, Som = Kyrgyz som.  
Note: Includes credit given by all types of nonbanking financial and credit organizations.  
Source: National Statistical Committee.

The dynamic of microcredit was controversial during the studied period. During 2005–2014, the volume of microcredit increased 10 times—from Som3 billion to Som31 billion—almost half of the volume of credit of banks. Then in 2015–2016, the sector of microcredit declined more than two times, and since 2017 it has increased again (Figure 5.6).

One of the reasons for the decline was the sharp depreciation of the Kyrgyz Republic's currency. This had a stronger effect on the microcredit organizations than on the banking sector because obligations of microcredit organizations are mostly in foreign currency, while all credit is in the national currency—82% of external debts are from foreign credit organizations and 18% are from international development financial institutions (National Bank of the Kyrgyz Republic 2018). At the same time, commercial banks demonstrate higher stability due to the more balanced currency structure of the liabilities in the national and foreign currencies. The second reason for the decline of microcredit organizations and the growth of banking credit supply was the transformation of three biggest non-banking microcredit institutions to the banks in 2014–2016.<sup>6</sup> The total amount of credit provided by those banks (former microcredit institutions) was equal to Som14.7 billion in 2016.<sup>7</sup> The estimated share of microcredit organizations' credit "loss" due to the transformation process reached at least half of the volume of the credit. It might be assumed that the share of the microcredit on the market lost by microcredit organizations was afforded by the increased banking sector in 2015–2017.

### 5.1.5 | SME Situation in the Kyrgyz Republic

The two main types of SMEs are firms and individual entrepreneurs. The number of small firms increased almost two times during 2001–2017. The number of medium-sized enterprises declined between 2001 and 2006 and then stabilized at the level of 800 enterprises.

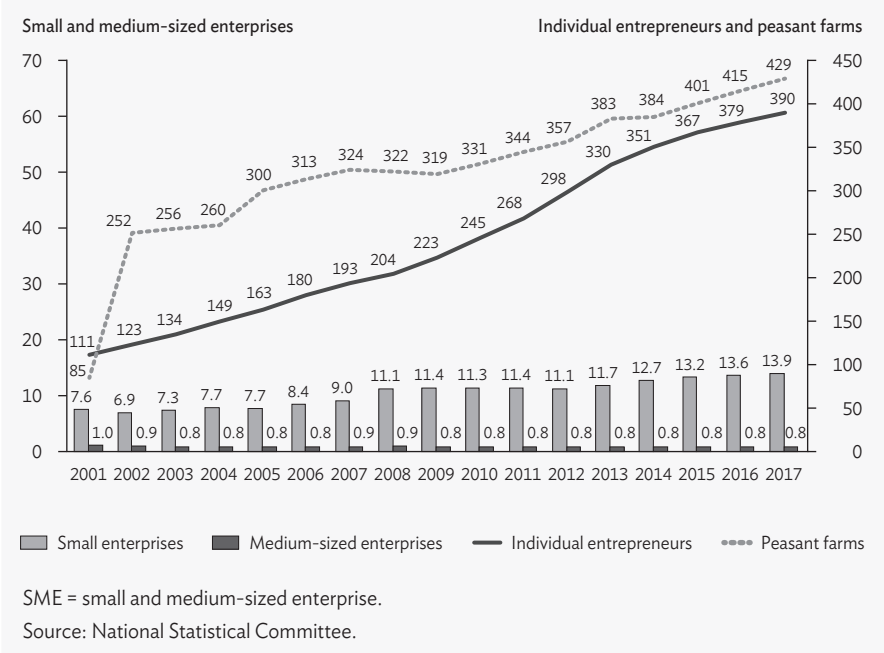
The number of individual entrepreneurs and peasant farms also increased (Figure 5.7). The number of farmers increased almost three times between 2001 and 2002 (from 85,000 to 252,000) due to the finalization of the land reform.

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<sup>6</sup> In 2014, the Bai-Tushum microcredit company (MCC) transformed into a commercial bank. In 2015, the microcredit company Finca MCC followed the same way, and at the beginning of 2016, the Kompanion MCC finalized this process.

<sup>7</sup> <http://www.finca.kg> (Annual Report for 2015); <http://www.kompanion.kg/> (Annual Report for 2016); <http://www.baitushum.kg/> (Annual Report for 2016) (accessed November 2018).

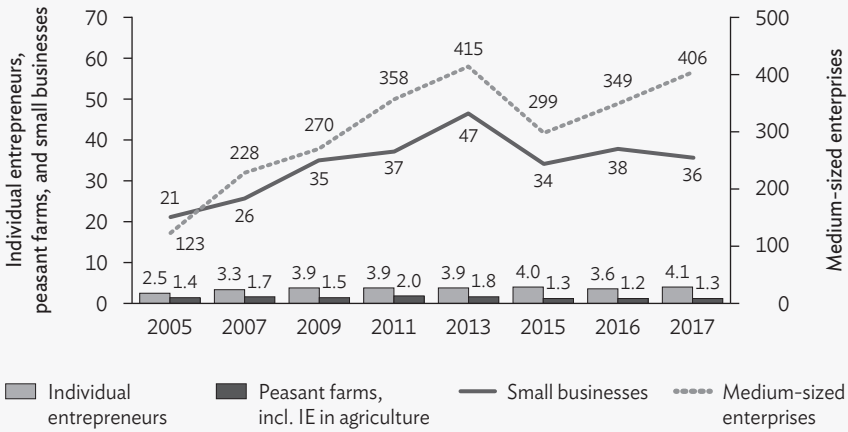
**Figure 5.7: Number of SME Entities in the Kyrgyz Republic, 2001–2017 ('000 units)**



Then it increased slowly, with the average growth rate ranging between 3.5%–4%. The number of individual entrepreneurs increased more uniformly, with an average rate growth of 8%. During the last 5 years, the growth rate declined to 5%.

There are no data on turnover for micro-SME entities (individual entrepreneurs and peasant farms) due to the absence of internal accountancy. It makes it problematic to apply a standard productivity analysis. However, household-based estimations for micro-SME and national account data allow for estimation of the level of value-added per one unit of each type of SMEs. Medium-sized enterprises, as well as small enterprises, increase the value-added per one business entity in the period 2005–2013. The fall of turnover for medium-sized enterprises in 2015–2017 coincides with the decline of the value-added in 2015, but quickly recovered in 2016–2017. The value-added for small enterprises also demonstrated a decline in 2015, but recovery was lower. Individual entrepreneurs’ value-added increased until 2015 and then varied on the level of \$3,500 to \$4,000 per entrepreneur.

**Figure 5.8: Average Annual Value-Added for all Types of SMEs in the Kyrgyz Republic in 2005–2017 (\$'000 per business entity)**



IE = individual entrepreneurs, SME = small and medium-sized enterprise.

Source: National Statistical Committee, own calculations.

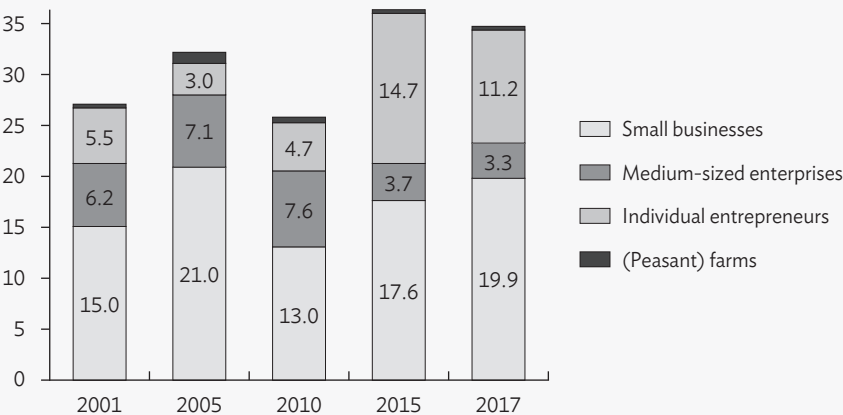
Value-added per one peasant farm, including individual entrepreneurs in agriculture, increased to a maximum of \$2,000 in 2011 and declined to \$1,200–\$1,300 in 2016–2017 (Figure 5.8).

Distribution of SME share within the overall output of the sectors in the economy is different. There are few sectors where the consolidated share of the SME sector is significant (2017):

- Agriculture (62.1% without rural household activity on a home plot of land),
- Retail trade and repairs of automobiles (82.6%),
- Horeca (hotels, restaurants, cafés) (96.7%),
- Transport and warehouses (62.1%),
- Contract works in construction (77.1%), and
- Manufacturing (21.4%).

The SME sector also plays a significant role in trade, except for peasant farms. SMEs conducted 35% of all export operations in 2017 (Figure 5.9).

**Figure 5.9: Share of SMEs in Exports in the Kyrgyz Republic, 2001–2017 (%)**



SME = small and medium-sized enterprise.  
 Sources: National Statistical Committee, author’s calculations.

### 5.1.6 | Access to Finance

Access to finance is provided by two types of financial institutions: banks and nonbanking financial institutions. The banking sector consists of 25 acting banks with 330 branches in all regions of the country. The nonbanking financial institutions consist of 658 organizations, including the specialized financial credit organization, JSC, which is a “financial company for support and development of credit unions,” microfinance organizations, credit unions, exchange offices, and the credit bureau.

Credit-providing, nonbanking institutions include:<sup>8</sup>

- Microcredit agencies – 42
- Microcredit companies – 94
- Microfinance companies – 8
- Credit unions – 106
- Credit unions with the right to attract deposits from participants – 7

<sup>8</sup> According to the register of the National Bank. <http://www.nbkr.kg/index1.jsp?item=89&lang=RUS> (accessed November 2018).

The average size of credit in the banks was \$3,900 per borrower at the beginning of 2017; for borrowers of microfinance organizations it was \$907, and for credit unions \$1,800. For the same period, there were 484,400 active credits registered, 66% of which were provided by commercial banks, 33% by microfinance organizations, and 1% by credit unions (Credit Bureau “Ishenim” 2017).<sup>9</sup>

The sectoral distribution of the credit demonstrates that access to finance for SMEs in the key sectors is different. Fifty-one percent of total credit in the country was allocated for the SME prevailing sectors—retail trade and services (27%), agriculture (21%), transport (2%), and hotels and restaurants (1%) (Table 5.3). Other sectors devoted to individual consumption are mortgages (9%) and consumer credit (13%), which also support the development of the SME service and production sectors.

**Table 5.3: Structure of Credit and Microcredit by Sectors of the Economy, 2016–2017 (%)**

No.		Total Credit in 2017	Banks	Microcredit Organizations	Total Credit in 2016
1	Agriculture	21	20	25	22
2	Processing production	7	8	1	8
3	Construction	8	8	8	5
4	Trade and repair services	27	29	15	33
5	Transport and warehouses	2	2	2	1
6	Hotels and restaurants	1	1	0	1
7	Mortgage (housing credit)	9	9	1	4
8	Consumer credit	13	10	33	12
9	Other sectors	13	13	14	13

Source: National Statistical Committee, author's calculations.

<sup>9</sup> Only registered participants of the financial market are covered.

## 5.2 Status of Financial Inclusion for SMEs in the Kyrgyz Republic

Access to finance and financial infrastructure is growing in the country. It has reached certain saturation in more developed areas of the country, but still more investment is needed in the rural and remote mountainous parts of the country. Indicators of access to financial infrastructure have developed over time—more ATMs are available, more debit and credit cards are issued, and more branches of banks were opened (Tables 5.4 and 5.5).

Most of the installed equipment and branches are located in the capital Bishkek and surrounding Chui Province (34%) (Table 5.6). The remote provinces (Naryn, Talas, and Batken) are covered poorly by banks due to their low population density and insufficient economic potential. The gap between the more developed areas and other regions is visible and seriously worsens access of financial resources to SMEs in the remote, rural, and mountainous areas.

Access to finance has improved for individual entrepreneurs and peasant farms. Regarding access to finance for firms, the results of the World Bank Enterprise Surveys are one of the useful sources of information for the firms registered as legal entities.<sup>10</sup> These results show that 54% of business entities did not apply for credit in 2013, and 37% of them have high interest rates (World Bank 2014a). The responses of the businesses show, however, that the demand for credit is not covered yet. Fifty percent of average-sized companies claim high interest rates as a reason for not applying for credit, while 16% of small companies select that answer and 31% of big enterprises. According to that data, a significant share of the SME sector (73% in 2017—See Figure 5.3) is excluded from the analysis of business environment studies.

The share of surveyed enterprises that stated that accessing credit is not a problem increased from 24% in 2008 to 39% in 2013. The share of enterprises reporting that they did not apply for a loan because there was no need also increased from 50% in 2008 to 54% in 2013. The share of enterprises purchasing consumables inputs to be paid on credit increased from 31% in 2008 to 44% in 2013 (World Bank 2014b).

<sup>10</sup> <http://www.enterprisesurveys.org>.

**Table 5.4: Financial Access Indicators in the Kyrgyz Republic, 2008–2017**

	2008	2010	2012	2014	2016	2017
ATMs per 100,000 adults	4.7	7.3	15.6	24.7	31.2	33.4
Borrowers at commercial banks per 1,000 adults	–	29.0	39.8	56.2	95.5	97.7
Borrowers at non-deposit taking microfinance institutions per 1,000 adults	68.3	100.3	109.8	110.3	54.9	64.4
Branches of commercial banks per 100,000 adults	6.8	6.1	7.7	7.8	8.4	8.1
Non-branch retail agent outlets: commercial banks per 100,000 adults	11.2	12.1	17.3	20.2	23.8	–
Debit cards per 1,000 adults	27.2	59.0	104.4	225.0	388.1	469.4

Source: IMF. 2017. Financial Access Survey.

**Table 5.5: Financial Inclusion, Selected Indicators in the Kyrgyz Republic, 2011–2017 (%)**

	2011	2014	2017
Account (% age 15+)	4	18	40
Debit card ownership (% age 15+)	2	6	19
Credit card ownership (% age 15+)	1	3	4
Borrowed from a financial institution (% age 15+)	11	13	9
Borrowed from family or friends (% age 15+)	26	21	17
Borrowed any money in the past year (% age 15+)		38	32
Saved any money in the past year (% age 15+)		36	24
Mobile money account (% age 15+)			3
Saved to start, operate, or expand a farm or business (% age 15+)		9	9
Borrowed to start, operate, or expand a farm or business (% age 15+)		6	9

Source: World Bank Group. The Global Findex Database 2017. [https://globalfindex.worldbank.org/#data\\_sec\\_focus](https://globalfindex.worldbank.org/#data_sec_focus) (accessed October 2018).



**Table 5.6: Penetration of Bank Services at the Regional and Country Level, 2018 (per 100,000 adults)**

Regions	Bank Cards	ATMs	POS Terminals in the Retail Network	POS Terminals in Banks	Payment Terminals
Bishkek + Chui	85,597	61	473	54	50
Issyk-Kul	54,211	48	124	60	56
Naryn	66,488	31	31	58	33
Talas	49,600	31	34	42	43
Jalal-Abad	41,830	25	35	35	27
Osh+ Osh (city)	37,172	23	42	37	27
Batken	41,168	21	9	37	27
National Level	57,314	38	185	45	37

POS = point of sale.

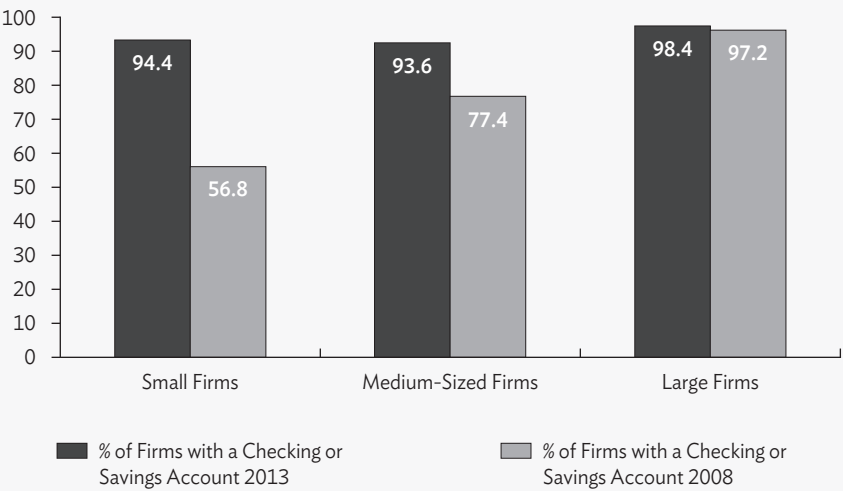
Source: National Bank of the Kyrgyz Republic (2018).Report on the State of Payment System at the Second Quarter of 2018. <http://www.nbkr.kg/index1.jsp?item=98&lang=RUS> (accessed October 2018); author’s estimation.

Enterprise survey data show that the number of SMEs with savings or checking accounts in banks increased in the country.<sup>11</sup> In 2008, 56.8% of small enterprises had an account at a bank, as did 77.4% of medium-sized enterprises. In 2013, this gap observed in the earlier period diminished. The proportion of enterprises with bank accounts varies between 94% and 98% (Figure 5.10). However, the gap in the occurrence of credit between SMEs compared to large firms declined, but still remains (Figure 5.11).

The share of small firms with credit increased from 13.7% to 24.4% between 2008 and 2013, as well as for medium-sized firms—from 19.2% to 28.1%. Large firms’ proportion of the credit declined from 50.6% to 42.3%. The difference between Bishkek and other regions also illustrates the existing gap in access to credit (8% minimum). The lowest figures are for Naryn Province (Figure 5.12).

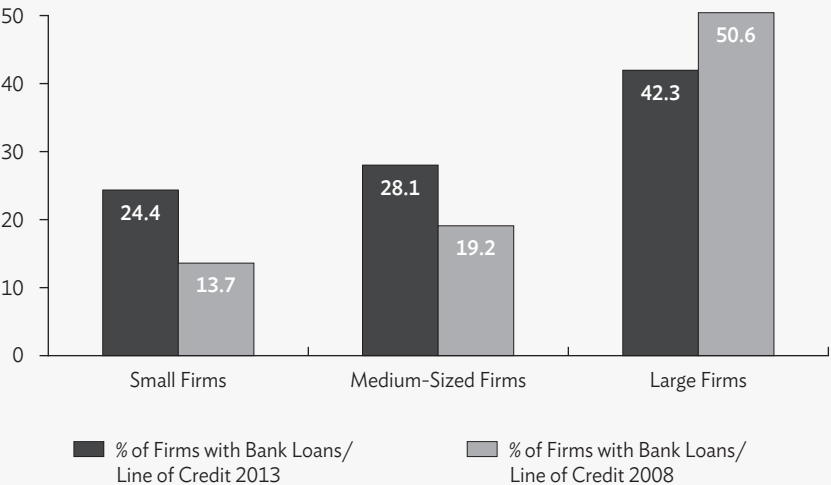
<sup>11</sup> <http://www.enterprisesurveys.org>

**Figure 5.10: Firms with a Bank Account in the Kyrgyz Republic, 2008 and 2013 (%)**



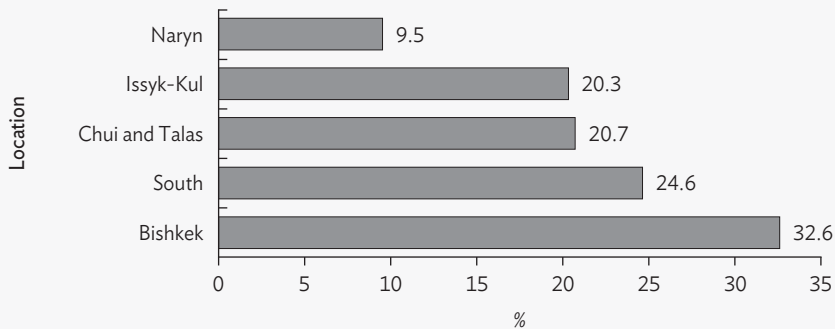
Source: World Bank. 2014. Enterprise Survey.

**Figure 5.11: Firms with Credit in the Kyrgyz Republic, 2008 and 2013 (%)**



Source: World Bank. 2014. Enterprise Survey.

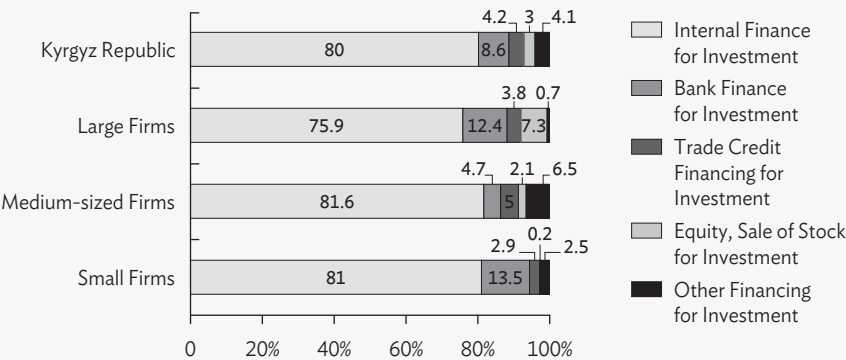
**Figure 5.12: Firms with Credit in the Regions of the Kyrgyz Republic, 2013**



Source: World Bank. 2014. Enterprise Survey.

The different sources of investment financing show similarities and differences in financing investment (Figure 5.13). Bank loans and trade credit financing play a supporting role in investment capital of SMEs. This share is bigger for small firms and for large firms. Medium-sized firms finance investment from credit sources below the country average. Equity financing is found to be more developed among large firms compared to SMEs. The biggest source of finance for investment is internal finances. It is caused by the high interest rate in the Kyrgyz Republic.

**Figure 5.13: Financing Sources for Investment in the Kyrgyz Republic, 2013 (%)**



Source: World Bank. 2014. Enterprise Survey.

### 5.3 Financial Knowledge and Skills of SME Entrepreneurs in the Kyrgyz Republic

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Financial literacy is an important factor in the development of the financial system as well as for SME development. It is necessary to take financial literacy into account for the micro, small, and medium-sized business sector, especially for the enterprise sector and the micro-business sector based on self-employment in agriculture and service sectors. It should be noted that the activities of both the state and international organizations, as well as financial institutions, for improving financial literacy are aimed primarily at increasing financial literacy of the population (including micro-entrepreneurs), and not at the level of enterprises.

In 2013, the International Finance Corporation (IFC) conducted a study of the financial literacy of the population. Of the respondents, 60% lack awareness and understanding of the effective interest rate, while around 10% have knowledge of compound interest. The understanding of financial concepts of most people was also insufficient (World Bank 2014c).

Assessment of the financial literacy of population was studied in by the National Bank in 2015. It covers all regions, and samples (2,072 persons), aiming for representativeness on the level of income, age, and education. The survey studied different aspects of knowledge of financial markets and included tests of the practical financial knowledge of respondents (assignments on the calculation of interest rates), household cost accounting, strategies for income shortage compensation, and other issues (Abakirov et al. 2015).

Self-assessment of financial knowledge of the population was stated as insufficient. In the survey, 40.3% of people assessed that their financial knowledge was at a low level, 17% of the participants answered two-thirds of the questions correctly, and only 1% answered correctly on all the questions. The proportion of women answering correctly compared to men was lower. According to the study assessment, 22% of respondents demonstrate unsatisfactory financial knowledge and 12% do not have any knowledge of finance. The study found that financial literacy positively correlates with the income of the respondents and the level of education. Poor and less-educated people demonstrated low financial knowledge and were less motivated to study it. The passive form of savings is prevalent—only 11% have some savings for unpredicted situations. Women have a higher tendency to save money or take credit. Most people were not motivated to increase their financial literacy (Abakirov et al. 2015).

The Mid-term Strategy of the Microfinance Development in 2006–2010 targets improving the knowledge of financial operators. It stated that the knowledge of microfinance specialists needs to be developed further with the support and monitoring of the National Bank.<sup>12</sup> The draft of the next strategy of the microfinance development for 2011–2015, which supported the idea of financial literacy improvement was not approved (National Bank of the Kyrgyz Republic 2011). This idea was later realized in the Program of the Improvement of Financial Literacy of Population for 2016–2020, which was approved in 2015.<sup>13</sup>

The program emphasizes the priorities of financial literacy of children and youth, financial literacy of adults, and equal access to financial information and services for all citizens. The main approach was an attraction of government bodies, the private sector, and donors. The program proposes the creation of a new curriculum for the early development of financial literacy. The promotion of knowledge through web platforms is one of the main areas of low-cost knowledge dissemination. The program does not have any specific measures for providing more emphasis on girls or women. The program is not very detailed (no costing or assessment mechanism).

There are a number of activities that have been implemented, including the development of the website <http://www.finsabat.kg> and Global Money Week in 2017, which included educational lectures by the National Bank and commercial banks, an IFC panel at higher educational institutions, and training of financial literacy.

In December 2017, the National Bank approved an internal program for the main activities of the development of microfinance sector on 2018–2021, including actions on the distant training of the population by microfinance organizations and training of lenders on financial literacy (National Bank of the Kyrgyz Republic 2018b).

Assessments of financial literacy cover individual entrepreneurs and peasant farmers since they address the needs of the population. The sector of firms (legally registered SMEs) therefore lies out of sufficient attention. In several sources, financial literacy of the SME sector was specified as insufficient (ADB 2015; IMF 2016; World Bank 2014d; OECD 2014a). Those statements, however, did not provide evidence-based information, e.g., a survey or assessment.

<sup>12</sup> Mid-term Strategy of Microfinance Development in the Kyrgyz Republic on 2006–2010. Approved by the Decision of the Government of the Kyrgyz Republic # 637/37/7 of 30 December 2005.

<sup>13</sup> Program of the Improvement of the Financial Literacy of the Population of the Kyrgyz Republic for 2016–2020. Approved by the Decision of the Government of the Kyrgyz Republic # 319 of 15 June 2016. <http://cbd.minjust.gov.kg/act/view/ru-ru/98549> (accessed October 2018).

There have been some efforts on the part of the Kyrgyz Republic government and international organizations to target the improvement of financial literacy of the entrepreneurs that have been realized:

- Kyrgyz Republic government and ADB Policy-based Loan and Grant for Second Investment Climate Improvement Program (ADB 2016).
- State Program on Financial Literacy to increase bank customer awareness of the benefits, costs, and risks of using electronic payments and financial services.
- International Bank for Reconstruction and Development—Kyrgyz Audit and Reporting Enhancement Project in 2016, including the promotion of internationally recognized accounting education and capacity building for accountants and business representatives.<sup>14</sup>

Unfortunately, the evaluation of the efficiency of those projects was not accessible.

## 5.4 Barriers to SME Finance in the Kyrgyz Republic

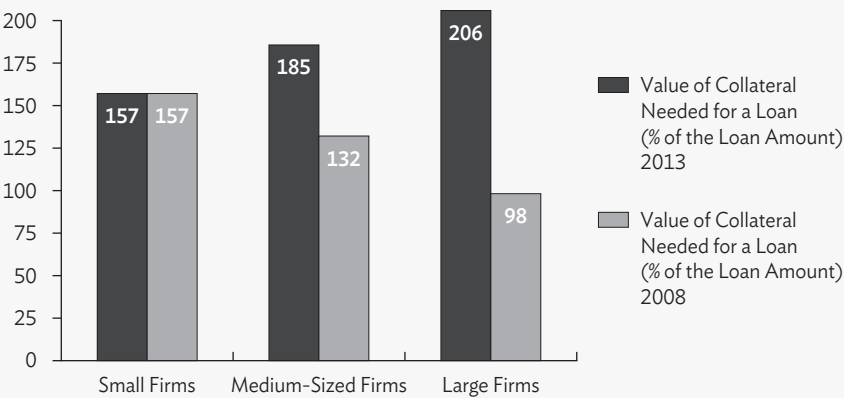
One of the potential reasons for the insufficient level of financial inclusion of SMEs could be caused by the collateral requirement of existing banks. The data show a contradictory trend. The situation was more favorable for medium-sized and large firms compared to small firms in 2008, which changed in 2013. The requirement for collateral for small firms remained at the same level, but it worsened for the medium-sized and large firms (Figure 5.14). This change might be explained by the higher political and economic volatility in the Kyrgyz Republic (global financial crisis and food crisis [Golay 2010], and the revolution in 2010).

The situation regarding the institutional barriers in the country is promising. Registering property in the Kyrgyz Republic is relatively easy. The index score for the Kyrgyz Republic is 24 from a maximum of 30 (17 in Kazakhstan and 7.5 in Tajikistan). Land dispute resolution was assessed as 6.5 from a maximum of 8 (World Bank 2018b). Several credit measurement indicators are presented in Table 5.7. The strength of the legal right index was assessed at grade of 9 of 12 (high level). This indicator includes rights of borrowers and lenders through collateral laws (0–10) and protection of secured creditors' rights through bankruptcy laws (0–2).

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<sup>14</sup> Supplementary letter of December 2016 to the Annex to the Grant Agreement between the Kyrgyz Republic and International Bank for Reconstruction and Development/International Development Association between IBRD and State Service for Regulation and Supervision of Financial Markets.

**Figure 5.14: Value of Collateral Needed for a Loan, 2008 and 2013 (%)**



Source: World Bank. 2014. Enterprise Survey.

The second indicator measures the depth of the credit information base on the scope and accessibility of information distributed by credit bureaus and registries (0–8). This indicator is on a satisfactory level of 6 from 8. The credit registry coverage is 0% and credit bureau coverage is 37%. This measures the number of individuals and firms listed in the largest credit bureau as a percentage of the adult population and the number of individuals and firms listed in credit registry as a percentage of the adult population.

**Table 5.7: Assessment of Getting Credit in the Kyrgyz Republic, 2018**

Indicator	Kyrgyz Republic	Europe and Central Asia	OECD Countries
Strength of legal rights index (0–12)	9	6.6	6.0
Depth of credit information index (0–8)	6	6.3	6.6
Credit registry coverage (% of adults)	0.0	22.2	18.3
Credit bureau coverage (% of adults)	37.0	42.8	63.7

OECD = Organisation for Economic Co-operation and Development.

Source: World Bank. 2018b. Doing Business.

There is uneven access to finance for women entrepreneurs. Even if there are no limitations for women in access to property or getting credit, the data show that only 29% of immovable property is registered to women, while 62% is registered to men, and 9% to other persons not living at the place of registration (National Statistical Committee and UN Women 2016). Most of the assets are registered to the male members of the household, as well as the right to use it. This means that, in practical terms, women have limited access to credit due to the general limitation of their rights. Data show that the proportion of women among the managers of SMEs registered as legal entities is 42% for small enterprises and 39% for medium-sized enterprises. The share of women among individual entrepreneurs is 34.7%, and for heads of peasant farms is 18.8% (National Statistical Committee 2017b). During the initial stage of development of microfinance organizations, a special focus was given by the development institutions to supporting the creation of microfinance centers in the Kyrgyz Republic, especially for women. At the beginning of the microcredit organization, the share of women in microcredit organizations reached 80%. Even now, the majority of borrowers of microfinance organizations are women entrepreneurs, predominantly in rural areas of the Kyrgyz Republic (Table 5.8).

**Table 5.8: Share of Female Borrowers among Borrowers of Microfinance Organizations in the Kyrgyz Republic, 2016–2017**

	2016			2017		
	Total Borrowers	Female Borrowers	%	Total Borrowers	Female Borrowers	%
Kyrgyz Republic	239,413	135,981	57	307,997	171,001	56
Batken	16,175	8,468	52	20,847	10,862	52
Jalal-Abad	32,803	19,289	59	42,368	24,715	58
Issyk-Kul	23,384	13,467	58	29,938	17,603	59
Naryn	19,703	12,324	63	26,215	15,984	61
Osh	53,924	27,920	52	72,295	36,969	51
Talas	6,972	4,313	62	8,365	5,139	61
Chui	42,656	25,452	60	49,377	27,855	56
Bishkek (city)	35,393	20,581	58	47,296	26,349	56
Osh (city)	8,403	4,167	50	11,296	5,525	49

Source: National Statistical Committee.



## 5.5 Status of Domestic and Global Value Chains in the Kyrgyz Republic

### 5.5.1 | Export-Oriented Value Chains in SMEs

A value chain is defined as “the full range of activities which are required to bring a product or service from conception through the different phases of production, delivery to the final consumers and final disposal after use” (Kaplinsky and Morris 2002). The global value chain is the same process occurring in several countries (Hernandez, Martinez-Piva, and Mulder 2013). Several selected products illustrate the global and domestic value chains in different sectors of the Kyrgyz Republic. The main criteria for the selection of the value chain were the export potential of the selected product and the importance for micro, small, and medium-sized business development.

The main selected exported goods are presented in Table 5.9. Each of these products creates global value chains on export markets. Clothing and clothing accessories include two categories of products: products imported from the People’s Republic of China (PRC) and re-exported, and domestically produced and exported textile goods. Unlike many other industrial productions, SMEs prevail in textile production.

**Table 5.9: Export of Main Clothing and Agricultural Products from the Kyrgyz Republic, 2013–2017 (\$ million)**

Product Type	2013	2014	2015	2016	2017
Export total	1,773	1,640	1,441	1,423	1,757
Clothing and clothing accessories	105	100	97	73	119
Vegetables	107	85	68	93	75
Kidney beans	73	62	44	55	45
Fruits	41	22	31	31	34
Cotton yarn	20	24	20	21	25
Milk and dairy products	18	25	27	23	24

Sources: UN Comtrade, National Statistical Committee.

Textile goods are exported massively to the EEU, mainly to the Russian Federation.<sup>15</sup> The volume of exports of textiles decreased in 2015–2016 and recovered strongly in 2017. The export potential of the garment industry is promising. The second potential product is kidney beans, which export to Turkey and Eastern Europe. Kidney beans are one of the key export crop products in the country, for which new export destinations are also being pioneered. Milk products are the only livestock origin value chain that have the potential for growth through targeting EEU markets, as the dairy industry is developing in a more sustainable manner. Thus, the export of goods demonstrating the potential to grow and support SMEs includes textile (garment) production, kidney beans, and milk products.

Services exports consisted mainly of tourism (52% of all export of services) and transport (26%) in 2017. Other activities—export of communication and financial services—are less important. That tourism is considered potentially important is based not only on its overall share, but also on its higher concentration of SME activity (NSC 2018a).

The future value chain products that potentially need additional exploration are fresh fruit, nuts, and vegetables for the target markets of the PRC and the Russian Federation (World Bank 2018a). These products demonstrate high value and an increasing demand is predicted within the next generation. Selected products include cherries, walnuts, apricots, and plums. Low productivity of land and labor decrease the potential gain of exports of those products. Ineffective agricultural policies, the absence of research and extension services, weak value chains, and market linkages prevent the development of the export potential of the sector. A potential future study for the World Bank may be to explore the idea that the above-mentioned fruits and nuts might be products with a relatively higher comparative advantage in the Russian Federation and the PRC, which may be possible to promote through market expansion, linking processing companies and farmers with the markets, and enabling the business environment (World Bank 2018a). That cluster might definitely be developed further with some critical limitation—orchards and forest areas are limited and production cannot be increased easily (Borne 2011). Therefore, value chain building of these products will require significant investments, not only in logistic infrastructure but also in gardens.

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<sup>15</sup> <http://www.eurasiancommission.org/>.

### 5.5.2 | Dairy Sector Value Chain

The dairy sector is an important agricultural activity for export promotion, as well as for internal consumption purposes. The number of cattle increased in the country by 54% over the last 19 years—from 512,000 cows in 1999 to 790,000 in 2017. The growth of cow herds led to an increase in milk production by 48% between 1999 and 2016. At the same time, milk productivity demonstrates a steady decline—in 2016, milk productivity per cow declined by 7.8% in comparison with 1999. More than half of the milk (52%) was produced by rural households, and the rest by smallholder peasant farms (2016). Most farms' herd size is three to four cows (World Bank 2016). Most of the milk produced in the country (70%) is traded by smallholder family farms in the form of fresh milk. Around 1.5 million tons of milk are produced every year, but only a relatively small amount is processed by milk factories (8%–10%).

Exports of milk products from the Kyrgyz Republic include processed milk and milk products (cheese, butter, yogurt, buttermilk, and ice cream). During the last decade, the volume of milk products exports fluctuated strongly. A significant increase in the export of milk products was demonstrated in 2017.

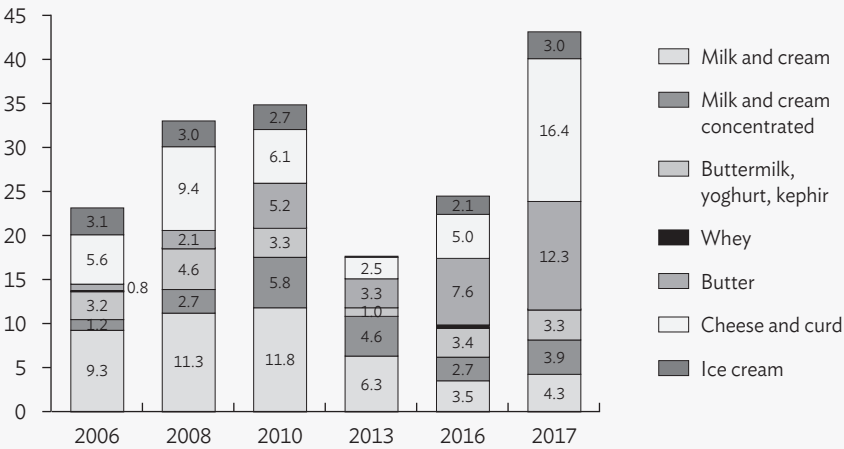
The main destination of the milk exports was Kazakhstan, and in the last couple of years it has also included the Russian Federation. In 2016–2017, Kazakhstan's share of milk exports reached 63%, and the share of exports to the Russian Federation was 36%. On average, for the last decade, the joint share of Kazakhstan and the Russian Federation in the Kyrgyz Republic's milk exports is 95%–99%.

The structure of the milk products exported varies significantly (Figure 5.15). In the previous period (2006–2010), milk and cream in liquid and concentrated form were the main type of supply of milk products, predominantly on the Kazakh market. Butter and cheese became the main types of exported milk products during 2016–2017.

Value chain-oriented milk exports include farmers, agents (milk collectors), milk factories, and exporters (Figure 5.16). Only processed milk can be exported; therefore, milk farmers oriented toward the processing factories are included in the milk export-oriented value chain. Milk farmers oriented toward selling their products to milk factories are located in the population points near the milk processing factories. The distance from the farm to the milk factory is around 20–30 kilometers and time of supply varies from 4 to 8 hours after milking. The farm gate price of raw milk is Som14–Som15 per liter.<sup>16</sup>

<sup>16</sup> Interviews with milk farmers in Chui Valley.

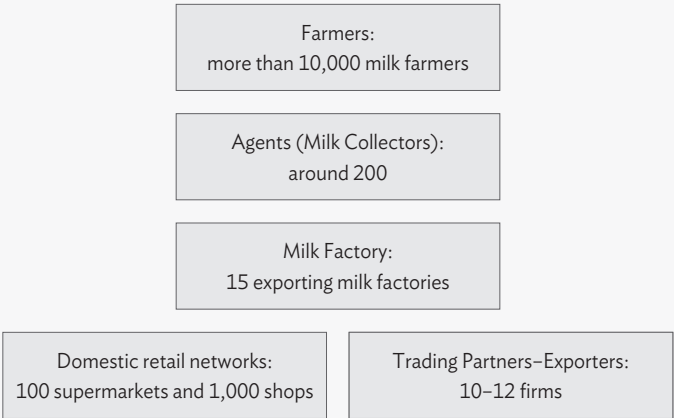
**Figure 5.15: Structure of Exports of Milk and Milk Products from the Kyrgyz Republic, 2006–2017 (\$ million)**



Note: Milk products include milk and cream, not concentrated or containing added sugar (commodity code – 0401); milk and cream, concentrated or containing added sugar (0402); buttermilk, curdled milk and cream, yoghurt, kephir (0403); whey (0404); butter (0405); cheese and curd (0406); and ice cream (2105).

Sources: UN Comtrade; Eurasian Economic Commission. <http://www.eurasiancommission.org/>.

**Figure 5.16: Milk Export Value Chain Structure**



Source: Author's presentation.

The final product at a supermarket in the Kyrgyz Republic costs from Som40 to Som50 per liter. The main value-added element of the value chain is the milk factory, which can provide a sufficient level of quality for the product to be exported. There are 15 factories included on the list of enterprises permitted to supply milk products to the EEU. A milk collecting agent is a keychain of milk consolidation from farmer to the factory. Agents consolidate milk, check the quality, and pay for the milk. Agents are responsible for the regularity and the quality of milk.

There are two value chain participants included as SME businesses—small farmers and milk collectors. Milk farmers and collectors assess the problem of financing current operations as important, and they complain about the higher interest rates for the borrowing of microcredit. Milk farmers borrow to cover operation costs—70% of operation expenditures are covered by loans (Punda and Naizarbekov 2017). Small-scale milk farmers and milk collectors are the weakest elements of the chain due to their small-scale production size, lack of knowledge, and limited access to finance. Milk factories are already out of the SME segment, as are the firms that control the exporting channels of milk products, due to the size of their operations.

Fluctuations observed in the supply of certain types of milk products to markets in Kazakhstan and the Russian Federation may depend not only on consumer preference changes, but might also be caused by the policy application of the technical regulations of the EEU. In 2017, Kazakhstan blocked the border with the Kyrgyz Republic (October–November) and crossing the border became a complicated task (Ministry of Economy of the Kyrgyz Republic 2017). The factories that were oriented toward butter and cheese were in a more favorable situation, due to the longer working life of the products.

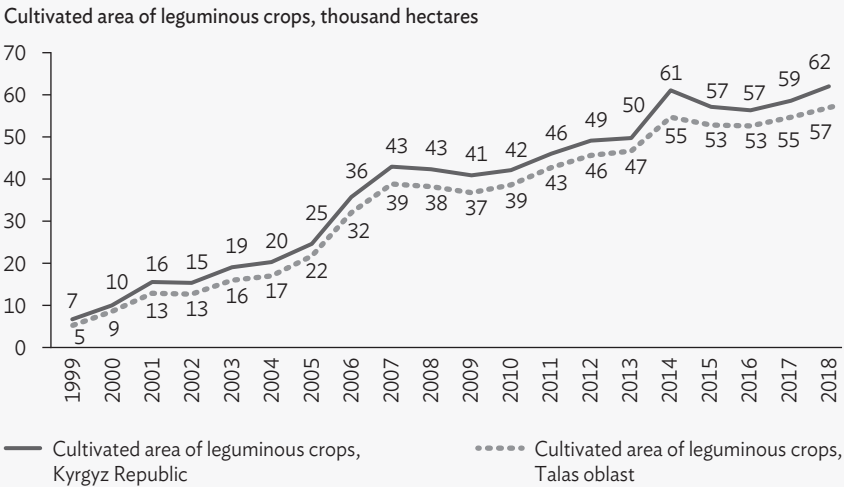
### 5.5.3 | Kidney Bean Value Chain

The kidney bean is a newly developed crop in the country.<sup>17</sup> Other legumes, e.g., peas and soybeans, were historically cultivated in the southern Kyrgyz Republic in low volumes. From the mid-90s, kidney bean production started to develop for commercial purposes in the Talas Province of the Kyrgyz Republic due to the efforts of representatives of Turkish merchants. Sustainable demand for beans from Turkish exporting firms played a key role in the bean's spread as the main crop of the region. The gross production of legumes increased almost sevenfold over 18 years (1999–2017) (Figure 5.17).

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<sup>17</sup> The section in the report presents in a condensed form the results of the previous work of the author (Tilekeyev et al. 2018).

**Figure 5.17: Growth of Legume Cultivated Areas in the Kyrgyz Republic and Talas Province, 1999–2018 ('000 hectares)**



Source: National Statistical Committee.

The yield productivity decreased over time—on average 1.7 ton per hectare. In the past decade, the Talas region produced 90%–94% of all leguminous crops in the country. In 2017, the total agricultural land share dedicated to beans reached 52.3% of the total arable land in the region, and 4.9% of all of the cultivated area in the Kyrgyz Republic. Beans have become a monoculture and play a significant role in the region. An indirect impact of the development of the bean sector has been an improvement of the poverty trends and employment opportunities in the area.

In 2009–2016, the Kyrgyz Republic exported 50,000–60,000 tons of kidney beans, on average. The value of exported beans varies significantly from year to year due to bean price fluctuations on international markets. It brings, on average, \$45 million–\$50 million annually in the observed period (Table 5.10). The share of bean exports in the total export of the Talas region is 92%–96%. Beans are the region’s main export commodity and number one agricultural export product in the country (NSC 2015).

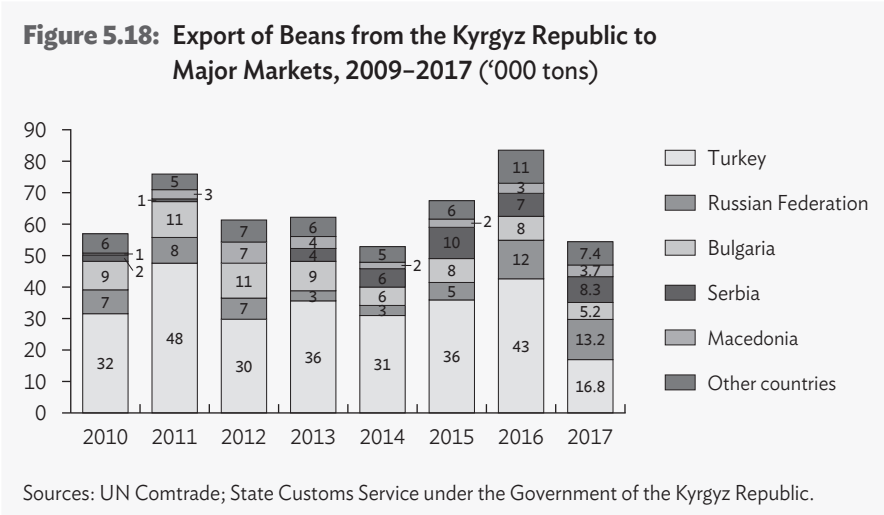
**Table 5.10: Export of Goods and Kidney Beans Share in Exports, 2009–2017**

	2009	2010	2011	2012	2013	2014 <sup>a</sup>	2015	2016	2017
Export of goods, \$ million	1,178.3	1,488.4	1,978.9	1,683.2	1,773.2	1,640.6	1,441.5	1,423.0	1,757.5
Export of beans, \$ million	29.6	35.1	51.8	48.2	73	62	43.7	55	45.2
Export of beans, '000 tons	53.3	57	76.4	61.4	61.7	53.1	66.7	83.7	54.6
Share of beans in the export, %	2.5	2.4	2.6	2.9	4.1	3.8	2.6	3.5	2.5

Sources: UN Comtrade; <sup>a</sup> State Customs Service under the Government of the Kyrgyz Republic.

Most of the harvested beans are exported to Turkey and the Balkan countries (Bulgaria, Macedonia, and Serbia). In 2017, exports to the Russian Federation and Kazakhstan increased due to better currency stability, while in Turkey, the currency fluctuates strongly (Figure 5.18). Purchase prices for Kyrgyz Republic’s beans depend on the situation in the global market. The yield in the PRC, Argentina, Egypt, and other major bean exporters, as well as demand in Turkey and the Balkans, and currency fluctuations in Turkey affect the purchase price and, consequently, the bean market development in the Kyrgyz Republic.

**Figure 5.18: Export of Beans from the Kyrgyz Republic to Major Markets, 2009–2017 ('000 tons)**



Sources: UN Comtrade; State Customs Service under the Government of the Kyrgyz Republic.

**Figure 5.19: Kidney Beans Value Chain Structure**



Source: Author's presentation.

The export-oriented kidney beans value chain is concentrated in a geographically narrow region in Talas Province (Figure 5.19). It includes farmers, farmers–agents, wholesale agents, exporters, and transport companies. Small farmers are key elements of the value chain of kidney beans due to the specifics of the product. The final quality of the beans depends mainly on the farmers; the next stages of the value chain deal with the distribution, sorting, and packing of the product, which do not add a lot of value to the final product. Therefore, farmers earn most of the value in the chain supply (62%) (Tilekeyev et al. 2018).

From the bean value chain, it is possible to specify the farmers and wholesale agents as two value chain participants who face limited access to finance. Talas Province's share in the credit and microcredit is only 3%. This lack of finance is partially covered by the activity of unregistered private money lending. However, the rates are higher compared to financial institutions and farmers try to not borrow from such sources. One of the solutions is the network scheme of financing between farmers and wholesale agents, who are members of the clan (extended family network) (see Box 5.1 in Section 5.6).

#### **5.5.4 | Value Chain in Manufacturing—Garment Industry**

The manufacturing sector has a stagnating share in the economy (Table 5.1). The share of industrial production fell from 18% to 12% of GDP between 2000 and 2012. Subsequently, it increased and stabilized at the level of 15%–16%. This sector has less access to finance than other sectors of the economy (Table 5.3). The reason for this situation is the relatively high interest rates on borrowing and their low share of long-term credit.



However, some specific clusters of industrial enterprises exist, which have developed in such conditions and which create resistant export-oriented value chains. One such cluster is a sector of textile and garments in the Kyrgyz Republic. It is based on the development of the trade flows of import of goods from the PRC to the Kyrgyz Republic, local production, and export of apparel and goods, in combination with PRC-originated goods, which move from the Kyrgyz Republic to the Russian Federation and neighboring countries. A number of studies were conducted in 2012–2014 on that matter (Birkin et al. 2012; OECD 2014b; ILO 2012; World Bank 2014e). In these studies, garment industry growth and decline was a topic of study and policy discussion. This industry still remains an important source of economic growth, employment opportunities, and export promotion.

The development of the garment sector of the economy was mainly due to the efforts of the private sector, with the support of the government at a later stage. The government creates a preferential regime for taxation based on a patent system for micro-entrepreneurs, mainly in the trade and service sector, expands it to import and export operations, and later also includes the garment sector in it. Such a pattern for foreign and domestic trade provided important competitive advantages in regional trade for Kyrgyz traders, including those who control the import of textile inputs and diversified production networks (Mogilevskii 2012).

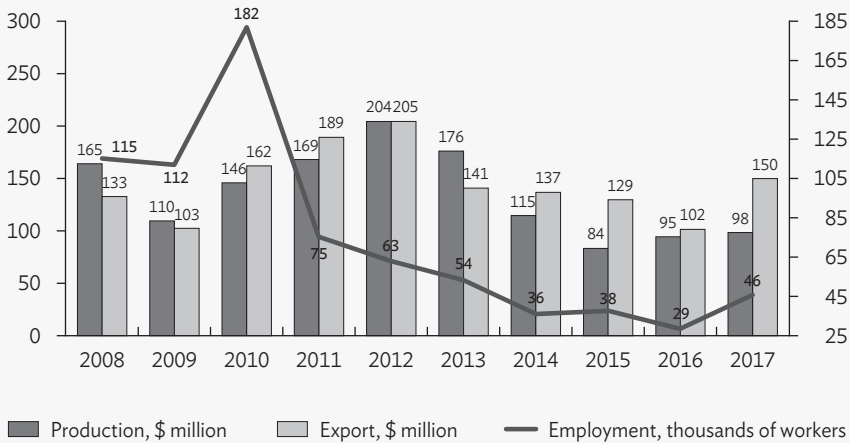
The decline of the garment sector took place in 2014 (Figure 5.20). The decrease of production and export of textile goods was caused by the consumer purchasing power crisis in the final destination markets of the Russian Federation and Kazakhstan. The Russian Federation's crisis in turn was determined by the oil crisis crash, and the exchange rate depreciation in 2014–2015 that followed coincided with the decline of remittances. After the recovery in 2016–2017, demand for consumer goods allowed for increasing production and export of goods. The employment figures in the garment sector (Figure 5.20) are underestimated in official data. Other sources propose the total employment in the sector to be from 100,000 to 200,000 people; the World Bank assessed total employment in the garment sewing business in the Kyrgyz Republic as 172,500 in 2014 (World Bank 2014e). One of the key peculiarities of the garment sector is the high concentration of the production and employment in Bishkek.

The sector performance indicators are characterized by the high fluctuations during the last 5 years due to a series of factors:

- Volatility in the end markets in the Russian Federation and Kazakhstan affected by currency depreciation caused by oil price decline.

- Dependence on inputs from imports, and, consequently from exchange rate fluctuations observed in 2014–2016.
- High mobility of the labor force—decline in one sector motivates people to switch quickly to another sector or migrate to the Russian Federation’s labor market due to the improvement of labor residency conditions.

**Figure 5.20: Production, Exports, and Employment in the Textile Sector in the Kyrgyz Republic, 2008–2017**



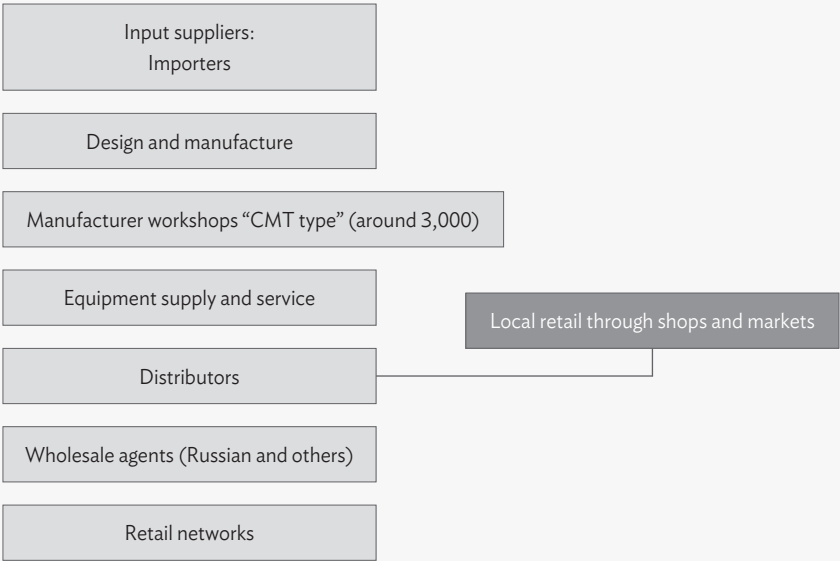
Notes: Production includes textiles, apparel, and footwear. Export of textiles only is included. Export includes also the re-export of textiles from the People’s Republic of China. Employment in the textile sector does not take into account the number of individual entrepreneurs, who work on a patent basis.

Source: National Statistical Committee, National Bank of the Kyrgyz Republic.

The export-oriented garment value chain is concentrated geographically in Bishkek and Osh cities and surrounding areas. It includes input suppliers (importers), design and manufacture workshops, cutting-making (sewing)–trimming (CMT) garment workshops,<sup>18</sup> equipment suppliers and service providers, distributors, wholesale agents, and retail network in the country and abroad. The most important value chain participant is the CMT garment workshops (Figure 5.21).

<sup>18</sup> CMT refers to the type of workshops where operations require labor-intensive operations with relatively low knowledge intensity (Fukunishi, Goto, and Yamagata 2013).

**Figure 5.21: Garment Value Chain Structure**



CMT = cutting–making (sewing)–trimming.  
Source: Author’s presentation.

It provides the majority of jobs specifically in SMEs. Such businesses also require less capital for the initial start-up of the business. Opening a small workshop requires from \$5,000 to \$10,000 (Jenish 2014). Value chain participants located previous CMT workshops and modeled themselves after them, specializing in the development of more complicated preliminary works and support of the equipment in working conditions. The decline of the demand in the Russian Federation caused by the downward movement of oil prices and sanctions led to a decrease in consumption. This negatively affected textile exports in 2015–2016 (Table 5.9). The lack of affordable finance with a low interest rate led to a reduction of production and exports in 2013–2015 (Figure 5.20).

The potential future development of the sector’s sustainability exists due to the combination of several positive determinants: the low taxation rate; a critically large pool of workers in the industry, including engineers, technicians, and designers; and better knowledge of tastes and preferences of the consumers of apparel in the Russian Federation and Kazakhstan (World Bank 2014e).

The industry structure also allows for quick diversification. However, dependence on one end market negatively affects the sector development. Since the Kyrgyz Republic's traders control the widespread, but shrinking, segment of the mass market, exports are also volatile.

There is no large international supplier involved with the big retail network that allocates some operations to the Kyrgyz Republic and which can outsource sewing operations to the best selected CMT workshops. Development of such a value chain may increase the supply of the garments to the different segments of the well-known markets, e.g., the Russian Federation and Kazakhstan. Even a few examples of such cooperation might be sufficient to promote the diversification of supplies to new markets along with the proposed Belt and Road Initiative (BRI) trade flows. Potentially involving large retailers oriented not only to the Russian Federation but to new markets, might be an opportunity to develop new destinations for the Kyrgyz Republic's textiles.

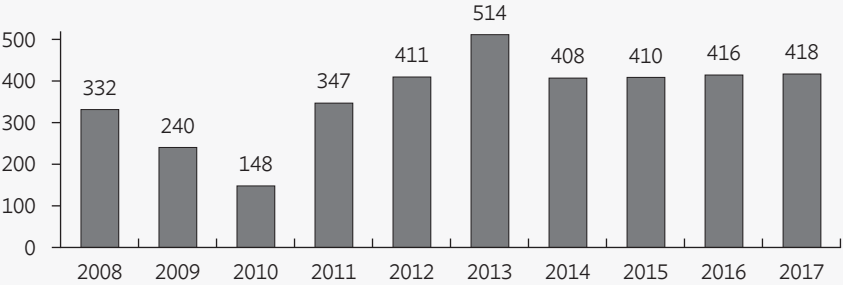
### 5.5.5 | Value Chains in Services—Tourism

The service sector is one of the underdeveloped sectors in the economy due to significant dependence on underfinanced infrastructure and institutional arrangements. Tourism development is still based on the recreation facilities created in resort areas around Issyk-Kul Lake and other areas developed during the Soviet period; these areas still attract tourists from the Russian Federation and Kazakhstan.

Tourism covers several types of services. In the Kyrgyz Republic, the GDP produced in the tourism sector is equal to 4.8% (2017). It includes businesses providing tourist excursion services; restaurants; tourist facilities related to accommodation, recreation, and entertainment (reserves, national parks, alpine camps); tourist-accompanied goods; and transport businesses. Approximately 107,500 businesses (legal entities and individuals) are engaged in economic activities related to the tourism industry in the Kyrgyz Republic (NSC 2018b).

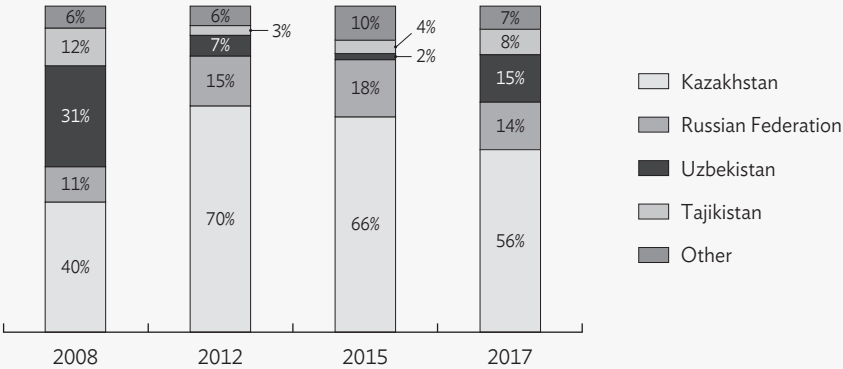
The flow of foreign tourists has varied significantly during the last decade. One of the negative causes detected was a revolution in 2010 (Figure 5.22). Since then it has recovered up to 1.1 million visitors and further growth has happened relatively slowly. Most of the visitors came from four countries: Kazakhstan, the Russian Federation, Uzbekistan, and Tajikistan (Figure 5.23). Tourists mainly came from Kazakhstan (57%) and the Russian Federation (14%), while visitors from Tajikistan and Uzbekistan came to their diasporas.

**Figure 5.22: Export of Tourism Services in the Kyrgyz Republic, 2008–2017 (\$ million)**



Source: National Statistical Committee.

**Figure 5.23: Number of Foreign Visitors Passing the Borders of the Kyrgyz Republic, by Country, 2008–2017 (%)**



Source: National Statistical Committee.

The growth of visitors from Uzbekistan was caused by the improvement in the political regime. Other tourists, including those from developed countries, consist of 6% to 10% of inflow. Visitors from developed countries are mainly leisure tourists. The export of tourism services has varied between \$400 million–\$420 million during the last years (Figure 5.22). The decline after 2013 is explained by national currency depreciation in the Kyrgyz Republic and the crisis in oil, which affected the economies of Kazakhstan and the Russian Federation.

The export-oriented tourism cluster is geographically concentrated in Bishkek and Issyk-Kul Province. Other regions also play an important role as part of a bigger tourist route, but they are less significant.

In the tourism value chain, the following participants were defined (Figure 5.24):

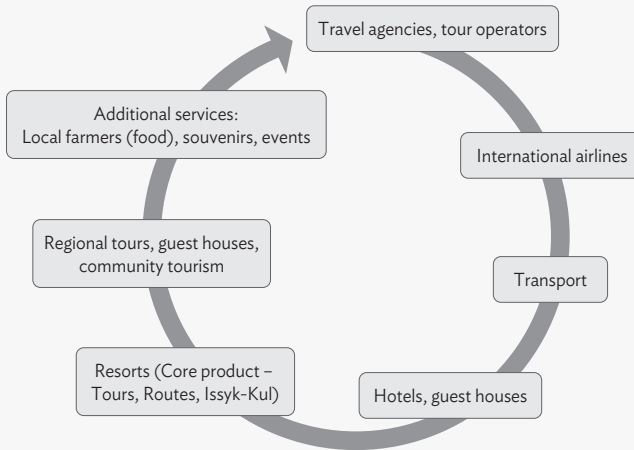
- **Tour operators**—the main element of the value chain; create a product and promote it through market channels, organize logistics, translation, and guide services.
- **International airlines**—international tourists' main transport from developed countries and the Russian Federation. Tourists from Kazakhstan mainly arrive by road due to their proximity; their route is mainly oriented toward the Issyk-Kul resort zone.
- **Transport**—includes buses and taxi services provided by local transport companies. The current structure of the economy and taxation allows outsourcing of transport services to individuals working on a patent base. Tourism regional bus routes provided may cover the whole of Central Asia, e.g., Kazakhstan–the Kyrgyz Republic–Uzbekistan.
- **Hotels**—the many hotels located in Bishkek and other local towns vary by level of comfort and facilities. Bigger hotels are not SMEs, but there are a lot of medium-sized hotels and small “family-type” hotels, as well as hostels with facilities for a few guests and with lower prices.
- **Resorts**—a key element, providing a core product combination or symbiosis of travel agency and resort (special hotel in the Issyk-Kul Lake resort zone or new hotels now established in the mountain zones and special places with the natural landscapes), e.g., Supara or Kaprize.<sup>19</sup> Travel agencies create logistics, look after advertising, and manage the program of travel, and the resorts provide facilities (infrastructure) and services. Insufficient levels of service quality and skills of staff are a critical constraint for the sector's growth (Jenish 2018). Efforts of the private sector and state stakeholders are needed for capacity building of the labor in the tourism sector.

On the tourist routes, there are possible additional tourist services that provide regional tours, accommodation in the rural community, ecological tourism, horse riding, guest houses, and tours of the wild mountain countryside.

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<sup>19</sup> <https://supara.kg/chunkurchak/en/glavnaya-ang/>; <http://www.kapriz.kg/en/>.

**Figure 5.24: Tourism Value Chain Structure in the Kyrgyz Republic**



Source: Author's adaptation of Jenish (2018).

Local farmers, special areas for handicrafts, and locally organized events, often supported by development organizations through regional projects, create additional services for the newly developed tourist flows.

Core product packages include larger firms and medium-sized enterprises—resorts, hotels, and international airlines. There are many small firms and entrepreneurs in tourism—travel agencies, transport services, small hotels and guest houses, food, and handicrafts.

The potential for the development of the tourism sector is based on the unexplored beauty of the Kyrgyz Republic's mountainous nature. The country's wild natural beauty has been saved in significant parts of the country due to the low density of population. Compared, for example, to Tajikistan, which has similar natural conditions, the Kyrgyz Republic demonstrates easier access due to investment in road infrastructure from external borrowing from the PRC, as well as a better situation with security issues.

The SME sector is faced with limited access to finance due to its low share of long-term credit. High interest rates (around 20%) make investment in tourism high-risk. Most investment in fixed assets in tourism, as well as in private business in general, is financed through own investment sources or private borrowings.

The demand for a long-term, specialized investment program in tourism infrastructure is evident. A private–public partnership might be an option for a tourism development concept and potentially create new horizons for foreign investment. One of the sources for financing tourism might be the PRC’s BRI. During the last 5 years, loans to the Kyrgyz Republic from the PRC reached \$3.98 billion (41% of all debts of the Kyrgyz Republic) (Laurelle 2018). Current investment projects are mainly oriented to building basic infrastructure, such as roads and energy projects. However, there might be an opportunity to create a special tourism cluster for clients from the PRC by a well-known tourism and leisure operator in the Issyk-Kul Lake area. A special conditional program for SME regional development could include contracting and financing of transport services, excursion service suppliers, food providers, translation services, and handicraft sales.

5.6 Value Chain Financing Analysis

Each of the observed value chains are located in different locations and represent different sets of SMEs. The results of the value chain availability analysis are presented in Tables 5.11 to 5.14.

Table 5.11: Availability of Financing of the Milk Value Chain SME Sector

	Description
1. Target SME group, characteristics	<ul style="list-style-type: none"><li>• Small-scale farmers with an average herd of cows being 3–4 head of cattle</li><li>• Agents (milk collectors)—around 20–30 agents per one factory</li></ul>
2. Geographic location	Target area—Chui Province
3. Quantification	10,000 small farmers (around 40,000 cows)
4. Assessment of the needs in finance	<p>Investment needed for the following purposes:</p> <ul style="list-style-type: none"><li>• Feed the cows during winter</li><li>• Investment in cattle sheds</li><li>• Increase herd size</li><li>• Equipment—milking machines, refrigerators</li><li>• Milk transport</li></ul> <p>Farmers borrow up to \$1,000 in the period of 1 year—mostly from microcredit organizations. Milk collectors borrow \$3,000–\$5,000 for repair of transport and working capital for milk purchase.</p>

*continued on next page*



**Table 5.11: Continued**

	Description
5. Availability of finance	<ul style="list-style-type: none"> <li>• Microfinance institutions: 25%–40% (national currency)</li> <li>• Banks: 16%–25% (national currency) 5%–10% (US dollars)</li> <li>• Collateral needed</li> <li>• Special credit for farmers (no collateral)—group credit of up to Som250,000 (\$3,500) for up to 2 years</li> <li>• Subsidized credit for farmers: 7%–10% (national currency)</li> </ul>
6. Gap or access to finance	<p>There are several ways for a small farmer to access credit. If a farmer does not have collateral, it is possible to get conditional, no-collateral, group credit.</p> <p>Subsidized credit is hardly accessible (long waiting lists in each locations). There exists a line to getting credit by farmers.</p> <p>Getting credit from a microfinance company is easier compared to a commercial bank.</p> <p>Of the covered participants (10 persons), 70% have credit (five from microcredit and two from the bank). Only one respondent has a 3-year credit; others have credit for 1 year. From the farmers who do not have credit, only one person does not want to get it. One person cannot get it due to the absence of collateral (and also group credit). The last person has a bad credit history (overdue loan).</p> <p>Milk collectors are oriented to the farmers–milk suppliers network creation. Credit is available for the milk collectors from the commercial banks. The purpose of the credit is for renovation of equipment and working capital for milk purchases. Immovable property (houses) is used as a pledge. Banks easily finance milk collectors because of the stable supply of milk, which supports a constant cash inflow.</p> <p>Milk collectors demonstrate the low scale of the business. Individual entrepreneur approaches have led to a low capacity for cooperation, constant competition, and the inability to create a network of milk collecting points. The majority of the borrowed money goes to covering the operational costs: milk payment fuel costs and repair costs for transport. Milk collectors need a two-component loan—a long-term leasing scheme with a low interest rate, and a short-term working capital loan.</p> <p>A separate gap is the absence of the possibility for start-up projects. Bank or microcredit organizations normally do not support starting a new business.</p>
7. Other support needed	<p>Capacity building (training of farmers):</p> <ul style="list-style-type: none"> <li>• Technical standards (HACCP)</li> <li>• How to increase milk productivity</li> <li>• How to improve the quality of milk</li> </ul>

HACCP = hazard analysis critical control point, SME = small and medium-sized enterprise.

Source: Author's representation.

**Table 5.12: Availability of Financing for the Kidney Beans  
Value Chain SME Sector**

	Description
1. Target SME group, characteristics	Small-scale farmers with an average land plot of 2–3 hectares, wholesale market agents
2. Geographic location	Target area—Talas Province
3. Quantification	12,000–13,000 small farmers (around 55,000 hectares of arable land)
4. Assessment of the needs in finance	<p>Investment needed for the following purposes:</p> <ul style="list-style-type: none"> <li>• Better inputs—fertilizers and herbicides, better seeds</li> <li>• Land quality improvement</li> <li>• Purchase of machinery for mechanical harvesting of kidney beans instead of manual harvesting</li> <li>• New diversification of products in addition to kidney beans</li> </ul> <p>Farmers borrow for the bean production at the beginning of the year. Typical borrowing is from \$1,000 to \$2,000.</p> <p>Wholesale market agents operate with a sum of \$20,000–\$25,000. Credit available is at the lower sum of \$7,000–\$10,000.</p>
5. Availability of finance	<ul style="list-style-type: none"> <li>• Microfinance institutions: 25%–40% (national currency)</li> <li>• Banks: 16%–25% (national currency) 5%–10% (US dollars)</li> <li>• Collateral needed</li> <li>• Special credit for farmers (no collateral)—group credit of up to Som250,000 (\$3,500) of up to 2 years</li> <li>• Subsidized credit for farmers: 7%–10% (national currency)</li> <li>• Internal financing scheme of clan-based borrowing (See Box 5.1 on the issue—case based on a study done in 2017).</li> <li>• Additionally, bean farmers and market agents were covered.</li> </ul>
6. Gap or access to finance	<p>There is a situation of regional underfinancing from the finance sector. According to the macro data, Talas Province receives only 3% of the credit in the country, which is lower than expected. The development of the internal financial resources supports the overcoming of this gap (Box 5.1).</p>

*continued on next page*

Table 5.12: Continued

	Description
	<p>The farmer usually gets access to credit from microcredit organizations. At the same time, half of the farmers informed that credit is not taken because available resources are sufficient for bean production on a land plot of 2–3 hectares.</p> <p>Subsidized credit for farmers is also not easily available. Again, farmers do not have the opportunity to receive credit at lower interest rates.</p> <p>Wholesale bean collectors cannot get sufficient credit from banks and usually seek private investment. One of the schemes is value chain financing through the relative network (Box 5.1). Many market agents seek a private investor with sufficient resources. Private money-lenders use this opportunity to fill the finance gap. Usually they participate by getting a share of the profits—effective interest rate may reach 50% per annum.</p> <p>Wholesale agents need working capital from \$25,000 to \$100,000 to be able to cover the needs of exporters. High interest rates and bean price fluctuations during the purchasing season (October–February) makes the operation high-risk. Creation of a network of small-scale farmers and a wholesale agent might decrease risk among participants and remove the financial institution from the scheme. Currently used networks among clans of relatives somehow exploit the idea. However, it is limited due to exclusion of minorities—small poor farmers, representatives of smaller clans, ethnic minorities. The demand for collective action on the community level is obvious. Start-up projects are also not supported.</p>
7. Other support needed	<p>State services improvement—the quality of inputs needs to be monitored.</p> <p>Capacity building (training of farmers):</p> <ul style="list-style-type: none"><li>• How to increase land productivity</li><li>• How to improve the quality of beans</li><li>• Diversification of agricultural activity</li></ul>

SME = small and medium-sized enterprise.  
Source: Author’s representation.

### **Box 5.1: Scheme of Mutual Funding—Case of Talas Kidney Bean Wholesale Agents and Small Farmers' Relatives Network Financing**

#### **Background**

The financing of kidney bean operations in Talas Province demonstrates an unusual institutional setting—mutual funding of the kidney bean farmers and wholesale agents through a network of relatives in Talas Province. The lack of finance at the level of farmers during the bean growing season is covered by wholesale agent. Later, in the fall, when the harvesting season starts and a wholesale agent needs working capital, farmers provide it via the beans. The wholesale agent makes a note for each farmer with the amount of kidney beans provided. It is expected that the price of the beans will increase during the season. The parties also agree that there will be a certain minimum price that will be provided by the wholesale agent. This is done to avoid a situation where prices suddenly decline.

The wholesale agent consolidates the bulk of beans (from 20 to 40 tons) and starts to supply beans to an exporter firm. Since they do not return the money immediately, it is possible for them to make several operations before the farmers will come for the money. Typically, this is around 2 months (September–November). The wholesale agent avoids financial institution costs (interest, services, and monitoring of the loan) and has a chance to increase their working capital.

Farmers expect that prices will increase on the external supply markets and they try to define the biggest peak price period. However, prices might drop suddenly, which could cause the market participants to lose their money. Farmers can come at any time and ask to withdraw the debt. The farmer receives the money based on the weight of the beans multiplied by the kidney bean price on the current market price day. If the market price is lower than the minimum agreed price, then the farmer receives the minimal price.

#### **Impact**

Farmers and intermediate agents use collective capital to support each other and reach a synergy effect through a self-financing system. Both parties win and share the profits and risks and exclude financial institutions from the scheme. Use of the scheme is limited due to limited levels of trust (even to relatives). It is also excludes marginalized farmers from participating.

Source: Author's representation.

**Table 5.13: Availability of Financing for the Garment Value Chain SME Sector**

	Description
1. Target SME group, characteristics	Small-scale wearing workshops with a number of sewing machines from 20 to 50 units
2. Geographic location	Target area—Bishkek (city)
3. Quantification	2,000–3,000 small workshops (around 80,000 workers)
4. Assessment of the needs in finance	Investment needed for the following purposes: <ul style="list-style-type: none"> <li>• Rehabilitation investment in the machinery—new equipment</li> <li>• Working capital for the business operations</li> <li>• Better facilities—heating, production spaces</li> <li>• Training of staff and technicians for better skills improvement</li> </ul>
5. Availability of finance	<ul style="list-style-type: none"> <li>• Microfinance institutions: not able to cover the gap due to the limitation of credit (\$700–\$2,500), in the case of collateral presence, the sum is bigger.</li> <li>• Banks: 16%–25% (national currency) 10%–15% (US dollars)</li> <li>• Up to 5 years</li> <li>• Collateral needed, credit history</li> </ul>
6. Gap or access to finance	<p>Current borrowings used by the value chain participants for covering working capital. Often entrepreneurs borrow not for business purposes, but for other personal consumer credit and spend it on their current working needs—equipment repair, rent of spaces, salaries, guarding, and communal services such as electricity, heating, etc. The gap is the absence of the possibility to borrow long-term money cheaply in order to be able to invest in the renovation of equipment—sewing machines, technological lines, upgrade of equipment.</p> <p>Two-component credit is needed: short-term credit for operational needs for 6–12 months and investment credit—equipment for 3–5 years.</p> <p>Start-up projects rarely supported. The businessman needs to invest in a new project with his own money first and demonstrate positive results.</p>
7. Other support needed	Capacity building (training of managers): <ul style="list-style-type: none"> <li>• Financial literacy, business planning, debt management</li> <li>• New technologies</li> </ul>

SME = small and medium-sized enterprise.

Source: Author's representation.

**Table 5.14: Availability of Financing for the Tourism Value Chain SME Sector**

	Description
1. Target SME group, characteristics	Small travel agencies, individual entrepreneurs (transport), small family hotels and guest houses
2. Geographic location	Target areas—Bishkek (city), Issyk-Kul, Jalal-Abad, Naryn, Osh, Talas, and Batken Provinces
3. Quantification	Around 200 travel agencies, 20,000 drivers, 100–150 guest houses and small family hotels
4. Assessment of the needs in finance	Investment needed for the following purposes: <ul style="list-style-type: none"> <li>Travel agencies—establishment of the international travel agencies network, equipment, office, launch of the business</li> <li>Drivers—new more safe and economic cars, ability to speak English</li> <li>Hotels and guest houses—renovation of infrastructure, good sanitation systems, water, electricity, better conditions, and broadband internet access</li> <li>Training of staff—English, internet communications, business correspondence, hospitality management, cultural diversity specifics</li> </ul>
5. Availability of finance	<ul style="list-style-type: none"> <li>Microfinance institutions: not able to cover the gap due to the limitation of credit (\$700–\$2,500)</li> <li>Banks: 16%–25% (national currency)      10%–15% (US dollars)</li> <li>Up to 5 years</li> <li>Collateral needed, credit history</li> <li>Credit is available in Bishkek and Chui Province, and also in Issyk-Kul Province. In other provinces limitation on the size and length of the credit is bigger.</li> </ul>
6. Gap or access to finance	<p>There is a gap in access to credit in Osh, Jalal-Abad, Talas, and Batken Provinces. There are few banks that provide credit to SMEs.</p> <p>In the tourism cluster segment, the following participants need loans for:</p> <p><b>Transport services</b>—credit for car renovation—buses, mini-buses, off-road vehicles (mountains), or to purchase it by leasing for 5–7 years with annual or seasonal payments. Other possible requirements of the leasing company—insurance on the car and for the driver, medical commission, English courses, excursion skills, training for the client's security rules.</p> <p><b>Hotels and guesthouses</b> (small and medium-sized—up to 50–60 clients)—credit for hotel renovations for regional tourism development—sanitary system installation, modern heating, and air conditioning systems, building insulation. Credit for renovation needs to be long-term (up to 10 years) and with low interest rate. Two-component credit needed: operational credit for the tourist season with higher interest rate and a short period of time and investment credit.</p> <p>Start-up projects are not supported in the tourism sector, except for donor projects.</p>
7. Other support needed	Capacity building (training of managers, staff, drivers): <ul style="list-style-type: none"> <li>Financial literacy, business planning, debt management</li> <li>Hospitality management, office works</li> <li>English</li> </ul>

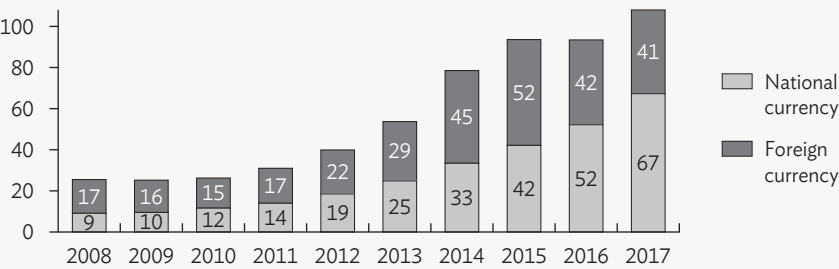
SME = small and medium-sized enterprise.

Source: Author's representation.

## 5.7 Policies to Promote SME Finance

The main effort of the government is targeted macroeconomic stability (currency stability, lowering interest rates) and improving balanced finance supply on the market. During 2008–2015, the share of credit in the national currency was low (Figure 5.25). During the last 2 years, it has started to prevail (62% in 2017) due to efforts of the government and the National Bank of the Kyrgyz Republic.

**Figure 5.25: Dynamics of Bank Credit in the Kyrgyz Republic in National and Foreign Currencies, 2008–2017 (Som billion)**



Source: National Bank of the Kyrgyz Republic, author's calculations.

A subsidized agriculture program called “Easy credit to farmers” was established in 2011. The program subsidizes the market interest rate (25%–27%) and decreases it for farmers to 10% (up to 7% for some activities, e.g., agri-food processing). Annually, 10,000 to 13,000 farmers receive support (about 3%–4%). In 2018, 10,300 farmers received subsidized credit of Som4.6 billion.<sup>20</sup>

The Russian–Kyrgyz Development Fund also provides support to increase credit resources for the financing business in the Kyrgyz Republic. The implementation of the program “Lending to small and medium-sized businesses through commercial banks” contributed to the expansion of the range of banking products for entrepreneurs in the country. There is also a realized program for microfinance organizations and leasing of equipment and transport vehicles.

<sup>20</sup> Interview of the Deputy Minister of Ministry of Agriculture, Food Industry and Amelioration, J. K. Kerimaliev. [https://24.kg/ekonomika/90206\\_snachala\\_2018\\_goda\\_fermeram\\_vydali\\_lgotnyie\\_kredityi\\_na45\\_milliarda\\_somov/](https://24.kg/ekonomika/90206_snachala_2018_goda_fermeram_vydali_lgotnyie_kredityi_na45_milliarda_somov/) (accessed November 2018).

During 2015–2017, the total value of the projects supported reached \$261 million. Another \$116 million was approved for SME sector support (Russian–Kyrgyz Development Fund 2017).

Since 2016, the Guarantee Fund (GF) of the Kyrgyz Republic has been in operation. Since 2010, under the United States Agency for International Development support, the problems of the SME sector were analyzed and pilot projects were implemented in four locations—Chui, Issyk-Kul, Osh, and Jalal-Abad Provinces. In 2016, the government and ADB invested \$4 million—the Kyrgyz Republic side provided 25%, the rest was invested by ADB. Currently, there are six branches operating in four provinces. The maximum guarantee is limited to 10% of the GF and must not exceed more than 50% of the credit. Estimations show that at least 100,000 entrepreneurs are seeking a guarantee. At the moment, the GF provides 237 clients with Som248 million. The partners of the GF commercial banks approve credit under guarantees of Som972 million (\$14 million) or 0.9% from the credit portfolio of banks (Guarantee Fund of the Kyrgyz Republic 2018). All described programs are implemented through commercial banks and counted in the total volume of credit in the Kyrgyz Republic.

Since 2013, an OECD initiative has been realized to support schemes of financing farmers through warehouse receipt financing. The program aimed to provide a new guarantee instrument valid for the banks in cases of absence of collateral. Recommendations include the creation of a regulatory framework, piloting of the scheme, and development of new storage facilities. Assessment of the program in 2016 shows that the regulatory framework was created. The pilot covered 32 warehouses in Chui and Issyk-Kul Provinces. Three banks participated in a pilot project, covering only a few clients (nine clients for \$55,000), but a lack of high-standard warehouses and the absence of a registry prevent further development of the warehouse receipt financing scheme (OECD 2018).

There are two programmatic documents in existence: one is a long-term strategy and the other a 5-year program developed by the Kyrgyz Republic government in 2017–2018. The National Development Strategy for 2018–2040 declares newly formulated areas of prospective development for the country.<sup>21</sup>

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<sup>21</sup> Approved by Decision #1 of 13 August 2018 of the National Council on Sustainable Development under the Chair of the President of the Kyrgyz Republic, S. Jeenbekov. [http://www.president.kg/ru/sobytiya/12774\\_utverghdena\\_nacionalnaya\\_strategiya\\_razvitiya\\_kirgizskoy\\_respubliki\\_na\\_2018\\_2040\\_godi](http://www.president.kg/ru/sobytiya/12774_utverghdena_nacionalnaya_strategiya_razvitiya_kirgizskoy_respubliki_na_2018_2040_godi) (accessed November 2018).



In it, SME development priorities are described as being an important task (Task 7.1). The government plans to increase SMEs to 50% of GDP in 2023 through improved credit supply for the SME sector and a better business environment.

The Kyrgyz Republic government developed and passed the new country development program for 2019–2023, “Unity, Trust, Creation” on 20 April 2018 # 2377-VI.<sup>22</sup> In the new mid-term program, the main chapter is related to the SME sector—chapter 4.4: “Small and medium-sized entrepreneurship development.” It declares the creation of a comprehensive state program for the development of SMEs. It plans to improve mechanisms for the financial support of SMEs. Long-term lending to small and medium-sized businesses and new types of bank lending to SMEs will be promoted. Special attention will be paid to the availability of concessional funds to representatives of SMEs allocated for various types of state programs.

However, the program is ambitious and needs elaboration and operationalization. All listed measures will require enormous funding and restructuring of the activity of state bureaucracy. Another gap is the absence of the assessment of the planned actions, as well as the costing of the programs. Budget reallocations will be required and cost-benefit analysis may help in prioritizing the actions to be done.

## 5.8 Conclusions and Recommendations

### 5.8.1 | Conclusions

Access to finance in general, and to the SME sector in particular, improved in the Kyrgyz Republic during the last decade. Credit (% to GDP) supply doubled during 2006–2017—from 10% to 21% (Figure 5.6). An important positive change is the growth of credit in the national currency, which reached 62% in 2017 (Figure 5.24). The government needs to stimulate further improvement of SME access to finance. Separate attention to the sector might be provided in the form of a separate strategic document or action plan to promote improvement of SME access to finance.

Regional disparity is significant in financial markets. SME access and financial infrastructure in Bishkek and Chui Province are better compared to other provinces.

<sup>22</sup> Ministry of Justice of the Kyrgyz Republic website, <http://minjust.gov.kg/ru/content/952> (accessed December 2018).

Separate attention needs to be formulated for improving SME access to finance in other regions of the country, especially in the south, where a significant part of the Kyrgyz Republic's population lives.

Access to finance is also different for different sectors (Table 5.3). Better access is provided for agriculture and trade. Other important sectors like industry and tourism should be supported through separate sectoral programs.

Financial literacy of the population is low and requires more effort. The current program of financial literacy improvement is not detailed and does not include actions to decrease the gap in knowledge between women and men. A more detailed and updated program for financial literacy needs to be developed with special attention for the SME sector.

The difference between legally registered large firms and SMEs declined over time, according to the World Bank Enterprise Survey (2013). Barriers to SMEs declined gradually (Figures 5.10, 5.11, and 5.13). The government should update these parameters and set them in the country's strategic documents as target indicators for the next stage of development.

The gap in access of women to resources has partially improved, thanks to the efforts of microfinance organizations (Table 5.8). However, access to finance for women in other sectors is still not adequate. Target shares for women-entrepreneurs in all key sectors of the economy should be defined. The strategy for improving gender balance needs a cross-cutting approach.

The strategy and program developed by the government are ambitious and need further details and operationalization.

The subsidy program for farmers needs transparency and efficiency evaluation.

The definition of SMEs needs to be rethought for a better analysis and to further target all sectors of the economy.

## 5.8.2 | Recommendations

General policy recommendations are formulated in the form of conclusive remarks. However, there are a few practical recommendations that may improve the state of the SME sector and access to finance across the value chains gaps defined:

**Dairy supply chain**—small farms and market agents need to be financed as a **group client**.<sup>23</sup> The combined financial product and a specified approach needs to be applied here:

- (i) Investment credit for milk collectors—renovation of equipment, transport, express analysis equipment.
- (ii) Operational loan for milk collectors—current transport expenses, payment for milk, other costs.
- (iii) Micro-loans for milk farmers—forage for cattle, cooling equipment, milking equipment, medical treatment, artificial insemination.
- (iv) Training component needs to accompany the value chain—technical standards, financial management, business planning, optimal forage to animals, medical treatment.
- (v) Milk collectors need to be responsible for the credit for farmers—collecting the payment in the form of the milk and repaying it to the bank.
- (vi) The pilot project needs to be applied based on the selected cluster (Chui Province).

**Kidney beans**—small farms and wholesale agents also need to be financed as a group. The difference between kidney beans and both milk and clan-based mutual finance schemes is in the level of the group forming, i.e., in both cases, it is a group of farmers forming based on certain principles. It is suggested that projects be realized through the local community in a way that covers all farmers. A trust fund might be created to finance the scheme for the local community.

<sup>23</sup> Within the group, the client is the group of milk-producing farms and market agents, who can receive credit on conditional requirements. Technically, it might also be organized through a cooperative, but this would change the level of taxation. Therefore, most market stakeholders do not want to move from the small business level to avoid higher taxation. Another constraint to cooperative development is a high level of mistrust among farmers due to the prejudice against collective work as a result of the Soviet-period legacy. Therefore, the group-client term approach is recommended as it was successful during development of micro-loans in the Kyrgyz Republic since 2000.

The local authority might play the role of selecting committee and facilitator of the process—it is important to arrange dialogue between farmers and middlemen at the local level to increase trust and transparency of the finance scheme. The following approach is needed:

- (i) Operational loan for a wholesale agent—current transport expenses, payment for beans, other costs.
- (ii) Micro-loans for bean farmers—mechanized works, improved inputs—seeds, fertilizers, herbicides.
- (iii) Training components need to accompany the value chain—financial management, business planning, optimal agronomic practices for soil productivity.
- (iv) Bean wholesalers need to be responsible managers of the credit provided for farmers. They may collect the payment in the form of the beans and repay it to the bank.
- (v) Community leaders need to be trained in the institutional arrangement facilitation. A series of consultations between the wholesalers and market agents is needed to clarify the rules of agreement and profit-sharing distribution between the parties.
- (vi) The pilot project needs to be located in the center of the bean cluster (Kara-Buura district).

**Textile CMT workshop clusters** need to be promoted in Bishkek and Osh cities. In each city, 20–30 workshops need to be supported and/or created (start-up production). For managing the finance of the project, a large international firm (textile retail network) needs to be invited by the government under ADB support—guarantee of the credit, subsidized interest rate credit. The international buyer will introduce standards of the quality of products and development agenda, e.g., equal salaries and conditions for women and men, the absence of child labor, etc. The CMT workshops will include a technical upgrading skills program and also a two-component finance scheme:

- (i) Long-term investment credit for equipment and production site renovation—heating, sanitary norms, working environment standards.
- (ii) Short-term credit for operational purposes—salaries, renting of space, repair, supporting inputs.

**Tourism development** approaches:

- (i) Regional tourism SME development—support through an association of tourist operators financing the small hotels and transport services:
  1. Hotels/guesthouses—long-term investment credit for renovation and new hotel construction (start-up projects) in the regions of the Kyrgyz Republic to develop local tourism potential, linking to local farmer supply and training programs. Short-term credit for operational purposes, such as for the launching of the current activities for a tourist season.
  2. Transport service individuals—support for leasing transport vehicles with a focus on training of hospitality management skills.
- (ii) The BRI offered the chance to realize investment projects on Issyk-Kul Lake under the management of an established international tourist operator. The project might bring infrastructure and technological decisions with conditional requirements from the Kyrgyz Republic's side regarding local supplies of products, services, labor (including training), and taxes. ADB can support such projects through a number of instruments (finance, technical expertise, regulative framework support, and research).

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# Leveraging SME Finance through Value Chains in the CAREC Landlocked Economies: The Case of Mongolia

Lakshmi Boojoo

## 6.1 Introduction

Mongolia transitioned to a market economy in 1990 and became one of the fastest-growing economies due to double-digit growth for 3 consecutive years in the early 2010s. With the slowdown of commodity prices, economic growth started to decline. The latest reports from the National Statistical Office (NSO) and the World Bank show that the poverty rate is 35.5% in the countryside, compared to 23.2% in urban areas.

Administratively, Mongolia is divided into 21 provinces (*aimags*) and the capital city of Ulaanbaatar, which is not part of a province. While up to 65% of the gross domestic product (GDP) is produced in Ulaanbaatar city and 10% is produced in Orkhon province where the Erdenet Mining Corporation has been active since 1978, the remaining 25% is divided among the other 20 provinces. GDP per capita is three times lower in the countryside than in the city. There is a lower level of job opportunity and the business environment is unfavorable, due to poor infrastructure and low market potential, among other problems.

The research question of this chapter is: Are business environment and financing mechanisms favorable for small and medium-sized enterprises (SMEs)?

### 6.1.1 | Analytical Framework

SMEs are the main drivers of an economy because they create most of the jobs and contribute to reducing poverty and inclusive economic growth. Thus, support of SMEs through effective policies and financing mechanisms remains the primary goal of countries across the world. Today, SMEs in developing countries are facing many difficulties. The objective of this chapter is to identify the bottlenecks and drivers of economic growth as well as value chains with high growth potential.

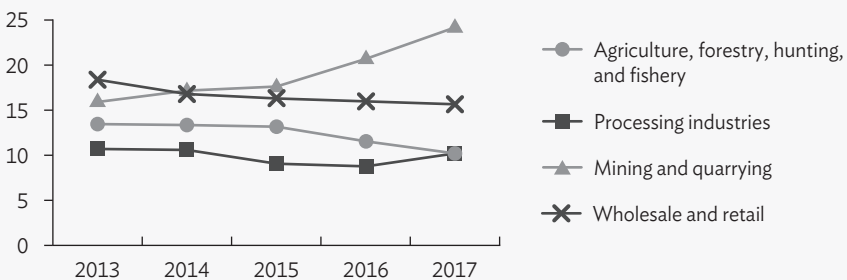
In general, the share of SMEs in GDP, the business environment, financing mechanisms, government policies, and inclusion of SMEs in the value chain of a country are important factors that have to be studied.

## 6.2 Economic Situation

Mongolia is landlocked and is one of the world's most sparsely populated countries. The economic growth of Mongolia was volatile in the last decade. Due to large projects in mining and infrastructure, economic growth from 2010 to 2014 was high. A sharp slowdown of growth occurred when commodity prices fell in 2016, which highlighted the high dependency on mining and the need for economic diversification. In recent years, migration in Mongolia has continued the trend of rural to urban flows, particularly in Ulaanbaatar. The present urban population is above 1.3 million or almost half of the population of Mongolia. Despite significant economic opportunities, poverty and inequality continue to be serious problems and inequalities are widening between regions and between rural and urban areas.

The main driver of economic growth is mining and quarrying (24.5% of GDP as of 2017), while the second largest sector is wholesale and retail (15.7% of GDP as of 2017), followed by agriculture (10.2% of GDP as of 2017) and manufacturing (10.5% of GDP as of 2017). The real estate sector makes up 6.0% of GDP, financial and insurance activities 5.1%, transportation and storage 4.8%, and construction 4.1% as of 2017 (Figure 6.1).

**Figure 6.1: GDP Breakdown by Sectors**



GDP = gross domestic product.

Source: NSO (2019a).

According to statistical information from the General Taxation Department, there are 78,585 legal entities active in Mongolia. Almost 70% of enterprises are located in Ulaanbaatar, and about 86% or 67,612 of those are SMEs.

The SME Law was first introduced in 2007 in which SMEs are defined as legally registered business entities with 199 or fewer employees with an annual turnover of up to MNT1.5 billion (approx. \$833,000), and the sectors in which they are active are also defined (Table 6.1).

**Table 6.1: Definition of SMEs in Mongolia**

Enterprise Category	Sector	Number of Employees	Annual Turnover in MNT
Small	All sectors	≤ 19 employees	≤ MNT250 million
	Services	≤ 49 employees	≤ MNT1.0 billion
Medium-sized	Wholesale	≤ 149 employees	≤ MNT1.5 billion
	Retail/Manufacturing	≤ 199 employees	≤ MNT1.5 billion

MNT = Mongolian togrog, SME = small and medium-sized enterprise.  
Source: SME Law of Mongolia (2007).

The NSO uses different employee number categorizations for the business register database and commercial banks use different definitions for their client segmentation.

The business register of the NSO divides enterprises according to the number of employees they have (Table 6.2). The NSO’s classification of enterprises is as follows:

**Table 6.2: Number of Active Companies**

Number of Active Establishment by Employment Size	Business Register, 2018-I	Share of Active Establishments
1–9 employees	69,264	85.5%
10–19 employees	5,212	6.4%
20–49 employees	4,075	5.0%
more than 50 employees	2,467	3.0%
Total	81,018	100.0%

Source: NSO (2019b).

Table 6.3 shows that there are 69,264 enterprises with one to nine employees and it is the biggest group within this registry. This means most of the companies active in the SME sector have between one and nine employees. In the second biggest group, there are 5,214 enterprises with 10 to 19 employees.

**Table 6.3: Classification of SMEs by Employment and Sector**

Number of Active Establishments, by Divisions of Economic Activities, by Employment Size Class	1–9 Employees	10–19 Employees	20–49 Employees	More than 50 Employees	Total
Total	69,264	5,212	4,075	2,467	81,018
Agriculture, forestry, hunting, and fishery	3,441	336	116	22	3,915
Mining and quarrying	493	95	80	109	777
Processing industries	5,050	472	238	205	5,965
Electricity, gas, and water supply	96	67	26	69	258
Construction	5,018	647	568	375	6,608
Wholesale and retail trade, repair of motor vehicles, household goods	30,010	831	489	272	31,602
Hotels and restaurants	1,947	238	120	51	2,356
Transport, storage, and communications	2,574	169	139	127	3,009
Financial services	1,099	41	29	24	1,193
Real estate, renting, and other business activities	6,820	469	324	219	7,832
Public administration and defense, compulsory social security	508	276	465	224	1,473
Education services	1,719	578	803	513	3,613
Health and social work	2,619	364	335	82	3,400
Other community, social, and personal service activities	7,846	629	343	175	8,993
Extraterritorial organization and bodies	24	0	0	0	24

Source: NSO (2019b).

According to the statistical information in Table 6.3, about 30,010 companies have between one and nine employees and are active in the wholesale and retail sector. The next biggest group of enterprises are active in other community, social, and personal service activities, the processing industry, and construction.

Most employment in the agriculture, forestry, hunting and fishing, and construction sectors is seasonal and informal. Therefore, the numbers shown in Table 6.3 are not the exact numbers, but only a small subset of them. Also, the samples have to be defined carefully.

According to Zolzaya and Zhou (2018), at the end of 2017, 141,500 establishments were registered at the NSO, and 75,700 of these were active. About 77% of these active establishments are SMEs and they account for 17.8% of the total GDP and 2.3% of the exports. Approximately 70% of the economically active population are employed in SMEs, while the Ministry of Agriculture and Light Industry reports that there are about 760,000 people employed in SMEs, which makes up 69% of total employment. Available statistics are inconsistent and fragmented, due to the lack of a unified database on SMEs.

### 6.2.1 | Mongolia's Financial Situation

After high economic growth in 2012–2013, the economy faced serious problems in 2015 when the GDP growth declined to 2.5% and was only 1.6% in 2016. Along with the economic boom starting in 2012, government debt also started to rise. In 2015, Mongolia's debt-to-GDP ratio was 62% and at the end of 2016 it had reached 93%.

After the elections of 2016, the new government started negotiating with the International Monetary Fund (IMF), and in 2017, they reached an agreement. Under the Extended Fund Facility program, the IMF and other development partners started providing financial support with \$5.5 billion packages. The IMF program was a 3-year program and ended in 2019.

In order to stabilize the economy in the short term and restructure it in the medium term, the Government of Mongolia has undertaken various policies and reform measures under the terms of the agreement. These measures, which have to be taken, are strengthening the fiscal policy to reduce the vulnerability of the boom and bust cycles of the economy and strengthening the financial sector and monetary policy (UNDP 2018).

The macroeconomic environment in Mongolia is not conducive to the development of the manufacturing industry. The real exchange rate has been rising over the last 10 years, depreciating the Mongolian togrog against major currencies. These relative exchange rate movements have widened Mongolia's cost disadvantage.

In the fourth quarter of 2018, external debt in Mongolia increased to \$28.7 billion, reaching an all-time high. The large amount of money that has to be repaid will negatively affect the economy, depleting the resources covering critical government services, including health, social welfare, and education along with financing of SMEs.

## 6.2.2 | Financial Infrastructure

Mongolia is one of the most sparsely populated countries in the world, which makes traditional banking outside of settlements difficult and costly. The financial sector of Mongolia is dominated by banks, which make up about 96%. There are currently 14 commercial banks in Mongolia. The commercial banks of Mongolia have the biggest infrastructure in the country, with Khan Bank and the State Bank having the biggest networks. Financial and insurance activities (MNT1.67 trillion) contributed 5.2% of GDP (MNT32.2 trillion) in 2018 at current prices.

**Table 6.4: Structure of the Financial Sector (MNT billion)**

	Assets		Profits		Equity	
	Amount	% of	Amount	% of	Amount	% of
<b>2018 Q2</b>						
Bank	30,259	94.7%	32	36.3%	3,180	74.3%
Nonbank financial institutions	1,144	3.6%	47	52.1%	888	20.8%
Insurance	282	0.9%	6.3	7.1%	127	3.0%
Credit and savings cooperatives	176	0.6%	1.1	1.2%	29	0.7%
Securities market	93	0.3%	3.0	3.4%	56	1.3%

MNT = Mongolian togrog, Q = quarter.

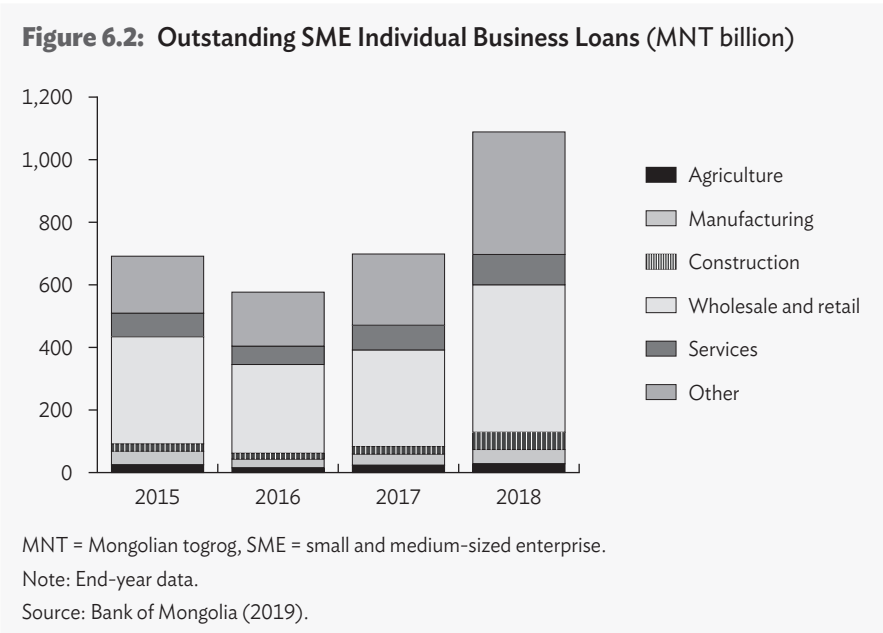
Source: Bank of Mongolia, Financial Regulatory Commission (2019).

The nonbanking financial institutions’ share in the financial system of Mongolia is about 3.6% of total assets. They provide a variety of financial services but most of them are located in Ulaanbaatar and only a few of them are active in rural areas.

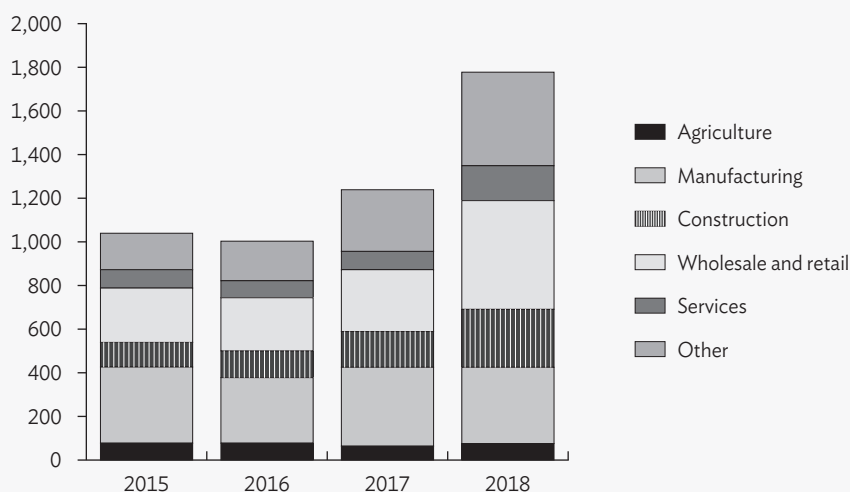
According to the Financial Regulatory Commission, there are about 400 savings and credit cooperatives registered in Mongolia, but only 289 are active. In Ulaanbaatar, there are 186, and in rural areas 103 are active. The cooperatives have about 61,000 members and less than a 0.5% share in Mongolia’s financial sector.

The total number of outstanding loans issued by banks to SMEs in the last 3 years was between MNT2.01 trillion and MNT3 trillion, about 17%–19% of total loans. That means that the number of SME loans has not increased dramatically over the last 3 years. The average annual interest rate in the last 3 years was between 17.9% and 19.9%.

Figure 6.2 shows the loans of individuals issued in different sectors, taken for business purposes. Most loans taken by individuals were taken in the wholesale and retail sector, followed by “others”.



**Figure 6.3: Outstanding SME Business Loans (MNT billion)**



MNT = Mongolian togrog, SME = small and medium-sized enterprise.

Note: End-year data.

Source: Bank of Mongolia (2019).

Figure 6.3 shows the data of outstanding SME business loans, where the highest loans have been taken by enterprises in the processing industry, with the next biggest group of companies active being in the wholesale and retail sector followed by the manufacturing sector.

In 2012, from the Rio+20 Declaration, Mongolia was chosen as one of the seven pilot countries to implement a green strategy. Within this initiative, Mongolia has signed up to the Partnership for Action on Green Economy. With the implementation of the partnership project, Mongolia started different green initiatives. The Green Development Policy was adopted by the Parliament on 13 June 2014, which defines green development goals, objectives, and their implementation policy divided into medium and long term. Mongolian government agencies, industry players, and financial institutions met in May 2013 at the first Mongolian Sustainable Finance Forum in Ulaanbaatar to discuss how they can work together toward a green civilization for Mongolia (Mongolia Bankers Association 2019). This forum has become an annual event where all major stakeholders of the Mongolian banking industry, including all 14



Mongolian banks, the Mongolian Bankers Association, the Banking and Finance Academy, and government agencies like the Bank of Mongolia and the Ministry of Environment and Tourism, come together to discuss offering sustainable finance. At the first forum, the Mongolian banks declared they would jointly develop the Mongolian Sustainable Finance Principles.

Only XacBank of Mongolia received an accreditation from the Green Climate Fund, on 14 October 2016 (XacBank 2016). On 11 May 2017, they received a \$20 million financing package. In the first phase, \$500,000 was granted to support micro, small, and medium-sized enterprises finance low-carbon initiatives (Green Climate Fund 2017).

The European Bank for Reconstruction and Development and the Green Climate Fund cofinanced a program to deliver climate finance through partner financial institutions in developing countries. The focus of the program is in the areas of energy efficiency, renewable energy, and climate resilience (Green Climate Fund 2018).

Khan Bank and XacBank are the two banks specializing in micro and rural lending. Another financial intermediary that offers microfinance and is not supervised is pawnshops. Their regulation is covered in different laws, but a special regulation for them does not exist. Therefore, exact numbers or statistics are not available. It is estimated that about 1,500 pawnshops are active and about 350 of them are in Ulaanbaatar. The items that are used as collateral are mostly movable property and are not registered in a unified database. The interest rates are between 3.5% and 15% per week. Many problems occur regarding lending since pawnshop operations are not sufficiently regulated. For instance, when pawnshops sell personal property, which has been used as collateral, at a higher price, they do not return the change to the lenders. Therefore, the responsibility of pawnshops should be increased, and, in order to do so, more regulations and a unified database that registers movable property, are required.

In recent years, microlending possibilities via mobile phones have been developed and have become more accessible. Now it has become possible to lend up to MNT2 million immediately using a mobile phone. For instance, the application LEND can be downloaded on a smartphone and offers such loans.

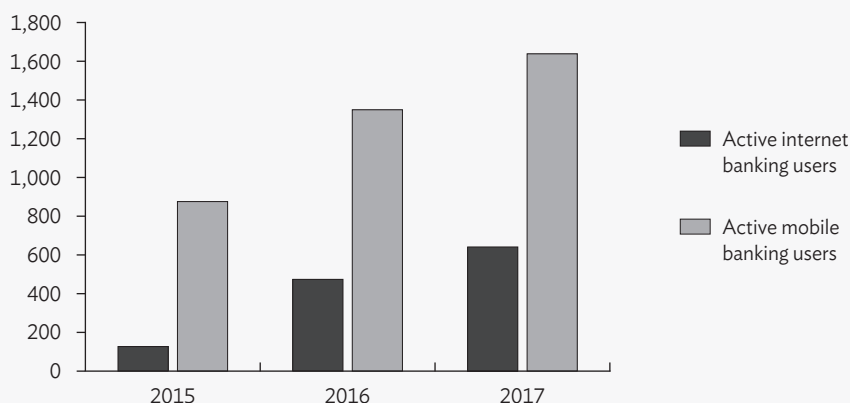
Diversified financing mechanisms are not available for SMEs. Other financing possibilities like venture capital, mezzanine capital, angels, crowdfunding, and crowdlending do not exist.

## 6.3 Status of Financial Inclusion for SMEs

Individuals and businesses are able to open an account at a bank and obtain affordable financial products and services. The banks offer a full range of banking products, such as transactions, payments, saving, credit, and insurance. According to the 2017 Global Findex survey of the World Bank, about 93% of the adults in Mongolia have a bank account. Since most payment services, including salaries, pensions, social welfare payments, and remittances are distributed through Khan Bank, almost every Mongolian citizen has a Khan Bank account. The Mongolian Bankers Association has stated that Khan Bank has provided its banking services to 2.4 million customers and had 1.7 million card owners and 53,000 corporate customers in 2017 (Khan Bank 2019).

In recent years, the number of mobile phone users has grown quickly, which has made internet banking, especially mobile banking users, grow steadily. Figure 6.4 shows that the number of internet banking users almost tripled and the number of mobile banking users doubled from 2015 to 2017.

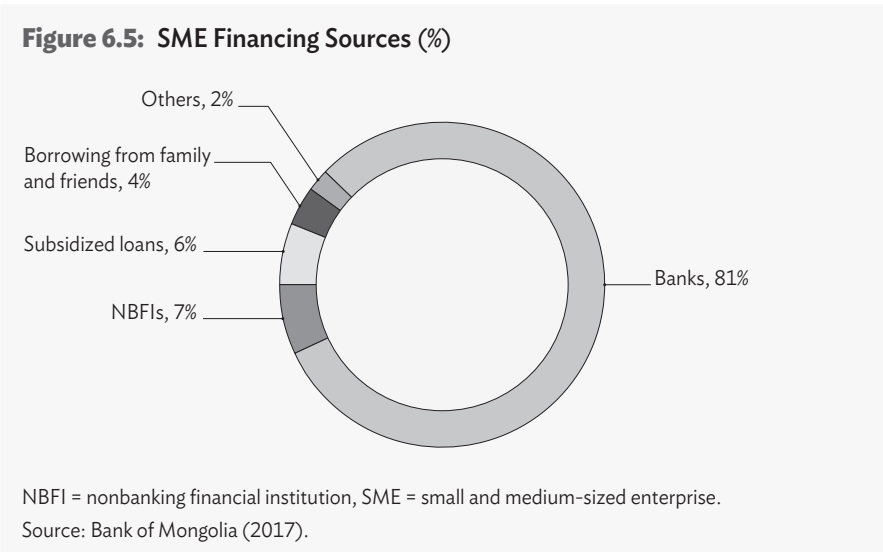
**Figure 6.4: Active Internet and Mobile Banking Users**



Source: Bank of Mongolia (2019).

Banks are the main source of funding, but there are also support schemes from the government and international financial institutions. The Bank of Mongolia publishes an annual survey, the “Development of SMEs and their Financial Situation” report, conducted among micro-enterprises and SMEs. The objectives of the study are to

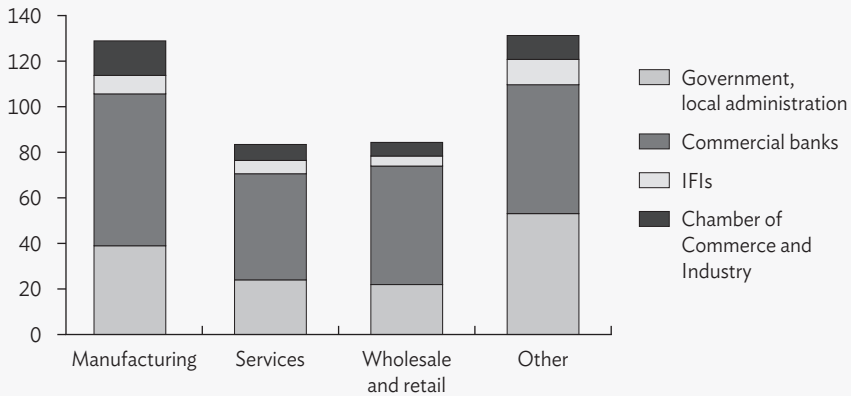
identify the development, operations, and financing situation, and financing issues and challenges faced by SMEs for policy makers. According to the Bank of Mongolia, there are 75,796 SMEs in Mongolia, with 48,519 in Ulaanbaatar and 27,277 in other provinces. According to the Bank of Mongolia, 56% of SMEs have used an external financing instrument for their business expansion. Among those enterprises, 81% have obtained loans from commercial banks, while loans from nonbanking financial institutions and subsidized loans were among the less frequently used financial sources at 7% and 6%, respectively (Figure 6.5). Also, 4% of SMEs use informal financial sources such as borrowing from family and friends.



The latest report of 2017 shows that SMEs get 53.7% of their financial support from banks, 32.8% from another source of funding, 15.3% from local government or provincial administrations, 13.5% from the government, 12.7% from trade unions, 10% from other financial institutions, 9.5% from nongovernment organizations, 7.9% from the Chamber of Commerce and Industry, 7.2% from industry associations, 6.0% from international organizations, and 5.0% from consulting companies. According to the World Bank Global Financial Development Database, 42% of SMEs had a line of credit in 2013.

Figure 6.6 shows in which sectors and by which organizations SMEs were supported. The commercial banks have provided the most financial support in all sectors.

**Figure 6.6: SME Support from Different Stakeholders by Sector (%)**

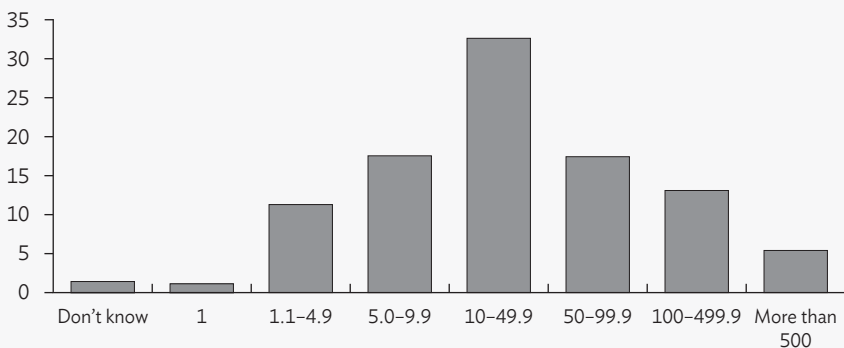


IFI = international financing institution, SME = small and medium-sized enterprise.

Source: Bank of Mongolia (2017).

According to the Bank of Mongolia survey (Figure 6.7), the majority of SMEs need about MNT10 million–MNT49.9 million (about \$3,800–\$18,900) annually. Figure 6.8 shows that by far the biggest use of credit is for working capital.

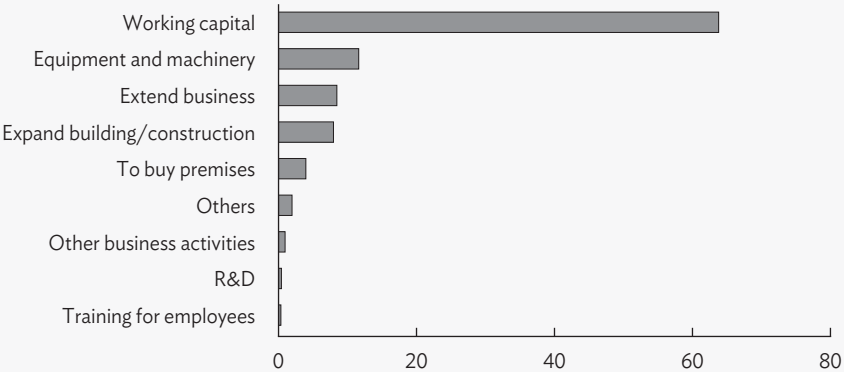
**Figure 6.7: Financial Support Needed (MTN million)**



MTN = Mongolian togrog.

Source: Bank of Mongolia (2017).

**Figure 6.8: Funding Expenditure by Type (%)**



R&D = research and development.  
Source: Bank of Mongolia (2017).

A credit information service is available at the Central Bank of Mongolia, which only holds information about the amount of credit, while only financial institutions have access to it. There is a separate registration system for collateral.

## 6.4 Financial Knowledge and Skills of SME Entrepreneurs

### 6.4.1 | Assessments of Financial Literacy

There are different research reports available on SMEs, but not specifically on financial literacy. Most of the banks, the Mongolian National Chamber of Commerce and Industry, and nongovernment organizations offer training on financial literacy but no assessment of financial literacy has been carried out. There are also no figures available regarding how many SMEs have taken up such training.

### 6.4.2 | Financial Literacy Programs

The Bank of Mongolia; the Ministry of Finance; the Ministry of Education, Culture and Sport; the Financial Regulatory Commission; the Mongolian Bankers Association; the Mongolian Insurers Association; the Savings Insurance Corporation;

nongovernment organizations operating in the financial sector; and relevant associations and universities have developed a program with the technical support of the World Bank's national midterm program 2016–2021 for financial literacy. The program focuses on four areas:

- financial literacy program for school children
- financial education for young people
- financial education for rural residents
- financial education through mass communication/media (Bank of Mongolia 2016).

The objectives of the program are to improve people's financial discipline, to improve their ability to make sound financial decisions, to increase long-term savings and financial investments, to increase people's trust in the banking system, and to promote the long-term and sustainable economic development of the country. No assessment has been carried out. SMEs are not part of this program.

## 6.5 Barriers to SME Finance

The biggest challenge SMEs are facing is that financial institutions cannot offer them long-term financing and the interest rates are very high. The maximum maturity is 48 months and the average interest rate is 1.5%–2.5% per month. If an entrepreneur is applying for a loan for the first time, the maximum maturity time is 24 months and the interest rate is the highest. If they have repaid the first loan in time and they apply for a second time they get more favorable conditions.

Most SMEs lack collateral. According to the Organisation for Economic Co-operation and Development (OECD 2016), collateral requirements are overly demanding, with the average amount reaching close to 200% of the value of loans in 99.7% of cases, which reflects the deep distrust shown by financial institutions.

SMEs cannot apply for funding from the SME Development Fund when they need it. They have to wait until funding is announced. A committee decides which SMEs will get the funding after they receive the projects. The funding of the projects selected will be transferred directly to their bank accounts. The funds have not been used properly since the project selection process has not been transparent.

Also, the tender announcement dates have also been unclear. The standing committee of the Parliament is changing the procurement process after some members of parliament misused the funding and approved funding for their own companies.

Access to finance is not sufficient for SMEs. In terms of access to finance, the financial products available are also insufficient. Commercial banks are the main source of funding for SMEs; however, there is no competition among the banks. The amount of the loan, collateral, maturity time, and interest rate offered to SMEs by the banks show no significant difference.

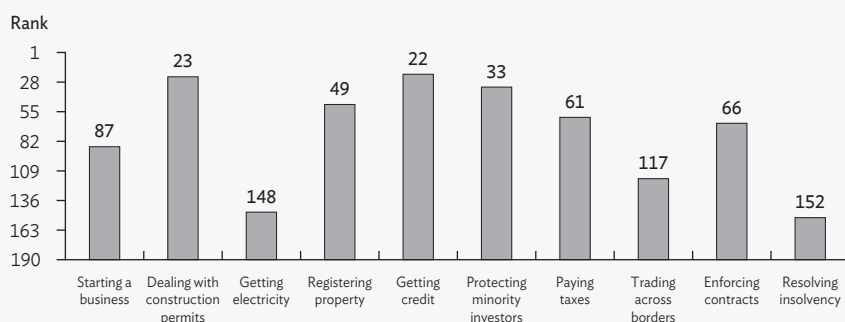
The mandatory social payments in Mongolia are relatively high. The basic corporate income tax (CIT) rate is 10% for income up to \$1.14 million and the portion of income exceeding that amount is subject to 25% CIT. CIT exemptions apply to business incomes deriving from innovative and environment-friendly technology, and to entities where the majority of employees are disabled. Investors and domestic businesses often point out bureaucratic hurdles and a lack of clarity in the application of tax laws and regulations, particularly with regard to deductible costs and valued-added tax rebates. The government revenues through taxation and state-owned entities remain high. Finally, real interest rates are high compared to other emerging markets. With this macroeconomic environment, many companies face the difficulties of high labor costs, high borrowing costs, and low productivity.

### 6.5.1 | Regulatory Framework

According to the World Bank's *Doing Business* report (World Bank 2019), Mongolia was ranked 74th out of 190 economies. The most hindering issues are resolving insolvency (152nd), getting electricity (148th), and trading across borders (117th). The ranking of Mongolia in the *Doing Business* topics is shown in Figure 6.9.

In the *Doing Business* report, investors report that the business registration process in Mongolia is reasonable, efficient, and clear. There is no differentiation between foreign and domestic enterprises. The big issue is the nontransparent, legal, regulatory, and accounting practice.

**Figure 6.9: Ranking of Mongolia in Doing Business Topics**



Source: World Bank (2019).

To be identified as an SME and get funding from the SME Development Fund and other funds, enterprises have to apply for a certificate at the Ministry of Agriculture and Light Industry after registration. The following documents are required for the application:

1. An official letter, which states the sector and direction of activities, specification, official address, telephone number, and email address.
2. A copy of the State Registration Certificate.
3. Attestation from the Social Insurance Department of the district with the total number of insured employees.
4. Attestation from the Tax Department of the district.
5. Confirmed financial statements for the previous year.

The Law on Land was adopted in 1994 and revised in 2002. Within this law, it is possible to own, use, and possess land. A holder of immovable property usually holds two separate certificates: one for the land and one for the building on the land. Having a certificate for land does not mean that you own the land, you only hold possession rights.<sup>1</sup>

<sup>1</sup> Owning land means legitimate control and disposing of land. Possession of land is the right to use the land oneself or sublease to others. Mongolian citizens and entities have the right to possess land for up to 60 years, to sublease, to transfer with the approval of the land authority, or to pledge it as collateral. Foreign citizens and entities cannot obtain possession rights over land in Mongolia (IFC 2014).



The Bankruptcy Law of Mongolia was first adopted in 1997 and since then it has not been amended. It defines bankruptcy as a civil matter. The bankruptcy process is too vague, onerous, and time-consuming. According to the World Bank's *Doing Business* report, it can take 4 years to become bankrupt.

Family ties still play a significant role, therefore many businesses are established as family businesses or with the support of family members. Business decisions are usually made jointly within the family.

Since the democratic changes in 1990, women have a high social status in terms of, for example, equality in education and social rights. Since these democratic changes, many women have started their own business and now perform the same jobs as men. The legal framework provides equal rights in inheritance, land use, and ownership of property. The primary caretakers of households and children are women. This is the reason why women's businesses are typically smaller, demonstrate lower turnover rates, and have fewer employees (UNDP 2018).

## 6.6 Status of Domestic and Global Value Chains in Mongolia

Developing value chains is crucial to enable landlocked countries to overcome the dependency on the mining sector. Overall, value chains can be defined as follows:

The value chain describes the full range of activities that firms and workers do to bring a product from its conception to its end use and beyond. This includes activities such as design, production, marketing, distribution, and support to the final consumer. The activities that comprise a value chain can be contained within a single firm or divided among different firms. Value chain activities can produce goods or services and can be contained within a single geographical location or spread over wider areas. (Duke University 2019).

A set of activities that are performed to design, produce and market, deliver, and support its product (Porter 1985).

International production, trade, and investments are increasingly organized with so-called "global value chains" (GVCs) where the different stages of the production process are located across different countries....

Global value chains have become a dominant feature of world trade, encompassing developing, emerging, and developed economies. The whole process of producing goods, from raw materials to finished products, is increasingly carried out wherever the necessary skills and materials are available at competitive cost and quality. Similarly, trade in services is essential for the efficient functioning of GVCs, not only because services link activities across countries but also because they help companies to increase the value of their products (OECD 2019).

In order to identify value chains in a country, numerous factors have to be researched, including supply chain and operational factors such as purchase order management, production, distribution, sales orders, management, and so on. Within this chapter, three factors of potential value chains are identified:

- products that have the potential to be exported;
- the majority of raw materials used for the production come from a local source, in other words, the existence of a production supply chain in the country; and
- many people work in this value chain.

### 6.6.1 | Manufacturing Sector

Mongolia is the second-largest producer of cashmere in the world and produces about 9,500 tons of raw cashmere per year, which makes up 28% of the world production, valued at \$368.2 million in total. It provides income and employment for over one-third of the population. In the past, the cashmere industry has received extensive funds, incentives, and technical assistance from the government and international donor organizations.

According to the Cashmere and Wool Association, the availability of raw materials is as follows: cashmere—8,500 tons; camel wool—1,400 tons; sheep wool—25,000 tons; yak molts—500 tons. Existing manufacturers in the cashmere and wool sector are as follows:<sup>2</sup>

- Manufacturers that produce final products—15
- Primary processing industry—23
- Small to medium knitting manufacturers—58
- Small household manufacturers—over 150

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<sup>2</sup> For information on the Mongolian wool and cashmere sector, see <http://mongoltextile.mn/nav/97> (in Mongolian).

**Table 6.5: Available (Used) Capacity of Cashmere Production Range**

Washing	Combing	Spinning	Knitting	Weaving
13,000 tons (8,500 tons)	6,500 tons (6,300 tons)	1,350 tons (1,100 tons)	2.8 million units (1.6 million units)	1,700 million meters (750 million meters)

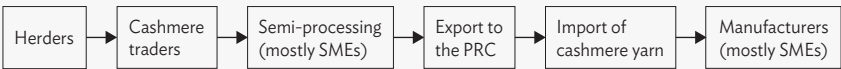
Source: <http://mongoltextile.mn>

In 2017, 9,200 tons washed and 5,400 tons of cashmere were exported. According to a study done by the Mongolian National Chamber of Commerce and Industry, the capacity of companies, which is crucial for production, is as follows:

First Stage	Second Stage	Third Stage	Fourth Stage
• Washing: 100%	• Wool carding: 25% of cashmere needed for production	• Spinning: 15% of cashmere needed for production	• Braiding yarn: 10% of cashmere needed for production

Only a few companies have full capacity until the end of production. Thus, there are two types of value chains—limited capacity (Figure 6.10) and full capacity (Figure 6.11):

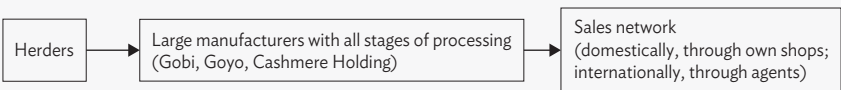
**Figure 6.10: Value Chain in Cashmere Sector (Limited Capacity)**



PRC = People’s Republic of China, SME = small and medium-sized enterprise.

Source: Author.

**Figure 6.11: Value Chain in Cashmere Sector (Full Capacity)**



Source: Author.

The main export destination countries for wool and cashmere products are the United Kingdom, France, the Republic of Korea, and Japan. Twelve companies exported goods worth \$4.58 million to the United Kingdom, 11 companies exported goods worth \$4.87 million to France, 11 companies exported goods worth \$5.56 million to Japan, and 26 companies exported goods worth \$7.23 million to the Republic of Korea in 2017 (Mongolian Wool and Cashmere Association 2018).

The biggest company in this sector is Gobi Cashmere. Gobi Cashmere was established in 1981 with investment from Japan and was privatized in July 2007. Since then it has been restructured and become a joint stock company. In December 2017, it bought Goyo Cashmere LLC, which was one of the first factories established with private investment in 1993 and one of the biggest. Gobi Cashmere and Goyo Cashmere LLC have a monopoly position in the Mongolian cashmere market, owning more than 70%, and they are part of the Tavan Bogd Group. Gobi Cashmere and Goyo Cashmere are also factories that have a full production range, from washing to wool carding, spinning and knitting, braiding yarn, and final products. They sell their products in 19 countries.

The second biggest cashmere producer, Cashmere Holding, was established in 1994 with the joint investment of a Mongolian company, Altai Holding, and a United Kingdom company, D.B. Holdsworth. D.B. Holdsworth had owned 30% of the shares until 2006 when Altai Holding LLC bought back the shares and became the full owner.

Companies that operate in the Mongolian cashmere sector face various challenges:

- The biggest challenge is that the People's Republic of China (PRC) causes price dumping of raw cashmere in the world market. The PRC companies also cause raw cashmere price hikes within the country when trying to buy Mongolian cashmere. As a result, the price of raw cashmere increases every year, burdening the local companies. As a countermeasure, the Mongolian government gives subsidies in order to get the herders to sell their raw cashmere to domestic companies. For example, government subsidies amounted to MNT22.6 billion in 2016 and MNT22.5 billion in 2017.
- The availability of raw cashmere is highly seasonal and possible only in spring; therefore companies need a huge amount of current assets. Furthermore, sufficient storage is required to accumulate enough raw cashmere.
- Big companies are interested in having a full production range, including washing and wool carding.

- One corporation has a monopoly position in the cashmere sector, due to insufficient regulations on fair competition. As a result, Mongolian SMEs will find it difficult to develop further.
- The fact that herders pay no taxes affects the quality of raw cashmere. There is also no tax on livestock, which causes excessive pasture carrying capacity and degradation of grazing areas. In recent years, the problems concerning the pastureland in Mongolia have been discussed a lot.

The two biggest cashmere companies, which have a monopoly position in the cashmere sector with over 70% of the domestic market share, belong to one company group, which owns a bank as well. The fact that the two biggest companies have created a monopoly position in the cashmere sector and a bank operates under the same group makes it doubtful whether principles of fair competition apply in the Mongolian cashmere sector. Table 6.6 shows the results of a strengths, weaknesses, opportunities, and threats (SWOT) analysis on the wool and cashmere sector.

**Table 6.6: SWOT Analysis for the Wool and Cashmere Sector**

Strengths	Weaknesses
<ul style="list-style-type: none"><li>• With natural breeding the quality of cashmere is without chemicals and treatments.</li><li>• Government programs, IFIs, and other companies are supporting in-country value-added cashmere processing.</li><li>• Relatively cheaper than other wool and cashmere products in the world market.</li><li>• Mongolian wool and cashmere are durable and easily refreshed.</li><li>• Some brands already have representative offices and sales agents abroad and are well-known in the world market.</li></ul>	<ul style="list-style-type: none"><li>• High cost of the working capital needed to purchase stocks of raw cashmere due to the availability of raw cashmere for a certain time of period. The producers have to buy the stock in the spring for the whole year.</li><li>• Inconsistent and uneven quality (as reflected in the price) of the raw materials, due to decreased fiber quality depending on age of goats.</li><li>• Price competition of traders.</li><li>• Highly seasonal with availability of raw cashmere only for a certain period.</li><li>• Exchange rates, especially the depreciation of the national currency, make the products too cheap.</li><li>• The quality is declining due to the substantial subsidies from the government such as no taxation for herders, free medical care, no pension, health, or disability contributions. If the cashmere quality (as measured by fiber diameters) increases, the average yield per goat declines.</li><li>• Most cashmere is exported with only low value added.</li></ul>

*continued on next page*

**Table 6.6: Continued**

Opportunities	Threats
<ul style="list-style-type: none"> <li>• Demand for, and interest in, ecologically pure, naturally made products are increasing worldwide.</li> <li>• In Europe, Scandinavia, and North America, the market for wool and cashmere products can be expanded, considering the cold, humid climate and higher living standards.</li> </ul>	<ul style="list-style-type: none"> <li>• Mongolia could face big competition from the largest producer of raw cashmere, the PRC. Since the PRC government has subsidized its cashmere sector with very low interest rates and other programs, the PRC could potentially dominate.</li> <li>• About half of Mongolia's raw cashmere is smuggled to the PRC for processing.</li> <li>• Price dumping.</li> <li>• Natural disasters such as <i>dzuds</i> could cause a shortage or even a loss of raw materials.</li> <li>• Ecological imbalance and deterioration in pastureland, due to high growth of goat herds.</li> <li>• Degraded cashmere quality due to the rapid growth of the industry.</li> </ul>

IFI = international financial institution, PRC = People's Republic of China.

Note: *Dzud* is a Mongolian term for a severe winter in which large number of livestock die.

Source: Author.

## 6.6.2 | Agricultural Sector

The Integrated Mineral Resource Initiative is a GIZ project in Mongolia that is implemented in four *aimags*. Within this project, there has been a value chain analysis of fruit and vegetables.

The main export destination countries are Japan, the Republic of Korea, and Singapore, and companies like Seaberry, UFC, Goo, and Lhamour have become relatively well known in the world market. The bigger companies are actively involved in improving the quality of production. Currently, the “Fruit and Berries” national program is being implemented to develop the sector. One of the main products is sea buckthorn (Figure 6.16).

There are a total of 54 SMEs processing raw materials and producing final products such as juice, oil, and wine in 14 districts (*sums*) of 10 *aimags* and six districts of the capital city of Mongolia. Factories have two to 50 employees and there are 595 people employed. The factories are capable of processing 500–600 tons of berries yearly, but most of them use only 3.3%–50% of their capacities. Currently, 2,041 tons of sea buckthorn are processed on average (MOFA 2017).

The fruit and berries sector in Mongolia has a good base to be developed as a value chain, but it requires a long-term development strategy and financial support to develop new technology and products with appropriate standards.

There are a number of problems that occur along the value chain pathway in the fruit and berries sector.

Ingredients and cultivars must remain the same to maintain a certain standard and quality of products. The biggest problem is the uncertainty concerning the cultivars of sea buckthorn. The most suitable and adaptable cultivars in the Mongolian climate have not been identified yet. Furthermore, human resources are one of the biggest challenges, since big companies or unions need agronomists and there is a need to prepare experts and specialized people in this sector. There are approximately 40 factories operating in the sector nationwide, and for these factories, advancement in technologies and access to finance are crucial. For instance, 30%–40% of the total harvests are lost during the process of harvesting due to the lack of technologies, since the berries are tightly bunched along the branches, and the harvesting of sea buckthorn is difficult and requires special equipment. Therefore, technologies such as harvesting equipment are important, since harvesting requires manual labor. In the future, the production of sea buckthorn should be automated.

There is a need to cooperate with national and international research organizations to improve this sector.

Long-term financing is required, because sea buckthorn starts bearing fruit 3 to 5 years after planting. To date, there have been no attempts to attract foreign investments in this sector, which should be considered in the future.

In total, 6,000 hectares (ha) have been cultivated and 3,000 tons of fruit and berries have been harvested. Big companies, including Khaan Jims, Kharkhorin, and Tovkhin Jims, have been operating in this sector. There are also many sea buckthorn farming households as a result of the implementation of the Chatsargana project. For instance, in 2017, the Mongolian government provided an area of 10 ha with infrastructure such as fences and watering systems in each *sum* of Bulgan Province. One household gets an area of 1–2 ha to share with others. The production of sea buckthorn can be developed further following this example. Table 6.7 shows the results of a SWOT analysis on the fruit and berries sector.

**Table 6.7: SWOT Analysis for the Fruit and Berries Sector**

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Endemic berries are well adapted to the harsh Mongolian climate.</li> <li>• They are widely used in organic beauty and treatment products due to their medicinal properties, including biological active substances, vitamins, and mineral elements.</li> <li>• They can be processed into various kinds of products, including food like organic juice, oil, beauty and medicinal products, and so on.</li> <li>• Sea buckthorn is a specific product of Mongolia.</li> <li>• Various sea buckthorn-related research has been carried out so far and this could be a good base for the further development of the sector.</li> <li>• Because of its extensive root system, sea buckthorn mitigates against desertification and is resistant to drought, which makes it suitable for growing in dry areas like western Mongolia.</li> </ul>	<ul style="list-style-type: none"> <li>• Only one third of sea buckthorn berries are harvested, due to the lack of technology and equipment.</li> <li>• The supply of raw materials is seasonal, thus scarcity could occur.</li> <li>• Lack of knowledge and know-how about sapling varieties could be an issue for the cultivation of sea buckthorn.</li> <li>• There is a small variety of fruit and berries available.</li> <li>• The equipment and technologies used on most farms are ineffective and cause a loss of yield.</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• The vast expanses of area where the fruit and berries can be cultivated.</li> <li>• There is a great opportunity to further develop organic fruit and berry products, since the global tendency to use organic and/or eco-products has been increasing.</li> <li>• The infection rate of diseases of the sapling is low.</li> </ul>	<ul style="list-style-type: none"> <li>• Mongolia has 66 million livestock, thus bigger plantations of fruit and berries must be protected with wire fencing from animals and birds, which requires a certain amount of investment. The PRC is presumably the biggest producer and exporter of sea buckthorn in the world, since most of the suppliers of sea buckthorn post on websites such as <a href="http://www.alibaba.com">www.alibaba.com</a> and <a href="http://www.zauba.com">www.zauba.com</a>. This may prevent Mongolia from expanding its sea buckthorn exports.</li> </ul>

PRC = People's Republic of China.

Source: Author.

### 6.6.3 | Service Sector

The tourism sector is one of the priority sectors of Mongolia. According to the National Tourism Association, there are 600 companies (tour operators) registered, with 280 active companies and 300 tourist camps in operation. Mongolia has visa-free regimes with 42 countries to attract more tourists.



Although Mongolia was the host country of ITB 2015, the target to receive 1 million tourists by 2016–2017 could not be reached. The main reason was that there was no additional infrastructure development carried out in the country, such as increasing the number of flights to and within Mongolia. The tourist companies of Mongolia are part of the global value chains. They have contracts with international companies offering tours through their networks.

According to the World Travel & Tourism Council (WTTC 2019), the total contribution of tourism to GDP (including wider effects of investments, government spending, supply chain, and induced income impacts) was MNT3.77 trillion or 11.8% of GDP, while the direct contribution of tourism to GDP amounted to MNT1.29 trillion or 4.1% of GDP (rank 110th) in 2017. Thus, the total contribution of the tourism sector to GDP is nearly three times greater than its direct contribution.

Tourism accounted for 133,800 jobs, including the jobs indirectly supported by the sector, and represents 11% of total employment. Table 6.8 shows the results of a SWOT analysis on the tourism sector.

Due to the high volatility of the Mongolian togrog, the tourist companies have to calculate their prices very carefully. Foreign tourists usually book and pay for their tours at least 6 months in advance; therefore, the fluctuation of the togrog against the US dollar can be a big risk.

The tourism sector is seasonal, due to the very cold and harsh winters in Mongolia. The tourist season is from June to September each year. Special programs such as winter or adventure tourism need to be developed to prolong the season.

- It is impossible to develop tourism in Mongolia as mass tourism, because only a few people with specific interests come to Mongolia and traveling costs are high. The tourism sector faces many other challenges as well.
- Due to the underdeveloped infrastructure, there are only domestic flights to a few provinces. Furthermore, the flights are relatively expensive.
- Another weakness is that the healthcare infrastructure is poor. In the case of an accident or illness in the countryside, the injured person needs to be transported to a city, where advanced healthcare is provided and this takes time.
- In recent years, travelers driving in their vehicles have come to Mongolia through the Russian Federation. But, due to the poor road infrastructure, there are not enough traffic signs. Thus travelers are usually unaware of the distance to the next filling stations or directions.

**Table 6.8: SWOT Analysis for the Tourism Sector**

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• The extensive lakes, rivers, streams, and ponds abound with fish and other wildlife and have the potential to attract nature-based and more specifically eco-tourists.</li> <li>• The Gobi Desert located to the south of the region enjoys its own special tourist attractions and has extensive potential.</li> <li>• A number of historic city sites offer potential if properly protected, signed, and interpreted.</li> <li>• Genghis Khan is well-known worldwide and offers much interest to overseas visitors to the region. Marco Polo is also associated with this area and therefore provides a link with Europe, which increases the potential European interest.</li> </ul>	<ul style="list-style-type: none"> <li>• Infrastructure has not improved, such as additional international flights, domestic flights, railways, etc.</li> <li>• Air market is not liberalized therefore expensive.</li> <li>• There is limited accommodation and much of the accommodation is not of international standard yet.</li> <li>• There are few medical aid centers and emergency services available in rural areas.</li> <li>• There is relatively little to purchase, especially in the tourism and interpretation centers, such as food, beverages, postcards, books, guidebooks, and souvenirs.</li> <li>• Greater levels of interpretation will be needed and more interpretation centers must be built, especially at sites such as those occupied by ancient cities.</li> <li>• Signage must be improved and appropriate environmental standards used.</li> <li>• Although there is little one can do about the climate, it should be recognized that the long, cold winters will make much of the tourism activity highly seasonal with consequent periods of little demand for resources and infrastructure.</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• The vast expanses of forests, grasslands, and deserts are barely being tapped at present and there are opportunities to develop many more tourist attractions in the future.</li> <li>• While Mongolia is a relatively isolated region of the world, it is that very isolation that gives the region much of its attraction.</li> <li>• Much of the tourism product is based on natural and cultural attractions and it is these types of attractions that are in high demand by international tourists. Nature-based and eco-tourism-based attractions and products are experiencing rapid growth in demand worldwide.</li> <li>• Cultural attractions are in even greater demand than natural attractions and there is great opportunity to further develop the cultural attractions in the region.</li> <li>• Winter sports, winter tourism, and adventure tourism, in general, have been identified as a potential growth market and there are a lot of opportunities to develop this sector further.</li> </ul>	<ul style="list-style-type: none"> <li>• The very nature of both desert and grassland landscapes makes any form of development highly conspicuous and there is a great danger of poor or inappropriate development ruining the scenic appeal of much of the area.</li> <li>• Care must be exercised to ensure that pollution does not detract from the relatively pollution-free environment that currently exists.</li> <li>• Tourism is not the only industry in the region and care must be exercised to ensure that other industries, especially extractive industries, are not allowed to ruin the tourism resource of the region.</li> <li>• There is faith around the world that if one develops eco-tourism, all will be well and little harm can occur in the natural environment. There is no guarantee that eco-tourism will be benign and as it occurs in some of the world's most sensitive places, the potential risk to the environment is enormous. This is true for Mongolia.</li> </ul>

Sources: Lkhalkham et al. (2018), ADB (2002).

## 6.7 Value Chain Financing Analysis

The limited access to finance by SMEs hinders them in terms of creating jobs, economic growth, and further developing their business. There are no value chain financing mechanisms available. The bank-dominated financial sector of Mongolia offers loans, and deposit and saving products. There is a need to develop venture capital, factoring, leasing, overdraft facilities, start-up finance, and other finance mechanisms.

There are no financial incentives for exporters.

## 6.8 Policies to Promote SME Finance

There are different laws and programs available to support the development of SMEs. A credit risk database is available at the Bank of Mongolia, but only banks have access to this database. Some of the important and relevant laws and programs are listed in Table 6.9.

**Table 6.9: Laws and Policies to Promote SME Finance**

LAW
<div><div>□ Law on SMEs</div><div><div>Year Introduced/Ministry in Charge: 2007</div><div>Objectives: First-time definition of SMEs</div><div>Short Assesment: The definition of SMEs is not widely used by SME stakeholders. The business register of the NSO has another client segmentation and also banks use their own definition.</div></div></div>
<div><div>□ Law on exemptions of customs duties and value-added tax on equipment and spare parts imported for the purpose of increasing employment, substitution of imports and export-oriented products for SMEs.</div><div><div>Year Introduced/Ministry in Charge: 2009, 2014, 2017</div><div>Objectives: The list of equipment to be released under these laws was approved by the Government of Mongolia's Resolution No. 191 in 2014 and Resolution No. 168 in 2017, respectively.</div><div>Short Assesment: Effective in developing the manufacturing sector in Mongolia. But the list of equipment released was only effective until the end of 2018.</div></div></div>

*continued on next page*

**Table 6.9: Continued**

**POLICY**

**□ SME program 2018–2020**

*Year Introduced/Ministry in Charge:* Ministry of Light Industry and Agriculture

*Objectives:*

1. Within the scope of the activities of the government: Improve the legal environment, support new technologies, encourage bilateral trade and investment cooperation.
2. Within the scope of nongovernment organizations: Create links between new markets, between large and small businesses, and management networks for value chain and sales. Inform and promote government policies and decisions, scientific achievements, and advanced technologies.
3. Within the scope of business: Capacity building of human resources, increasing capital and savings, improve internal controls, risk assessment, market capacity, and pricing. Focus on export orientation.

*Short Assessment:* This policy is only on paper, with no implementation so far. In the program, there are no monitoring activities and timelines, involvement, and the role of other ministries and agencies are planned.

**□ Export promotion program**

*Year Introduced/Ministry in Charge:* Ministry of Foreign Affairs

*Objectives:*

1. Creation of a favorable, sustainable export environment
2. Diversification of export
3. Improve quality and simplify trade and expand the export market and access

*Short Assessment:* No assessment has yet been done.

NSO = National Statistical Office.

Source: Author.

The Government of Mongolia has established funds to provide financial support for SMEs. The following funds are available for SMEs (Table 6.10).

The SME Development Fund was established to support financing by providing long-term concessional loans for SME operations, allowing them to access production equipment through financial leasing, offering double guarantees and promoting activities of subsidized SMEs, organizing workshops and training from the Ministry of Food, Agriculture and Light Industry. From 2009 to 2017, the SME Development Fund received 26,454 applications. Only 18% or 7,536 were approved and they received total funding of MNT835.2 billion in concessional loans, or 4.3%–6.5% of total SME finance. But the government structure supporting SMEs, including the SME Development Fund, was not sustainable in the past.

**Table 6.10: Available Funds for SMEs**

	Requirements	Terms	Partners	Development Plans
SME Development Fund	<ul style="list-style-type: none"> <li>• Business project</li> <li>• Number of employees without contracts 199</li> <li>• Operation more than 1 year</li> <li>• No outstanding loans</li> <li>• Advanced technology implemented without adverse impact on environment and technology</li> </ul>	<ul style="list-style-type: none"> <li>• 4 years, interest rate 5%, min loan: MNT30 million</li> </ul>	<ul style="list-style-type: none"> <li>• Fully supported from budget</li> </ul>	<ul style="list-style-type: none"> <li>• No information available</li> </ul>
Credit Guarantee Fund	<ul style="list-style-type: none"> <li>• Business projects</li> <li>• Certificate</li> <li>• No bad credit history</li> <li>• Operation more than 1 year</li> <li>• With certain income</li> </ul>	<ul style="list-style-type: none"> <li>• Long term (10 years)</li> <li>• Low interest rate (12%)</li> </ul>	<ul style="list-style-type: none"> <li>• Asian Development Bank</li> </ul>	<ul style="list-style-type: none"> <li>• Additional products planned: women, eco-business and start-up</li> </ul>
Employment Creation Fund	<ul style="list-style-type: none"> <li>• Unemployed citizens registered at the Labor Office</li> <li>• Living in the community for 3 months</li> <li>• Self-employed</li> <li>• No bad credit history</li> </ul>	<ul style="list-style-type: none"> <li>• For individuals MNT2 million; for herders, individuals establishing partnership cooperatives up to MNT5 million; for individuals establishing cooperatives up to MNT10 million for 2 years, interest rate 0.85%/month</li> </ul>	<ul style="list-style-type: none"> <li>• Fully supported from budget</li> </ul>	<ul style="list-style-type: none"> <li>• No information available</li> </ul>

MNT = Mongolian togrog, SME = small and medium-sized enterprise.  
Sources: SMEDF (2019), CGF (2019).

For instance, the SME fund operated under different ministries. From 2012 to 2014, it operated under the Ministry of Economic Development, from 2014 to 2016 under the Ministry of Industry, and from 2016 under the Ministry of Agriculture and Light Industry. The Ministry of Economic Development was dissolved in 2014 and the Ministry of Industry was dissolved in 2016. Therefore, a long-term development strategy for SMEs is not available.

**Table 6.11: Average Funding for a Project from the SME Development Fund**

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Average funding amount per project (MNT million)	24.3	25.2	158.4	381.8	147.9	155.2	150.8	425.5	324.7

MNT = Mongolian togrog, SME = small and medium-sized enterprise.

Source: SMEDF (2019).

**Table 6.12: Projects Implemented by Sector, 2009–2017**

Sectors	Number of Projects	Expansion of Production	New Factory
Light industry	2,095	443	129
Food production	1,081	243	88
Farming	752	243	88
Animal husbandry	1,158	443	129
Warehouse	122	25	18
Nonmetallic (manufacture of minerals)	657	213	101
Soap, disinfection	48	13	8
Waste	10	8	2
Trade and services	911	161	77
Processing factory	28	22	6
Other	674	102	65

Source: SMEDF (2019).

From 2013 to 2018, the Credit Guarantee Fund (CGF) guaranteed MNT76.8 billion for 646 guaranteed credits worth MNT164.4 billion (CGF 2019). Currently, MNT37.3 billion for 111 guaranteed credits have been granted: 84 of these guarantees were issued in Ulaanbaatar, and 27 in local areas. Financed by foreign credits and grants, there are no subsidies from the budget.

The CGF is located only in Ulaanbaatar. It cooperates with five commercial banks. If the collateral of an SME is not enough to get credit, they can apply for a credit guarantee. The usual process is that they have to apply for it at their local bank and the bank submits the application to the CGF. The CGF studies the application and the submitted documents. When the CGF approves the application, the bank examines the documents carefully. The final decision is made by the credit committee of the bank.

## 6.9 Conclusions and Recommendations

The main source of funding for SMEs is commercial banks. Loan guarantees are used by the government to ease SMEs' access to finance. Some funds have been established to support the development of SMEs.

Access to finance and a lack of collateral are important issues for SMEs. The cost of financing is high and there are insufficient support and subsidies from government agencies. The banking system offers basic and traditional financing mechanisms, a lack of value chain financing, and other risk mechanisms for exchange rate fluctuations. Long-term financing schemes are needed.

Studies on the financial literacy of SMEs have not been conducted. Therefore it is difficult to assess the financial education of SMEs.

Thus, the following recommendations can be formulated.

1. A proper definition of SMEs is needed with changes to the law. If not, funding from the SME Development Fund and others will be misused in the long term.
2. A unified database for SMEs is needed to obtain accurate statistics and develop effective policy measures, and a credit risk database is necessary to overcome the problem of information asymmetry faced by SMEs. Especially aggregated data on development of SMEs and gender is needed. Research on long-term development of SMEs is needed.
3. Studies on the financial literacy of SMEs are needed to identify their real needs and a national financial literacy strategy should be developed. Such studies should be carried out on a regular base to identify their development and to develop focused products for them.
4. Annual studies on the development of SMEs are needed. Information needed to develop effective measures includes number of employees, equity situation, active sector, and expanding of activities.
5. According to the International Trade Center, regulatory burdens hit small firms twice as hard as large firms. Therefore, an extensive survey of the business environment is needed. The survey should include the operational difficulties faced by SMEs to better define problems and diagnose solutions to support their operations. Operational difficulties can be poor infrastructure, abrupt changes of regulations, market downturn, finding suitable premises for expanding, complying with administrative procedures, and others.

6. Expand the credit guarantee system through special programs for women, people with disabilities, etc.
7. Improve the Bankruptcy Law. Efficient bankruptcy regulations are important for financial stability. Simplify the insolvency proceedings through categorization and decrease the number of required documents.
8. Implement the SME program 2018–2020.
9. The appraisal of collateral has to be done by independent valuation companies. Thus, such regulation is needed.
10. Explore the possibilities of developing alternatives to bank lending, and in particular diversifying the financial sector, such as venture capital, business angel investment, mezzanine financing, crowdfunding, leasing, factoring, and green financing. Develop a regulatory framework to export-orient the SMEs so that they can become subcontractors to larger multinational producers through global value chains. Offer diversified financing schemes for each stage of development of SMEs. For example, in the first 1–3 years, the SMEs are offered extensive training and appropriate financing, with the next development stage from 3–5 years supporting the SMEs with concessional loans from the SME fund to give them the possibility to grow. Offer bank financing for SMEs successfully operating for more than 5 years.
11. Develop programs for the development and finance of value chains based on studies.
12. Improve the environment for fair competition through the improvement of Competition Law and environment.
13. Prolong the period and extend the list of equipment under the law on exemption of customs duties and value-added tax on equipment and spare parts.
14. A business voice in the design and implementation of border procedures is needed.
15. Tourism companies should cooperate with local manufacturers and promote their products by advertising them.



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# Leveraging SME Finance through Value Chains in Tajikistan

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## 7.1 Introduction and Overview of SMEs' Role in the Economy and SME Finance

Despite 27 years of robust economic growth, Tajikistan is still far from economic resilience and remains the poorest and least developed country in Central Asia. The economy is still at an early stage of development with a relatively low value added and narrow export base.<sup>1</sup> Since 2010, economic growth has averaged 6.3% annually, while poverty was halved to less than 30% of the population during the period 2000–2017. In 2017, the size of the economy was about \$7.1 billion, with per capita gross domestic product (GDP) close to \$813. More recently, Tajikistan was hit by adverse economic shocks—a sharp drop in commodity prices,<sup>2</sup> a significant slowdown in major trading partners,<sup>3</sup> and a loss in competitiveness due to sluggish investment in value chains in comparison with neighboring countries.<sup>4</sup> Economic growth has continued to be driven by growth in remittances and public investment. Accordingly, low foreign investment and depressed domestic demand mean that future growth is likely to be unsustainable in the presence of external economic shocks.

Labor migration continues to fuel Tajikistan's GDP growth through consumption, with personal remittances comprising about \$2.5 billion in 2017.

<sup>1</sup> According to the World Bank and the National Development Strategy (NDS) 2016–2030, the government's ambitious goal of doubling the country's gross domestic product (GDP) by 2030 requires the daunting task of maintaining at least 7% annualized real growth rates.

<sup>2</sup> Particularly for oil and metals, such as gold and aluminum. Tajikistan is a non-oil economy, but there is a high correlation with the changes in the oil price because over 80% of remittances come from the oil-rich Russian Federation.

<sup>3</sup> Especially the Russian Federation and Kazakhstan (both countries are oil exporters).

<sup>4</sup> Alongside a decrease in the value of the Tajik somoni by more than 70% against the dollar during 2015–2018.

The Asian Development Bank (ADB) argues that growth would be as low as 3.1% if remittances were taken out of the equation.<sup>5</sup> Remittances represented 49.6% of GDP in 2013 (the highest recorded figure for Tajikistan as a share of gross domestic product), and by 2017 they had declined to 35.5% of GDP, and have since stabilized around those levels. In addition, growth should be at least 9% to keep pace with demographics. This highlights the country's vulnerability to the external economic environment,<sup>6</sup> with implications for growth and trade.

The domestic labor market is weak, with workers often underpaid, unskilled, and lacking incentives. Labor migration represents one of only a few exit strategies for households, particularly in rural areas, and fiscal buffers (e.g., reserves and deficit) are unlikely to withstand another economic downturn. At the same time, emerging sectors such as garments, handicraft, financial intermediation, renewable energy, tourism, and information and communication technology (ICT) may spearhead the country's long-term growth. For this to happen, private investment and the density of small and medium-sized enterprises (SMEs) need to grow. According to ADB, the ratio of private investment to total investment is only 26%, while the average among lower-middle-income countries is 75%. Total employment declined by 7.8% between 2010 and 2016, while mean productivity increased by 39.8% during the same period. Agriculture is the biggest employer, having expanded from 41% of total employment in 1991 to about 60% in 2017. Productivity in services has declined and employment in manufacturing—despite its recent surge—declined from 46% to 17% during the period 1991–2016.<sup>7</sup> This trend should be reversed and new jobs created, particularly in productive sectors and by SMEs, for structural transformation to kick in in Tajikistan.

The Law of the Republic of Tajikistan “On the State Protection and Support of Entrepreneurship” (Article 5) distinguishes commercial legal entities between small (with a gross turnover of up to TJS500,000 or about \$53,000), medium (with a gross turnover amounting to between TJS500,000 and TJS15,000,000, or up to \$1,591,500), and large firms (with a turnover of above TJS15,000,000, or above \$1,591,500). This distinction was adopted by the Government of Tajikistan

<sup>5</sup> In the meantime, about 181,000 Tajik nationals are still banned from entering the Russian Federation, which puts severe pressure on creating jobs at home. A recent recovery in remittances contributed to growth as well as a narrowing of the current account deficit from –\$361.5 million in 2016 to –\$35.7 million in 2017.

<sup>6</sup> Structurally, Tajikistan is highly exposed to the Russian Federation, especially through the labor market and currency channels. The EBRD estimates that a 1 percentage point decline in the Russian Federation's growth translates into a decline in growth of 0.2 percentage points in Central Asia.

<sup>7</sup> Sources: Ministry of Economic Development and Trade of the Republic of Tajikistan and ADB.

in March 2015, but is rarely used in official government statistics or policy making. Instead, the government and national stakeholders distinguish SMEs not by gross turnover but by employment level (i.e., the size of the workforce in an enterprise).<sup>8</sup>

SMEs play an important role as a source of employment, but their contribution to GDP remains low, not least due to the relatively small gross turnover per firm (Figure 7.1). Based on Agency for Statistics data from 2017, there are 499,372 commercial taxpayers consisting of 64,592 firms, 197,138 individual entrepreneurs working with a patent, 73,011 individual entrepreneurs working with a certificate, and 164,631 *dehkhans* farms paying single tax. Only the first group, i.e., commercial taxpayers, are broadly regarded as SMEs. According to official government sources, the share of SMEs in total employment is about 35% in Tajikistan.<sup>9</sup> The economy outside the industrial complex (i.e., extractives and manufacturing) is dominated by small, family-run companies and SMEs are seen as part of the growth transmission mechanism contributing to the well-being of households. However, SMEs' contribution to GDP in Tajikistan is relatively low (about 30%) compared to the Organisation for Economic Co-operation and Development (OECD) average of 50% in 2017. This indicates that SMEs are mainly operating in low-productivity sectors (Figure 7.2), but, as the following sections will elaborate in greater detail, growth prospects for businesses are being held back by regulatory and economic impediments.

Despite steps undertaken by the Government of Tajikistan to privatize companies,<sup>10</sup> state-owned enterprises (SOEs) continue to exercise control over strategically important sectors, such as electricity and heating, ferrous and nonferrous metals, mining, food processing, agriculture, construction, transport, and telecommunications. In 2017, assets of the 24 largest SOEs (out of about 1,100) accounted for 51% of the GDP.<sup>11</sup> They also accounted for over 30% of total employment and continue to receive sizeable state financial support, which undermines potential market entry by smaller firms and discourages the creation of a level playing field in terms of competition and access to resources.

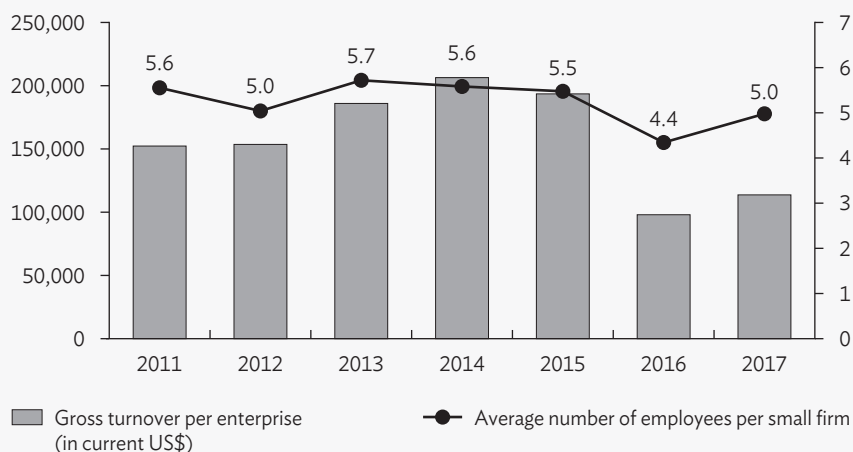
<sup>8</sup> Small firms—up to 30 employees; medium-sized firms—between 31 and 200 employees; and large firms—more than 200 employees (Agency for Statistics under the President of the Republic of Tajikistan).

<sup>9</sup> Ten years ago, according to the Agency for Statistics under the President of the Republic of Tajikistan, the share of SMEs in total *formal* employment was approximately 48%.

<sup>10</sup> According to the State Committee on Investment and State Property Management, over 9,600 small firms and over 1,300 medium-sized and large firms have been privatized since the country's independence.

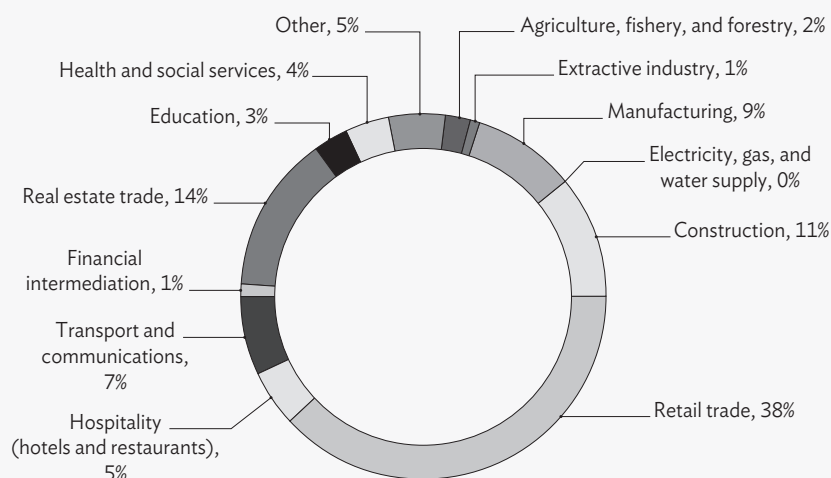
<sup>11</sup> Or 35% of GDP excluding current assets as receivables.

**Figure 7.1: Selected Indicators for Early-stage (Small) Enterprises in Tajikistan, 2011–2017**



Source: Agency for Statistics under the President of the Republic of Tajikistan (TAJSTAT).

**Figure 7.2: Distribution of SMEs in Tajikistan, 2017 (in %)**



SME = small and medium-sized enterprise.

Source: Agency for Statistics under the President of the Republic of Tajikistan (TAJSTAT).

SMEs' price competitiveness and capacity to absorb new employment have weakened significantly in the past decade, not least because exports are concentrated on products with inelastic demand. Since 1995, there has been virtually no change in the composition of Tajikistan's exports. The country continues to rely on a few commodities for its export revenue, such as aluminum alloys (26.3%), gold (17%), zinc ores (9.5%), lead ores (8.6%), and cotton (7.1%). The export concentration and heavy dependence on natural resources make Tajikistan's exports vulnerable to volatile international commodity prices. For instance, aluminum—the largest metal export product—amounted to 25% of the total share of exports in 2017, whereas prices were 65% lower compared to 2013. In terms of light industry, for example, knitwear, shoes, and cotton and silk fabric production have shrunk significantly despite the country's comparative advantage. This is because investment in these niche sectors has been low and value chains underdeveloped. In spite of a surge in heavy industry, financing comes primarily from the People's Republic of China (PRC), albeit on concessional terms. The mining sector is already a contributor to Tajikistan's export earnings, driving tax revenues, domestic production, and employment, but remains poorly regulated and heavily dependent on a few major operations.<sup>12</sup> On the other hand, agriculture has performed well, even though its productivity margins remain relatively low.

### 7.1.1 | Overview of the Financial Sector

In Tajikistan, SMEs access financial services from 16 commercial banks and 80 microfinance institutions (MFIs)<sup>13</sup> operating in the domestic financial system. The traditional banking sector comprises 16 banks, of which six are classified by the National Bank of Tajikistan (NBT) as systemically important. The largest banks are Agroinvestbank (AIB), Tojiksodirotbank (TSB), Oriyonbank, and Amonatbank, and they account for over 70% of all bank assets in Tajikistan. Local banks have 256 branches and 1,028 banking service centers, representing a significant expansion in outreach compared to the early 2000s. The fragility of Tajikistan's banking sector constrains access to finance, as well as the range of consumer products and services offered by SMEs.

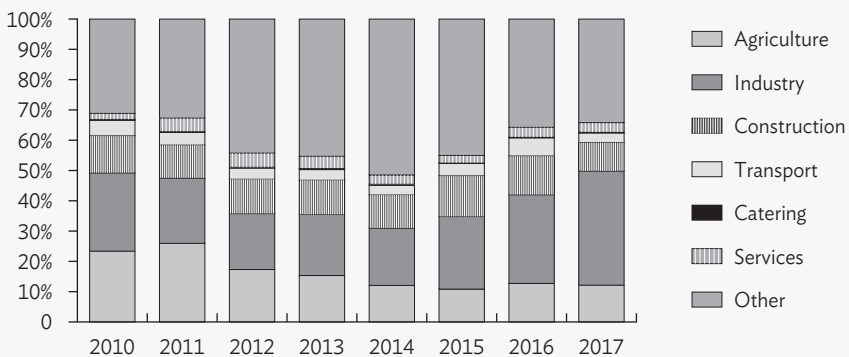
According to the NBT, banks and MFIs lend heavily to firms in agriculture and industry (Figure 7.3). In fact, industry is the largest sector in the lending portfolio of banks (38%), followed by foreign trade (17%), agriculture (12%), consumption (11%),

<sup>12</sup> In Tajikistan, TALCO, an aluminum smelter, is responsible for up to 35% of export earnings.

<sup>13</sup> Of these, 34 are microcredit deposit organizations, 13 microcredit organizations, and 33 microcredit foundations.

and construction (9%). Consumption loans account for the majority of loans issued by MFIs (34%), followed by credit to SMEs in agriculture (26%), industry (13%), and services (12%). The balance (i.e., 15%) includes SMEs belonging to construction, catering and transport, foreign trade, and other sectors (Figure 7.4).

**Figure 7.3: Loans from Banks by Key Economic Sectors in Tajikistan, 2010–2017**



Source: National Bank of Tajikistan (NBT).

**Figure 7.4: Loans from MFIs by Key Economic Sectors in Tajikistan, 2010–2017**



MFI = microfinance institution.

Source: National Bank of Tajikistan (NBT).



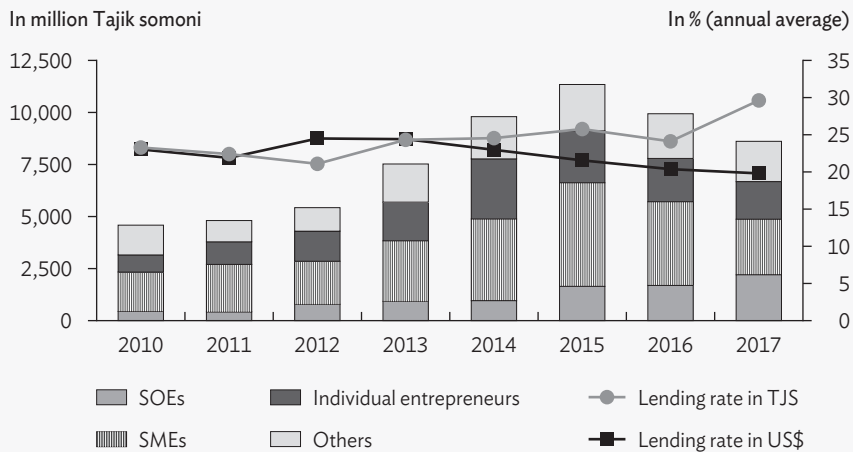
All banks and MFIs rely heavily on debt as their primary financial service to smaller firms, which is always collateralized and often guaranteed by third parties, such as other banks or international development partners (e.g., the European Bank for Reconstruction and Development [EBRD], KfW, the International Finance Centre, SECO, and others). In 2017, credit to the private sector was 13.7% of GDP. Unlike banks that rely on foreign currency lending, MFIs lend to SMEs and individual entrepreneurs mainly in local currency (Figure 7.6). The total volume of bank loans to SMEs in foreign currency has declined from \$1.2 billion in 2015 to \$0.6 billion in 2017, and they now account for 37.6% of banks' total loan portfolio as of January 2018 (compared to 49.9% in 2015). Local banks provide loans mostly to enterprises (including SOEs), but MFIs have a more balanced portfolio between individuals and SMEs.

Local banks have limited or, particularly among banks that face liquidity shortages, no access to international debt markets. Access to local currency funding also remains a challenge for financial institutions, while capital markets are virtually nonexistent for enterprises to raise money.

In 2017, 21.3% of all bank loans were disbursed to individual entrepreneurs, while SMEs received 31% of all bank loans (compared to 50.1% in 2010) and SOEs accounted for 25.4% (compared to 11.7% in 2000). As for the MFIs, almost half of their total lending (i.e., 48.7%) goes to individuals for consumption purposes, followed by individual entrepreneurs (33.4%) and SMEs (14.5%). To date, SOEs have been a negligible part of the lending portfolio of MFIs. The latter also appear to be better shielded against directed lending practices and related party lending, which are still prevalent in banks. In addition, individual entrepreneurs seem to be more eager to get loans from MFIs, as total volumes of MFI lending to individuals have kept stable over time and have actually surpassed those of banks since 2017. This could be a combination of better terms provided by MFIs, a lower appetite on the part of banks for the SME segment of the market, and a lack of trust by bank customers. For more information on lending, see Figures 7.5 and 7.6.

The high proportion of nonperforming loans (NPLs) remains one of the biggest impediments for SMEs in accessing credit from banks. The NPL ratio had risen to more than 50% of all assets by early 2017, while the capital adequacy ratio declined to 11.5% in March 2016, driven by the largest banks. This poses serious threats to bank solvency and banking stability, with adverse spillovers resulting in a higher cost of credit to local firms. NPLs have grown rapidly, especially in large banks, while official numbers mask major asset quality weaknesses in some banks.

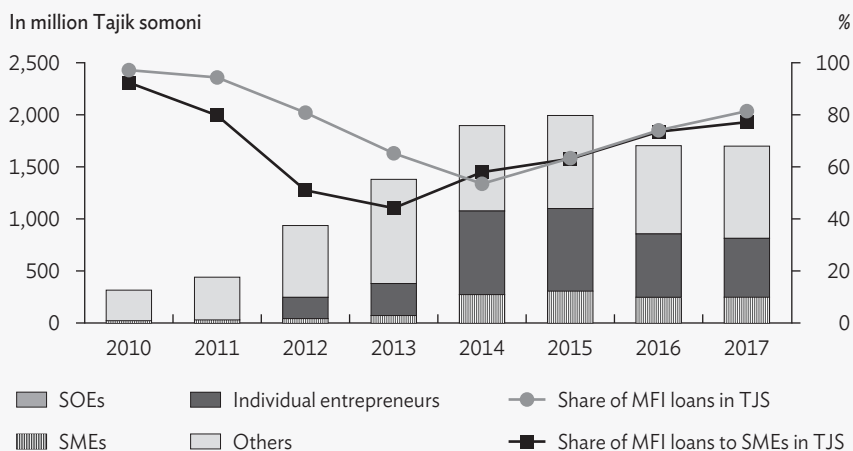
**Figure 7.5: Bank Loans by Type of Borrower and Average Lending Rates in Tajikistan, 2010–2017**



SMEs = small and medium-sized enterprises, SOEs = state-owned enterprises, TJS = Tajik somoni.

Source: National Bank of Tajikistan (NBT).

**Figure 7.6: MFI Loans by Type of Borrower and MFI Lending in Tajikistan, 2010–2017**



MFI = microfinance institution, SMEs = small and medium-sized enterprises, SOEs = state-owned enterprises, TJS = Tajik somoni.

Source: National Bank of Tajikistan (NBT).

In addition, the lack of proper classification and inadequate reporting by banks has kept the NBT in the dark as to the size, quality, constitution, and distribution of NPLs. Other mezzanine products, e.g., equity investments, are rarely employed and traditional lending instruments (including credit guarantees) represent one of the few financial products available for SMEs in Tajikistan.

The microfinance sector in Tajikistan has grown rapidly in the past several years, albeit from a very low base, and it provides an important source of finance to SMEs, as well as a crucial opportunity to save. Financial participation has been growing from a very low base<sup>14</sup> and increased more than fourfold to 11.5% of adults over the age of 15 having an account at a financial institution in 2014. Rural financial penetration increased over the same period, although it did not reach the low-income country average, while more than a quarter of adults reported having borrowed money in 2014. While the preference for informal savings and borrowing is still strong, there is great potential for further growth of the microfinance sector, but its rapid growth, especially in an environment of limited regulatory capacity and weak financial consumer capability, has presented significant risks.

As external shocks increased in summer 2015,<sup>15</sup> and with a worsening portfolio performance, pressures mounted on the microfinance and banking sectors to consolidate. The NBT hiked capital requirements drastically, such that eight microcredit deposit organizations and more than 20 microcredit organizations have effectively struggled to reach the new benchmark, merge, or exit the market since the end of 2015. While the penetration of financial services was still very low, the microfinance sector was expanding rapidly, foreign exchange-denominated lending was widespread, and the risks in the financial sector appeared quite high. MFIs had overexposed themselves by lending excessively to non-hedged corporate borrowers. This partly accounted for severe portfolio deterioration among MFIs between 2015 and 2017. Financial institutions also relied too heavily on collateral, which discouraged many otherwise eligible SMEs from accessing credit from MFIs.

<sup>14</sup> World Bank Financial Inclusion database (Findex). In 2011, the percentage of adults aged over 15 having an account at a financial institution in Tajikistan was 2.5%, compared to a significantly increased 47% in 2017.

<sup>15</sup> In particular, the sharp depreciation of the Kazakh tenge, Russian ruble, and the PRC yuan in mid-2015 put strong pressure on the Tajik somoni to depreciate, while NBT efforts in Tajikistan to control against depreciation reduced liquidity in the market. Higher-priced imported goods and slowing economic growth were also factors weakening household incomes and the repayment capacity of corporate borrowers.

Thus, it was important to measure household levels of overindebtedness, strengthen financial consumer protection, and improve financial capability at the grassroots level. In 2016, those who were borrowing indicated a high degree of stress (Pratt 2016). The survey had found that 50% of borrowers recognized a debt dependency to maintain their lifestyle, 30% of borrowers indicated loan repayment difficulties, and 40% had committed basic expenditures in excess of 75% of their income. The picture in Tajikistan was of a microfinance sector that would struggle to grow its client base without increasing financial pressure on the balance sheets of SMEs. Lending in foreign currency and larger loan sizes against collateralized microcredits increased the vulnerability of smaller firms who were, and are, highly sensitive to cost-of-living increases, currency depreciation, and external price shocks.

Tajikistan's insurance sector is perhaps the least developed in Central Asia (except for Turkmenistan). Legal provisions have been recently accepted to move the insurance supervisor as a subentity to the NBT, effective from January 2017. Although the 2010 Law of the Republic of Tajikistan "On Insurance Activity" (updated from 1994 and approved in 2014) set out to abolish the state monopoly on mandatory insurance classes, this monopoly is effectively still in place. There are 21 insurance companies in Tajikistan, of which two are state-owned and one is foreign. Insurance claims by SMEs are rare and usually unattended, which significantly undermines trust in the insurance sector. Insurance of privately owned assets and property is voluntary, and most SMEs opt out of insuring their corporate assets. The absence of insurance experts, actuaries, underwriters, and loss adjusters further complicates the sluggish relationship between SMEs and local insurance providers.

Furthermore, Tajikistan's financial system is shallow in terms of fundraising for corporate needs. The OJSC "Central Asia Stock Exchange" (CASE) was established in 2015, but interest from corporate clients remains low. The country's securities and capital market is in its infancy but, once fully established, will raise capital for SMEs, create investment opportunities for individual investors, and provide a cost-effective trading platform for B2B transactions. According to the 2014 survey, 59% of companies were ready to be open for foreign investors<sup>16</sup> and 82% of companies knew that issuance of shares is considered a financing source.

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<sup>16</sup> At the same time, 79% of surveyed companies did not have state participants in their shares.

Moreover, 53% of surveyed financial institutions were willing to use investment and debt securities as an alternative source of financing. The average annual capital need of surveyed financial institutions (FIs) was approximately \$12 million, and close to \$3 million of financing was needed by SMEs. Past assessments showed that market capitalization of the Tajikistan market could reach \$80 million<sup>17</sup> in the 5 years after the creation of the stock exchange. To date, the OJSC “Bank Eskhata” has issued corporate bonds<sup>18</sup> worth TJS20 million (about \$2.1 million), but other financial institutions and SMEs have so far been reluctant to raise funding or quote their shares on a stock exchange.

## 7.2 Status of Financial Inclusion for SMEs

To the detriment of fuller and more detailed analysis, up-to-date information and statistics on the SMEs’ access to finance in Tajikistan are virtually unavailable from either government sources or international development partners. When data for previous years are available, they are too outdated (e.g., from 5 or more years ago) or unreliable (e.g., based on government-commissioned or donor-funded surveys).

According to the NBT, only 17% of small firms and 24% of medium firms use bank loans as a source of financing for investments—as opposed to 42% of large firms in 2017.<sup>19</sup> Exclusion from financial services extends beyond credit products: Only 75% of SMEs possessed a checking account, as opposed to 88.6% in Europe and Central Asia (World Bank 2013).

Several large banks and MFIs provide mobile banking services, but penetration rates are still low. The NBT reports that the total number of online managed accounts reached 67,600 and the number of accounts accessible from mobile devices was 59,300. In general, the government’s objective is to facilitate financial inclusion of the currently unbanked population and commercial entities through the implementation of electronic and digital financial service solutions by various providers and their networks. Electronic and digital financial service solutions can be a powerful tool for directing remittance flows into the formal financial sector, which

<sup>17</sup> And the corporate bond market could reach up to \$1 million.

<sup>18</sup> At a fixed rate of 22% per annum in local currency.

<sup>19</sup> According to the National Bank of Tajikistan, the total amount of loans disbursed by banks reached TJS8.6 billion (equivalent to around \$1 billion), which made up 14.1% of GDP in 2017. However, the total credit portfolio increase is combined with a high level of nonperforming loans, particularly among individual borrowers. NPLs rose sharply from 9% in 2012 to 36.5% in 2017.

is highly relevant for Tajikistan. Notwithstanding the support currently provided by a number of bilateral (e.g., SECO) and multilateral institutions (e.g., the International Finance Corporation [IFC]), this is a long-term reform effort.

In Tajikistan, money transfer services are an important means for SMEs and individual entrepreneurs to access nonbank sources of funding to maintain operational activity. This is also an important business line for local financial institutions in Tajikistan. In 2017, 11.7% of adults sent or received domestic remittances using an account (higher than lower-middle-income countries and close to the Europe and Central Asia average), up from a mere 1% in 2014. Yet a significant percentage of adults send or receive remittances in person and in cash only (10.2%), or through an over-the-counter service (7.8%). These figures have also grown with respect to 2014, suggesting that entrepreneurs have not yet chosen banks or MFIs as their preferred means to remit incomes from labor migrants working abroad back home and into entrepreneurial activity.

Furthermore, SMEs often rely on financial technology to advance their products and reach out to a potential customer base. To that end, the national payment system “Korti Milli” as well as international payment systems, such as Visa, Mastercard, and UnionPay, are uniformly used in Tajikistan’s financial system. This is in line with the National Payment Systems Strategy for 2015–2025, which was adopted by the NBT Board in October 2014. Furthermore, the draft law “On payment services and payment systems” is currently in the Parliament pending review and approval. Similarly, the NBT is in the process of procuring a new automated transfer system, which will significantly enhance the efficiency, functionality, and soundness of the payment infrastructure. Once these reforms are in place, the NBT will be able to address more effectively payment system oversight issues, challenges associated with remittance systems, and lackluster growth in the use of cashless systems by SMEs and individual entrepreneurs.

A recent Asian Development Bank Institute (ADBI) report argues that the total number of payment cards issued by local financial institutions reached 1,746,621 at the end of June 2018. This represents a 3.5% increase year on year, with “Korti Milli” accounting for 80.5% of all issued cards (Mogilevskii and Asadov 2018). The surge in payment cards and current accounts in local banks is partially explained by the requirement for social payments to be transferred to individual accounts, e.g., for pensions and salaries. The next steps include the introduction of electronic payment for communal services via point-of-sale terminals, championed by large state-owned utility companies such as Barqi Tojik (power supply), Dushanbe Vodokanal (water supply), and Tajiktelecom (fixed-line telephone).

The total share of cards issued by the state-owned Amonatbank<sup>20</sup> is 75.9%, which shows the low degree of diversification of financial technology in the country. While successful and well-reasoned, the newly introduced payment system is mainly used for cash withdrawals rather than bank-to-bank or bank-to-business transactions among entrepreneurs.

### 7.3 Financial Knowledge and Skills of SME Entrepreneurs

The financial sector in Tajikistan is characterized by a strong imbalance in financial information or information asymmetry. Reducing this information asymmetry often has three components, namely: (i) consumer protection, as executed by the NBT; (ii) financial literacy, as executed by state and nonstate parties; and (iii) dispute resolution, as executed via a specific financial sector ombudsman or via the introduction of a specific framework for voluntary dispute resolution outside of the court system. To that end, a good financial literacy system effectively aims to reduce the potential of credit bubbles and system risks by inducing a more responsible behavior on the part of both financial institutions (to lend wisely) and corporate clients, or SMEs (to borrow wisely). This is relevant to Tajikistan, as recent overindebtedness studies have shown both the potential buildup of a microfinance bubble and the lack of understanding by entrepreneurs of how to borrow wisely.

Following the consumer protection and financial literacy diagnostic carried out by the World Bank in April 2013, the Government of Tajikistan decided to develop the financial education strategy, but a banking sector crisis delayed this process. At the present time, the NBT has developed and agreed its concept “Strategic Priorities of NBT on Development of Mechanisms on Protection of the Rights of Consumers of Financial Services in the Republic of Tajikistan for 2017–2019.”<sup>21</sup> In addition to adopting the principles of SmartCampaign<sup>22</sup> by local financial institutions, the NBT has partnered with international development partners to undertake training courses and awareness-raising events to strengthen financial literacy among individual and corporate borrowers.

<sup>20</sup> Amonatbank processes and disburses all public sector salaries, state pensions, and other social payments.

<sup>21</sup> Available in English on the official NBT website: [http://www.nbt.tj/files/Protection/strategiya/Strategiya\\_en.pdf](http://www.nbt.tj/files/Protection/strategiya/Strategiya_en.pdf).

<sup>22</sup> SmartCampaign represents a global initiative aimed at strengthening the consumer protection in microfinance.

Currently, the Government of Tajikistan reviews draft changes to current laws, for example, on protection of consumer rights and on banking activities. In line with the National Development Strategy (NDS) of the Republic of Tajikistan for 2016–2030, it is imperative for the government to develop and implement the State Program on the Improvement of Financial Literacy of the Population. The program is not yet in place, but efforts have been undertaken nationally and regionally, for instance, via financial literacy weeks, awareness-raising workshops, and specialized training courses to target underserved and financially illiterate segments of the population. These efforts remain largely ad hoc and nonsystemic, although they are reportedly effective and impactful.

Since 2010, the IFC, GIZ, AKF, and other multilaterals have piloted financial counseling services to consumers and demonstrated that counseling significantly improved the financial planning, savings, and even incomes of entrepreneurs in rural areas (although it had a negligible impact on arrears). The following impact assessments (IFC and M-Vector 2016) revealed that financial counseling demonstrated significant positive impacts on planning, budgeting, and even income generation. Interestingly, counseling showed impacts on SME debt exposure and income generation. Nearly all project completion reports by IFIs claimed reductions in the ratio of entrepreneurs' loan repayments to monthly income.

In addition, Germany and Switzerland have supported product and service innovations as a complementary, market-based measure to guide, remind, and nudge entrepreneurs into making financial choices more in their self-interest. These and a number of government-led programs raised awareness of the psychological and behavioral aspects of financial decision making by SMEs and individual entrepreneurs. The preparation of corporate savings plans through ExpressPay terminals, product simplification, the use of mobile applications such as e-Wallet, financial management and accounting, and the use of more cost-effective electronic services are examples of topics of these training courses and support initiatives. These initiatives have reportedly helped entrepreneurs to progress from knowing that they should improve to actually improving their financial management and accounting practices.

A 2018 study funded by ADB claimed that more than 91% of surveyed firms in Tajikistan find the lack of candidates with suitable skills problematic in regard to running day-to-day business (Mirzoev 2018). When put on the same scale as taxes, a shallow labor force, and current legislation, the lack of adequately skilled (and trained) professionals overshadows other influencing factors.



However, in 2019, employers on average have offered no more than 6 days of skills development for approximately 25% of personnel. This suggests that while SMEs are concerned about the lack of skilled professionals in the labor market, entrepreneurs' own efforts to enhance the skills of current personnel have been limited. SMEs recognize that financial skills are a problem but are not ready to invest in their own personnel to fill the skills gap.

Other assessments undertaken by financial institutions, such as FINCA International's Client Assessment Tool, as well as IMON International's and the First Microfinance Bank's client surveys, showed greater difficulty in obtaining loans for lower-income groups, and greater reliance on collateral and guarantees, reflecting a more conservative approach to lending. A linear relationship between the portfolio quality of MFIs and the financial literacy of local entrepreneurs raised the question of whether SMEs are financially excluded from financial products and services, or if products other than credit are needed to respond to SMEs' financial needs.

SMEs can also benefit from advisory services and mentoring programs available through specialized networking and acceleration services, e.g., offered through incubators and coworking workspaces, which are presently located mainly in Dushanbe. Training and mentoring themes span from business planning and marketing to export promotion and product diversification. Basic financial education and literacy of entrepreneurs is an integral part of these programs.

In the past decade, the Aga Khan Development Network (AKDN) and 55 Group have separately set up their own enterprise growth accelerators and an enterprise investment fund. For instance, the AKDN's Accelerate Prosperity currently has two offices in Dushanbe and Khorog. From July 2016, it began to establish a network of mentors (i.e., seasoned entrepreneurs), and built an entrepreneurship support program in close collaboration with the University of Central Asia. In parallel, 55 Group has also created the School of Young Entrepreneurs, which offers courses for small businesses in areas such as marketing research, business planning, risk assessment, and others (AKDN 2018).

Business associations, such as the National Association of Small and Medium Business, the National Association of Business Women in Tajikistan, the Association of Innovative Technology in Entrepreneurship, the Association of Banks of Tajikistan, and the Trade and Commerce Chamber of the Republic of Tajikistan, provide acceleration services and financial education courses to entrepreneurs and, specifically, women-led businesses. Various start-up and SME competitions,

for instance, the Prosperity Cup and the female entrepreneurship competition “Farah,” are popular and effective means of fostering greater understanding of financial risks and financial management issues in running a business. Since 2010, an estimated 10,000 individual entrepreneurs and over 2,000 SMEs have benefited from financial education courses and awareness raising rendered by various in-country stakeholders and international development partners.

## 7.4 Barriers to SME Finance

Access to finance for SMEs in Tajikistan is limited by demand-side, supply-side, and broader business environment constraints (Table 7.1). These affect the ability of SMEs to access credit, information, and know-how in order to develop their businesses. In Tajikistan, a demand-driven and client-based approach to SME development—e.g., through access to the right mix of affordable financial products and tools tailored to their needs and specific stage of their growth—is critically lacking. Significant financial sector constraints in Tajikistan have led to greater burden for the private sector and, according to the Tax Committee, resulted in approximately 27,000 businesses (with up to 90% of them being individual entrepreneurs) effectively closing between 2015 and 2017.

The financial sector in Tajikistan is weak and shallow. Credit to the private sector is low, equivalent to less than 14% of GDP, and is significantly behind other countries in the region. In addition, the small volume and short maturity of deposits limit the ability of banks to provide credit.

Confidence in Tajikistan’s banking sector remains low, not least due to liquidity problems, the insolvency of several large banks, and deposit withdrawal issues<sup>23</sup> from these banks. Local consumers have understandably lost trust in the banking sector and continue to withdraw deposits. Between 2015 and 2017 local financial institutions gained 17.4% in the total volume of deposits, but mostly because deposit holders were unable to withdraw funding from troubled banks. While the first devaluation led customers to turn their deposits into dollars, the second devaluation triggered a rush of deposit withdrawals, even those made in dollars.

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<sup>23</sup> At the present time, depositors are only insured up to TJS17,500 (or about \$1,850) per single deposit account. Accordingly, reform of Tajikistan’s Deposit Insurance Fund is needed to fully insure depositors and compensate those affected by the insolvency of the AIB, TSB, and the liquidated banks (Tojprombank and Fononbank).

Table 7.1: Key Barriers to SME Finance in Tajikistan

Demand-side Constraints	Supply-side Constraints	Business Environment Constraints
<ul style="list-style-type: none"><li>Weak corporate governance</li></ul>	<ul style="list-style-type: none"><li>Information asymmetries</li></ul>	<ul style="list-style-type: none"><li>Weak macroeconomic management</li></ul>
<ul style="list-style-type: none"><li>Limited financial literacy</li></ul>	<ul style="list-style-type: none"><li>Lack of corporate know-how</li></ul>	<ul style="list-style-type: none"><li>Inadequate banking supervision</li></ul>
<ul style="list-style-type: none"><li>Low transparency</li></ul>	<ul style="list-style-type: none"><li>Portfolio constraints</li></ul>	<ul style="list-style-type: none"><li>Weak regulatory role of the NBT</li></ul>
<ul style="list-style-type: none"><li>Insufficient collateral</li></ul>	<ul style="list-style-type: none"><li>Limited range of financial products</li></ul>	<ul style="list-style-type: none"><li>NBT's administrative measures</li></ul>
<ul style="list-style-type: none"><li>Lack of investor information</li></ul>	<ul style="list-style-type: none"><li>High collateral requirements</li></ul>	<ul style="list-style-type: none"><li>Lack of investment incentives</li></ul>
<ul style="list-style-type: none"><li>Low risk appetite</li></ul>	<ul style="list-style-type: none"><li>Low risk appetite</li></ul>	<ul style="list-style-type: none"><li>Absence of a level playing field</li></ul>
<ul style="list-style-type: none"><li>Lack of corporate know-how</li></ul>	<ul style="list-style-type: none"><li>Shallow credit guarantee system</li></ul>	<ul style="list-style-type: none"><li>Volatility of prices and local currency</li></ul>
<ul style="list-style-type: none"><li>Lack of incentive to formalize</li></ul>	<ul style="list-style-type: none"><li>Limited acceleration services</li></ul>	<ul style="list-style-type: none"><li>High rates of NPLs in banking sector</li></ul>
<ul style="list-style-type: none"><li>Low trust in banking system</li></ul>	<ul style="list-style-type: none"><li>Underdeveloped capital markets</li></ul>	<ul style="list-style-type: none"><li>Volatility of remittances</li></ul>

NBT = National Bank of Tajikistan, NPL = nonperforming loan, SME = small and medium-sized enterprise.  
Source: Authors.

Delays, administrative restrictions imposed by the NBT, and conversion losses have made SMEs less willing to put trust in local banks. To counter this, the NBT raised its key policy rate from 6.9% in 2014 to 14% in 2018. The rate is now at its highest level since 2008. This inevitably increases the cost of borrowing, further hindering the loan market for SMEs, which otherwise have limited alternative means of raise funding.<sup>24</sup>

For SMEs, obtaining loans with more than 3 years of maturity is challenging. According to the World Bank’s 2018 Systematic Country Diagnostic, only 5% of all investments in 2013 were financed by commercial bank loans.

<sup>24</sup> SMEs often raise capital through other means, including selling assets and borrowing from other companies or individuals, thereby undermining and bypassing the country’s formal financial system. However, the limited and ad hoc nature of private funding keeps businesses small.

The main reasons for not taking loans from local banks, based on the 2013–2014 Enterprise Surveys, are a lack of long-term financing, high interest rates, and prohibitive collateral requirements.<sup>25</sup> The recent financial crisis made the banking sector fragile; thus, banking sector vulnerabilities resulted in more difficult access to loans for SME clients.

Interest rates are high—ranging from 18% in foreign currency to about 35% in local currency—and collateral requirements are difficult to meet.<sup>26</sup> The high cost of credit is being passed on to business, while the limited amount of financing available is often provided on short tenors and in foreign currency. As a result, SMEs are unable to raise long-term financing in the same currency as their revenues, thereby choking off capital investment and exacerbating foreign exchange risk. In these challenging circumstances, SMEs find it difficult to repay loans or borrow at favorable rates in local currency.

Currency depreciation increases market volatility and reduces the resilience of SMEs to shocks. The somoni has lost about 75% of its value against the dollar since 2015 and speculation in the foreign exchange market soared until the NBT employed administrative controls. The impact of the currency depreciation on the banking sector was severe, with system-wide NPLs spiraling to more than 47% by 2016 (up from 7.4% in 2010), and the capital adequacy ratio falling to 16.6% by the end of 2014 and rising to 22.9% in 2017, driven primarily by the financial position of the largest banks.

The low success rate of transformation of SMEs in Tajikistan is partly due to increasingly risk-averse financial institutions. SMEs are chronically undersupplied with finance, which constrains their expansion, while virtually no credit is available to start-ups because default and currency risks are too high.<sup>27</sup>

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<sup>25</sup> The World Bank's 2018 Systematic Country Diagnostic notes high levels of collateral requirements as a business constraint to getting loans. According to the 2013–2014 Enterprise Survey, "firms were required to pledge a collateral valued at 165% of the loan on average. The volume of collaterals was significantly higher for credits extended to the retail sector (271%) than for manufacturing (137%). The high collateral requirement reflects weaknesses in creditor rights as discussed above, as well as the lack of standard evaluation method for assets in Tajikistan."

<sup>26</sup> Often ranging from 120% to 200% of the value of the loan.

<sup>27</sup> SMEs are often referred to as the "missing middle," i.e., too large for most MFIs but too small and risky for banks.

This is where the microfinance sector<sup>28</sup> comes into play, but arguably less than one third of all MFI clients are entrepreneurs. Specifically, with regards to start-ups, the only source of funding comes from grant-based ad hoc competitions run by donor-funded initiatives such as the Prosperity Cup and Start-Up Weekend. This is neither sustainable nor conducive to balanced growth of early-stage businesses.

In addition, the availability of financial products is limited only to debt instruments. In the absence of donor-backed risk-sharing facilities and credit guarantees, SMEs are prohibited from accessing equity investment, royalty-based deals, factoring, supply chain finance, export insurance, and other mezzanine products. Leasing is offered by eight companies but the terms offered to SMEs are generally unfavorable unless stimulated through grant-based funding from international development partners (e.g., GIZ, ITC). Limited venture capital and the low number of angel investors and privately managed investment funds further complicate the challenging environment for SMEs whose growing demand for financing remains unmet.

Directed lending, weak underwriting and governance standards, and overall regulatory weaknesses have continued to be at the forefront of the vulnerabilities of the sector. According to the International Monetary Fund's (IMF) 2016 Financial Sector Stability Assessment, a number of local banks had offered uncollateralized liquidity at unusually high maturities to affiliated businesses (IMF 2016). This practice has potentially crowded out investment to underserved SMEs and resulted in the shrinkage of the loan portfolios of several top systemic banks. Tojiksodirotbank, the country's largest deposit holding bank, was temporarily put under administration, while another large bank, Agroinvestbank, reported negative capital and significantly reduced liquidity. The remaining 12 banks experienced underperformance in at least one basic prudential norm.<sup>29</sup> Since bank lending is heavily skewed toward corporate loans to SMEs (as opposed to retail lending among MFIs), the banking crisis reduced access to credit for SMEs.

<sup>28</sup> The microfinance sector in Tajikistan is governed by the National Strategy for the Development of the Microfinance Sector 2015–2025 and offers modest funding to early-stage firms, but it comes at a very high cost, demands significant collateral requirements, and rarely exceeds 36-month maturity.

<sup>29</sup> These basic prudential norms are: (i) capital adequacy ratio, (ii) liquidity ratio, (iii) large exposure limits, (iv) insider lending, and (v) shares in other entities.

## 7.5 Status of Value Chains and Value Chain Financing in Tajikistan

Although SMEs in Tajikistan have made significant progress since 2010, they are still poorly connected to regional and global markets, and struggling to transition to a market-based economy. Opportunities to link to the markets in South Asia (e.g., Afghanistan and Pakistan) will take time to materialize, leaving it highly vulnerable in the interim to external shocks and instability. Improved relations with Uzbekistan, energy connectivity (e.g., CASA-1000),<sup>30</sup> and the construction of the Rogun Dam are opening up opportunities, but limited information, resources, and networks of SMEs are hampering the development of, and access to, global value chains (GVCs).<sup>31</sup>

Since the early 2000s, the country has also become increasingly dependent on the PRC as the main creditor and vital trade partner amid the implementation of the Belt and Road Initiative. Tajikistan's accession to the Eurasian Economic Union is a distinct possibility, but the extent to which SMEs may be able to take advantage of GVCs and attract investment will depend on concurrent improvements to its business environment and banking system.

Notwithstanding a number of regulatory and institutional impediments to growth, the opportunities for SMEs in value chains are significant. The Government of Tajikistan and national nonstate stakeholders have not adopted the definition of GVCs; hence, there is no national definition to use.

To that end, the term “value chain” refers to a firm's basic framework for business linkages between its activities (from producing to consuming a product or service) to promote firm competitiveness (Porter 1985). “In its most basic form, a value-added chain is the process by which technology is combined with material and labor inputs, and then processed inputs are assembled, marketed, and distributed” (Gereffi et al. 2005). ADB treats GVCs as a broader concept than

<sup>30</sup> Resumed trade and gas supply from Uzbekistan is welcome, but Tajikistan's limited capacity and obsolete condition of its existing energy infrastructure remains unaddressed. And while hydropower projects, such as the construction of the Rogun Dam, as well as the rehabilitation of hydropower plants in Nurek and Kayrakkum, have drawn significant attention from the government and IFIs, the country will place greater emphasis on non-hydro renewables and solar energy, rural electricity services, and cross-border transmission connectivity.

<sup>31</sup> In addition, the challenging terrain and proximity to Afghanistan highlight security and infrastructure concerns.

production networks, and argues that SMEs face a dual task: (i) to access a GVC, and (ii) to move up the tiers through firm expansion and growth (ADB 2015). The World Trade Organization (WTO) identifies GVCs as a framework involving “the generation and transfer of value within the system as a consequence of firm efforts to optimize production networks and, conversely, the mechanism of how the value distribution structure affects the firm’s choice of the organizational form of international production networks.” These considerations triggered SMEs to reach out to opportunities beyond Tajikistan’s borders. However, deeper specialization and broadening of the production portfolio has proven to be a difficult task due to the high cost of credit and of market entry, a lack of investment, unfair competition practices, and a challenging regulatory environment.

At the present time, Tajikistan faces the challenge of putting in place basic preconditions for integration into GVCs. These preconditions are diversification of production and trade, private investment, professional education and training (relevant for skills development), financial system development, transport and communications infrastructure, and business regulation.<sup>32</sup> The country lingers in the bottom 30% of countries according to its Doing Business ranking, has suffered from a damaging banking sector crisis, offers prohibitively costly credit to the private sector, and remains a net exporter of low-skilled labor.

Tajikistan’s high exposure to the Russian Federation’s economy through remittances and trade channels puts competitive pressures on SMEs, affecting their ability to increase and sustain profits. Moreover, sector-based (i.e., vertical) initiatives should complement ongoing efforts to accelerate structural and economy-wide (i.e., horizontal) reform. Several crosscutting issues merit further attention, such as macroeconomic fundamentals, access to quality education and training, technology upgrading, trade facilitation, and removing barriers to participation.

According to Table 7.2, the choice of value chains was based on the attempt to answer the basic question: What value chains can serve as good proxies for job creation and competitiveness policies in Tajikistan? A three-step methodology for the selection of value chains included overall assessment of Tajikistan’s economy (step 1), identification of a long list of subsectors (step 2), and selection of up to two value chains (step 3).

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<sup>32</sup> Firms can specialize in some stages of the value chain or integrate some of them, but the main assumption is that all SMEs benefit from an enabling business environment. Without it, the growth of SMEs will remain marginal.

**Table 7.2: Key Objectives Achievable by SMEs Employing a Value Chain Approach**

Improved Employment Outcomes	Improved Firm-level Competitiveness
<ul style="list-style-type: none"> <li>Identifying what activities can best catalyze job creation (more jobs)</li> </ul>	<ul style="list-style-type: none"> <li>Understanding competitive pressures and key trends in demand (markets)</li> </ul>
<ul style="list-style-type: none"> <li>Empowering SMEs to capture more value and engage in skills upgrading (better jobs)</li> </ul>	<ul style="list-style-type: none"> <li>Identifying growth strategies and constraints based on shared challenges along the value chain</li> </ul>
<ul style="list-style-type: none"> <li>Integrating small firms with established sources of demand (inclusive jobs)</li> </ul>	<ul style="list-style-type: none"> <li>Estimating what skills sets are, and will be, required to sustain successful business models</li> </ul>

SME = small and medium-sized enterprise.

Source: Authors.

In reference to Table 7.3, agriculture has been selected—and meat (beef) and dairy value chains<sup>33</sup> within the agriculture sector—based on the criteria presented in Table 7.4. Additionally, the President of the Republic of Tajikistan, in his latest address to the Parliament, explicitly pointed to agribusiness, including its underdeveloped niche sectors with proven potential, as one of the sectors that will provide an impetus to growth. Furthermore, the Government of Tajikistan has recently waived value-added tax and import duties for agricultural equipment, particularly for processing (including dairy and meat). Thus, in addition to economic rationale, these two value chains were also selected on the basis of strategic prioritization of “food security” sectors, which are meant to “feed” growth (literally and metaphorically).

In 2017, agriculture accounted for 60% of the total employment and 23% of Tajikistan’s GDP. The potential to develop the agribusiness and agroprocessing sectors would yield comparative advantages in Central Asia, particularly because of Tajikistan’s soil, water, and weather conditions. More than 70% of the population resides in rural areas, which is where the demand is with respect to labor-intensive crops and livestock breeding. In short, the supply of low-skilled labor in rural areas far exceeds the demand by SMEs. However, value chains in agribusiness are generally accepted to be fragmented and disjointed.

<sup>33</sup> Other potential “candidates” included value chains belonging to a number of sectors such as textile and clothing, tourism/hospitality, construction materials, dried fruit (e.g., apricots, grapes), mining, and cotton.



**Table 7.3: Sectoral Breakdown of Value Addition and Employment in Tajikistan, 2010–2017**

	Value Added (in somoni million, 2010 = 100)			Total Employment		
	2010	2017 <sup>a</sup>	% Change	2010	2017	% Change
Agriculture (crops and livestock)	4,713.3	7,645.8	62.2	1,469,100	1,538,500	4.7
Fishery and forestry	5.3	17.0	219.0	200	400	100.0
Extractive industry	1,082.1	1,107.6	2.4	21,000	11,430	-45.6
Food products	752.1	1,364.2	81.4	7,300	9,150	25.3
Metallurgy and metals	520.6	692.5	33.0	13,200	14,309	8.4
Chemical and petrochemical	17.6	58.3	231.8	2,200	1,320	-40.0
Machinery and equipment	84.5	42.2	-50.1	4,800	1,672	-65.2
Light industry	353.2	1,226.4	247.2	18,000	21,258	18.1
Other sectors (industry)	38.6	90.7	134.7	5,900	7,734	31.1
Electricity, gas, and water supply	214.8	1,008.0	369.3	16,800	17,848	6.2
Construction	2,124.6	4,146.1	95.1	72,300	67,100	-7.2
Trade, auto repairs, and catering	5,188.0	5,182.6	-0.1	144,400	161,700	12.0
Transport and communications	3,656.3	4,257.1	16.4	57,200	56,000	-2.1
Financial services	98.8	259.1	162.3	27,200	44,400	63.2
Public administration, social insurance	889.4	2,036.0	128.9	33,100	36,500	10.3
Education	1,111.7	1,739.8	56.5	181,800	220,500	21.3
Health care	469.4	703.4	49.8	81,300	106,700	31.2
Social and individual services	667.0	1,258.6	88.7	77,500	68,900	-11.1

<sup>a</sup> Monetary data for 2017 are presented in constant 2010 prices.

Source: Agency for Statistics under the President of the Republic of Tajikistan.

**Table 7.4: Filtering from 18 to 2 Value Chains  
Based on Established Selection Criteria**

Competitiveness	Jobs	Momentum
Scale and Upgrading Potential	Impact on Target Groups	Readiness and Change, Additionality
1. Existing scale and scope	1. Employment intensity/multiplier	1. Organization and representation
2. Trade competitiveness	2. Reach to specific target groups	2. Political will
3. Value addition potential	3. Impact on poverty (better-paid jobs)	3. Ongoing interventions
4. Investment requirements	4. Fostering stable jobs (vs. seasonal)	

Source: Authors.

The lack of access to machinery, know-how, financial resources, and skilled labor and nonlabor inputs<sup>34</sup> explains why agribusiness is lagging its neighbors in Central Asia. On top of the aforementioned barriers, the rural population forgoes opportunities in agriculture due to the reservation wage.<sup>35</sup> The latter is a direct result of remittances coming from rural-based family members, which mainly meet basic household consumption needs in Tajikistan.

Most farmers operate aging and outdated equipment and machinery, while levels of production remain low. Productivity increases in agriculture since 2010 have been marginal, and limited access to farm machinery prevents SMEs from realizing their full potential. Food processing plants have been supported by international development partners, but low domestic demand and limited production capability of farmers mean that food processing plants operate at a fraction of their capacity.

Although both the dairy and meat industries are underdeveloped owing to a lack of investments and access to capital as well as poor infrastructure and entrepreneurial capacity, Tajikistan does have the potential to develop these areas to improve food security. Dairy and meat products carry essential nutrients, and there are increasing external and internal demands for them in the market.

<sup>34</sup> Farmers are often unable to obtain seeds, fertilizers, and pesticides. This is why post-harvest losses are disruptive.

<sup>35</sup> The reservation wage refers to the lowest salary rate for which a person would have to be willing to work. Normally, employees reject it due to opportunity cost considerations.

Afghanistan, its neighboring country, with a population of over 30 million, is looking for perishable goods, such as dairy and meat products, to import from its closest neighbors. There have been several cases where Afghan businesses have approached Tajik entrepreneurs directly or through international development partners (e.g., the IFC) to set up joint ventures and export dairy and meat products to Mazar-i-Sharif, Herat, and Kabul, where the demand is increasing; but owing to military conflicts there, the risk of building the physical infrastructure required for establishing factories and plants is too high. Furthermore, there is also an increasing domestic demand for dairy and meat products, as discussed further below.

### 7.5.1 | Dairy Industry

In 2017, there was a population of 2.3 million cattle (51.4% cows) in Tajikistan and almost 1 million tons of milk were produced that year (Agency for Statistics 2017). The average estimated milk yield in private households is 780 liters (3 liters per day multiplied by an average 260 days of lactation) per lactation, which is several times less than in other neighboring countries. Currently, only around 10% of milk is processed in the country by 55 large and small processors, and they have to compete domestically with imported products from the Russian Federation, the Kyrgyz Republic, the Islamic Republic of Iran, and other countries.

According to the Agency for Statistics under the President, the production of dairy products increased by 43.8% in 2010–2017. Similarly, the annual sales growth of dairy products amounted to 15% in the same period. According to a UN Food and Agriculture Organization study, in the last 4 years, 82% of the population have consumed dairy products. The potential capacity of the market for milk and dairy products is estimated to be approximately 1.7 million tons.<sup>36</sup>

The dairy trade is decentralized, and export volumes are low. In fact, most dairy products are imported from neighboring Kazakhstan, the Kyrgyz Republic, and Uzbekistan. In 2017, fresh milk imports equaled 581 tons and condensed milk imports equaled 2,282 tons. It is difficult to quantify the number of households that offer commercialized milk and dairy products, let alone small-scale dairy farms that export (or plan to export) their produce overseas.

<sup>36</sup> Bearing in mind that the population in 2018 is an estimated 9.1 million, on average, 1.7 million tons of milk and other dairy products would ideally meet the current market demand in Tajikistan.

Large processors produce yogurt, fresh cheese, cottage cheese, and other cultured milk products. These processors are largely outdated and technologically challenged facilities, which lack investment and know-how. Hard-cheese production is limited, while storage and refrigeration facilities<sup>37</sup> require massive investment in order to develop distribution channels (such as allowing the trade of cottage cheese and fresh milk), which are relatively primitive.

There are no decentralized milk collection and cooling facilities, and large processors operate significantly under capacity due to capitalization issues, unreliable electricity access, old technology, and varying degrees of demand for dairy products due to seasonality and geography. Investment in these areas could spur value chain development in the dairy sector. Accordingly, the cost of capital and lack of investment are important impediments to value chain development for milk products in Tajikistan.

## 7.5.2 | Beef Industry

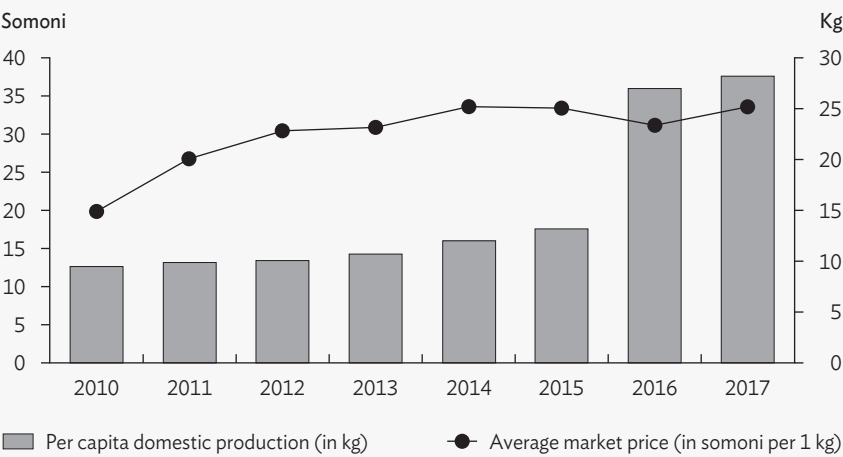
Beef is the single most consumed meat product in Tajikistan, accounting for over 55% of domestic meat consumption. Most of the beef produced domestically has a dual purpose—dairy and meat production. According to official statistics, on average, meat consumption per capita per year is 15 kilograms (Figure 7.7). However, the demand for meat is estimated to have reached approximately 40 kilograms per capita per year. With a population of 9.1 million, Tajikistan needs to produce around 364,000 tons of meat each year. To put it simply, the demand for beef is already high and will continue to increase.

The vast majority of the country's meat production—and specifically beef production—is consumed domestically (Figure 7.8). Despite rising production volumes of meat products, an increase in the volume of exports did not follow. In 2017, only 84 tons of cattle meat (fresh or frozen) were exported at a total cost of about \$100,000, while imports comprised 1,507 tons at a cost of about \$1.8 million. This negative trade balance was sustained each year during 2010–2017.

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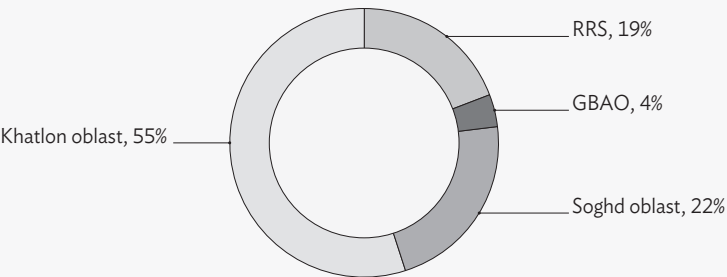
<sup>37</sup> The lack of refrigeration facilities, including refrigerated transport, limits the geographical range for milk sales.

**Figure 7.7: Per Capita Production and Average Market Price of Beef in Tajikistan, 2010–2017**



Source: Agency for Statistics under the President of the Republic of Tajikistan.

**Figure 7.8: Domestic Meat Production by Region in Tajikistan, 2017**



GBAO = Gorno-Badakhshan Autonomous Oblast, RRS = regions under Republican subordination.  
Source: Agency for Statistics under the President of the Republic of Tajikistan.

Perhaps the biggest impediment to the growth of the beef industry is per capita consumption, which is the lowest in Central Asia and has reportedly decreased by more than 50% since 1992.<sup>38</sup> However, this also presents opportunities for not only increasing domestic per capita consumption but also increasing production capacity in order to export meat products to neighboring countries with larger markets and higher average market prices such as Afghanistan, Kazakhstan, and Uzbekistan. Beef is losing ground to other meat products due to high market prices and low domestic production volumes, but opportunities are being explored by individual investors and a handful of SMEs to increase supply and reduce the cost of finishing beef, which would translate into lower beef prices in Tajikistan.

Innovative technological solutions are needed through private investment in the beef value chain to achieve improved cattle fattening and reduce the cost of raising cattle. Opportunities exist to ensure the most cost-effective balanced ration for production. The various feed components are readily available at the household level or in the local market, but the main obstacle to the commercialization of improved livestock feed is farmer education. Unfortunately, ration development expertise is not readily available and, in a similar vein, there is currently little to no connection between feed rationing and new technologies. Such technologies can only come alongside private investment in beef value chains.

### 7.5.3 | Value Chain Financing

Traditional financing for SMEs in beef and milk value chains has been limited. Although aggregate data are unavailable for bank and MFI loans in these markets, the biggest challenge has come from the unavailability of a wider range of financial products to meat and dairy farms, e.g., investment loans, equity financing, working capital instruments, export finance, and others. Financial instruments like factoring or supply chain finance would help SMEs in these sectors secure their revenue, which is a persistent problem. Most households that control cattle and dairy production usually secure financing through informal networks from friends and extended relatives who work abroad. Moreover, a quite simple combination of direct credit or leasing to dairy farms and processors could significantly increase their production; and using the equipment as collateral would have a strong effect if combined with affordable interest rates.

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<sup>38</sup> Due to the civil war between 1993 and 1997 and outward migration of Tajikistan's labor force, primarily to work in the Russian Federation.

In other instances, financing schemes are available from local financial institutions, but the obstacles are limited awareness of opportunities and SMEs' difficulty in meeting lender requirements with regards to corporate governance standards, due diligence, and financial sustainability. There are a number of donor-funded projects that help SMEs, including those in the meat and dairy industries, to identify appropriate lenders, understand the requirements, and submit credible and comprehensive business plans. These projects offer partnerships with local financial institutions in order to on-lend to SMEs in local currency at subsidized interest and longer maturities. Notwithstanding the positive effect of these efforts, they are often limited to just a few sectors, such as agribusiness, climate resilience, or energy efficiency. For example, the European Union-funded Enhanced Competitiveness of Tajik Agribusiness Project,<sup>39</sup> implemented by the EBRD, offers loans and extension services to agricultural producers and aggregators. A similar project, currently implemented by GIZ and called "Towards Rural Inclusive Growth and Economic Resilience,"<sup>40</sup> improves the competitiveness of SMEs and small producers in selected value chains through business development services in agriculture.

Despite strong demand for meat and dairy products, there are few development agencies focusing on financing agribusiness. Chief among them are ADB, IFC, GIZ, and EBRD. Their main goal is to help increase and diversify agriculture production and improve access to markets through value chain development. Likewise, IFIs target the development of pasturelands and income generation among rural population through new jobs, in particular for female-headed households.

The IFC and the EBRD have standalone, replenishable facilities that support SMEs in Tajikistan through finance and advisory services. However, stringent due diligence and the size of credit lines restrict their offer to larger businesses. Direct loans with a lesser degree of flexibility regarding sector focus are also provided by the Eurasian Development Bank and the KfW Development Bank at reasonable rates, but a high credit threshold renders many SMEs ineligible for financing (EDB 2018).

The EBRD's Small Business Initiative is one of several strategic initiatives with a unique mix of skills and expertise, a country-focused approach offering an integrated toolbox for SMEs. On this basis, the EBRD established a funding architecture—

<sup>39</sup> Offers matching European Union grants for equipment and machinery (up to 20% of the total project cost, e.g., up to \$50,000) and a guarantee mechanism through the EBRD. The program is implemented jointly with the Frankfurt School of Management.

<sup>40</sup> This intervention is the successor to the DFID-funded "Growth in the Rural Economy and Agriculture in Tajikistan" (GREAT), which was implemented by GIZ and cofinanced by the German BMZ in 2013–2017.

the Small Business Impact Fund (SBIF)—that supports SME development more flexibly and leverages additional funding from donors supporting SME-related activities in Tajikistan. Switzerland has chosen to channel funds through the SBIF facility. Firms from meat and dairy industries would be eligible for financing and advisory services through the SBIF facility.

In 2017, ADB also implemented the Climate-Resilient Dairy Value Chain Development Project, which links dairy farmers to processors and urban markets through the development of efficient dairy value chains. By partnering with Access Bank, ADB promotes financial inclusion through greenfield banking, e.g., via the economic activity of underserved farmers and SMEs through equity investment and loans.

The Tajikistan Climate Resilience Financing Facility offers investment in improved climate-resilient technologies to help make the country's private sector more resilient to climate change. The program is developed by the EBRD and Climate Investment Funds, and financed by the United Kingdom's Department for International Development and the EBRD Early Transition Countries Fund. The facility offers loans to large businesses, farmers, and households through local financial institutions.

Nontraditional partners, such as the European Investment Bank, often skew financing toward relatively more resilient neighbors. The Asian Infrastructure Investment Bank does not render support to SMEs, but Uzbekistan has pledged to provide preferential lending in the amount of \$100 million to support Tajik entrepreneurs doing business with Uzbekistan. The preferred mechanism and oversight structure are not yet set up, although on-lending is expected through local financial institutions.

## 7.6 Policies to Promote SME Finance

In September 2016, the Government of Tajikistan adopted the National Development Strategy (NDS) for 2016–2030 and embarked on a new path to economic development, to be rolled out over the next 15 years.<sup>41</sup> On 22 December 2017, President Emomali Rahmon's annual address to the government reaffirmed the country's intended transition to an "industrial-innovative" economy by means of

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<sup>41</sup> The NDS 2016–2030 is positively ambitious and sets the wheels in motion in order to halve poverty and eliminate extreme poverty, double the GDP, improve ranking in the UN's Human Development Index and the World Bank's Doing Business, significantly increase spending on social safety nets, and bring the share of the middle class up to 50% of the population.



greater productive employment, investment in human capital, and innovation.<sup>42</sup> The strategy highlights the need to shift from a remittance-driven model towards greater complexity and diversification of the economy fueled by the growth of SMEs and shared prosperity.

Strong economic institutions are at the forefront of achieving this goal. To prevent sliding back into crisis and mitigate the risk of losing the gains from past reforms, preventive measures have been developed by key economic institutions, which embed accountability and risk management practices. To that end, the government's 2015 crisis mitigation plan demonstrated an urgent need for coherent and evidence-based policy decision making, and was able to facilitate technical assistance in key areas, such as financial stability, banking supervision, risk management, corporate governance, and NPLs. The National Bank of Tajikistan, the State Committee for Investment and State Property Management, and the Ministry of Economic Development and Trade have been the champions of business environment reforms, including much-needed reform of the banking sector.

One way that the government has effectively reduced the risk of lending to SMEs is through the creation of the Credit Information Bureau of Tajikistan (CIBT), which has also been supported by the IFC. The CIBT provides information on credit histories to individual and corporate clients. Having started its operations by partnering with 12 local financial institutions in 2010, the CIBT has expanded its reach to 86 financial institutions and now covers over 90% of Tajikistan's financial market. In 2015, thanks to the CIBT and the NBT's continuous support, the country's Doing Business ranking on getting credit improved from 180 in 2012 to 109 in 2015 (out of 190 economies). In January 2018, the new Law of the Republic of Tajikistan "On Credit Histories" was approved by the legislature, which has improved access to credit histories via private credit bureaus. In April 2018, the CIBT joined the newly created Association of Credit History Providers, which includes private bureaus from Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, and Ukraine. In addition, during 2017–2018, the CIBT expanded its services by introducing new products: (i) a portfolio monitoring instrument for

<sup>42</sup> The NDS 2016–2030 presents three development scenarios: (i) inertial (or conservative) scenario where the existing agrarian-industrial model is preserved, resulting in a twofold increase of the GDP; (ii) industrial (or median) scenario where existing and prospective projects in energy and infrastructure are implemented in full, resulting in a nearly threefold increase of the GDP; and (iii) industrial-innovative (or optimistic) scenario where innovative approaches to addressing long-standing issues in the economy and social sectors will be adopted and implemented. The latter would result in an increase of the GDP by 3.5 times over the next 15 years.

financial institutions; (ii) a new scoring model developed and adapted specifically for Tajikistan's financial market context; and (iii) a cash-flow-linked agriculture risk assessment tool to help account for the risks of lending to SMEs and individual entrepreneurs in agribusiness.

The Government of Tajikistan believes it is important that the banking sector is put on a better footing as there would be no SME funding in Tajikistan without viable banks or a strong regulator. Since May 2015, the NBT has made significant positive changes in its organizational and management structure. New management teams have been put in place and financial stability risk analyses and consumer protection divisions have been established to institutionalize the NBT's mandate in these areas. This has significantly strengthened its regulatory functions, although in the absence of the new IMF program the technical assistance has been limited.

The prevailing view by the authorities has been that banking sector issues will persist unless high NPLs, risk management, and undue interference in lending decisions<sup>43</sup> are addressed by the regulator. A greatly improved bank resolution framework was passed in September 2016, preceded by agreement with key partners such as the IMF, the World Bank, and the EBRD over the need to undertake asset quality reviews of the four systemic banks, improve corporate governance of state-owned banks, and lend liquidity support to the AIB and TSB. All 16 at-risk banks were stress-tested and a financial stability committee was established in 2015. In terms of NPLs, a number of key resolutions were passed with the intention of ensuring that the financial institutions are properly provisioned. Furthermore, a complaints department was set up and a consumer protection strategy was developed. These efforts helped stimulate financial sector stability and safeguard the cost of credit to SMEs from rising further in the near future.

Strengthening financial sector resilience is a strong enabler of private sector growth. In this regard, the key areas of focus in Tajikistan remain financial stability, bank resolution, NPLs, and the administrative measures of the NBT. To date, policies that promote SME finance have been undertaken largely by the NBT and include improvements in financial stability, the elimination of NPLs, consumer protection, the prevention of illegal currency trade, and insurance. Each reform area has contributed to the improvement of the enabling environment for SMEs, e.g., through greater oversight of banking practices by the regulator, monitoring and

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<sup>43</sup> For example, poor banking practices have resulted in loans against flagship projects that are rarely commercially viable.

managing the risks of borrower default, the operationalization of the Consumer Rights Protection Unit in the NBT, stricter regulation of foreign currency operations, and the establishment of insurance sector oversight mechanisms.

A consumer protection and financial literacy diagnostic was carried out by the World Bank in April 2013 (World Bank 2013). The study was prepared at the request of the NBT and was positively received by policy makers. Three broad areas covered were banking, microfinance, and insurance. The study assessed Tajikistan's existing legal and legislative framework, institutional arrangements, and market practices, and compared them to international best practice. A list of nine high-priority and one medium-priority recommendations was produced and thoroughly discussed by the government and development partners.

One of the first and main recommendations of the consumer protection and financial literacy diagnostic was the establishment of a consumer rights protection unit, which the NBT began implementing in September 2015. As of today, on the positive side, there is a unit in the NBT, which is mostly focused on dealing with complaints from the public. The unit has also developed a draft strategy, and a set of the basic regulations to be introduced. On the negative side, it is severely limited in its capacity to expand, due, for instance, to the lack of a legislative framework, overall strategy, and institutional arrangements for enforcement. There are no clear, mandatory, standard procedures to be followed in providing information to consumers (including SMEs) about prices, terms, and other features of financial services, and there are no laws or regulations that require financial institutions to provide borrowers with clear, understandable, and timely information.<sup>44</sup>

In the context of NPLs, the question of insolvency and credit rights is one of the potential tools and instruments for providing solutions. In weak insolvency regimes, struggling companies and their assets often languish unproductively, thereby limiting creditor recovery. Effective insolvency reform in Tajikistan will be associated with a lower cost of credit, increased access to credit, improved creditor recovery, strengthened job preservation, the promotion of entrepreneurship, and other benefits for SMEs.

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<sup>44</sup> As detailed in the World Bank's Consumer Protection and Financial Literacy Diagnostic Report conducted in April 2012 and presented in Dushanbe in June 2013 (World Bank 2013).

In fact, a modern and efficient insolvency regime helps creditors achieve maximum value for assets, facilitating higher distribution to creditors as a whole and reducing the burden of insolvency.<sup>45</sup> The in-court reform by the Government of Tajikistan includes (i) modernization of the national insolvency legislation—and related regulations—to introduce rehabilitation and more efficient procedures; and (ii) a training and supervision framework that will increase the competence and accountability of financial institutions. Out-of-court reform is aimed at establishing a mechanism to facilitate transparent and structured negotiations for a viable business facing financial troubles in reaching an agreement with its creditors to modify existing credit terms so the business can continue operating. This area is considered important for SMEs, and the experience of other countries reiterates its importance in the long run.

The government recognizes that achieving the NDS 2016–2030 targets requires real growth rates of at least 9% per annum, as well as uninterrupted delivery of reforms to improve access to finance, governance, and economic management of future drivers of growth. The World Bank's 2018 *Doing Business* and 2016 BEEPS indicators suggest that finance-related obstacles to doing business are still formidable. Combined with administrative barriers and inefficient business regulation, this environment has hindered new market entrants and the growth of early-stage SMEs. The Prime Minister's Office and the State Committee on Investment and State Property Management have undertaken a series of vital interventions to improve licensing, permits, and inspection systems, thereby enabling SMEs to “breathe” and spend less time on compliance with the state's regulatory requirements. In the meantime, the appropriate incentive structures should be in place to increase the risk appetite of financial institutions to invest in SMEs, allowing smaller firms<sup>46</sup> unimpeded entry to markets and room to grow, and thus increase jobs and incomes.

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<sup>45</sup> In terms of recovering from insolvency, the AIB and TSB are unable to reform quickly. In 2017, the government of Tajikistan paid TJS2.25 billion (\$263.2 million) and TJS1.07 billion (\$125.2 million) to bail out troubled banks through Treasury bills. However, the strategy of printing money to do this has come at the cost of higher inflation and a weaker currency. As a result, this is severely depressing business activity.

<sup>46</sup> In 2014, there were only 200 private firms that had more than 200 employees (OECD 2015).

## 7.7 Conclusions and Recommendations

Tajikistan is an early transition country with significant cross-sectoral transition challenges, higher-than-average risks, and significant business environment constraints, which are particularly problematic for smaller firms. SMEs often face barriers to market entry and weak protection from takeovers or mergers, although this is based on anecdotal evidence from SMEs and is difficult to ascertain empirically. In addition, political economy constraints have threatened financial system stability. The resulting banking sector crisis was highlighted by the insolvency of the AIB and TSB, and the liquidation of two smaller banks. Even when Tajikistan muddles through the banking sector crisis and recovers from economic downturn, these links between politics and business will continue to affect the growth pattern for years to come. The negative spillovers will be felt by SMEs across the board.

The implementation of investment climate reforms—especially around access to finance for SMEs—has been comprehensive but requires sustained effort to see the reforms through to full implementation. Tax administration and inspections are two notable examples of such nonlinear<sup>47</sup> and complex reforms. While Tajikistan ranked 123rd (out of 190 countries) in the World Bank’s 2018 *Doing Business* report, it notably lags other countries in Europe and Central Asia. The country’s progress on the Doing Business metric is evident, albeit slow—for example, it became easier to start a business, obtain credit, pay taxes, deal with construction permits, and trade across borders over the period between 2013 and 2018, due to coherent and targeted implementation of reforms by key economic institutions.<sup>48</sup> However, investment climate reforms aimed at creating a “level playing field” have not generally worked. Instead, development partners have concentrated their effort on initiatives that have minimal impact on *de jure* policies but which signal a shift in policy implementation (e.g., inspections, licensing and permit systems, and other nontariff barriers to trade). Perhaps it is best to adopt the sectoral focus in which effort is concentrated on a few most significant emerging drivers of economic growth.

<sup>47</sup> In the sense that results are not continuously and directly proportionate to funding.

<sup>48</sup> Specifically, the ease of doing business improved from a score/rank of 44.6/143 in 2013 to 57.1/126 in 2018; getting credit improved from 12.5/159 in 2013 to 40.0/124 in 2018; paying taxes improved from 23.8/178 in 2013 to 61.4/136 in 2018; dealing with construction permits improved from 51.1/184 in 2013 to 61.3/135 in 2018; and trading across borders improved from 3.9/188 in 2013 to 59.1/148 in 2018.

Tajikistan's economic development trajectory has not translated into actions by government institutions, or, when action is taken, implementation is weak and poorly monitored. In fact, reform champions often have fluid structures that do not allow for the accumulation of skills or institutional memory. Staff turnover and the low risk appetite of senior decision makers have compounded the government's inability to see policies and reform plans through to full implementation. Therefore, the government should step up its commitment to improving access to finance and the overall regulatory environment through reforms in the financial sector and investment climate. There are exceptions, e.g., the NBT and the State Committee for Investment and State Property Management, but they are rare. Unless the government reverses the outflow of knowledge and skills from public institutions to the private sector, and adopts modern and more efficient governance and management practices, progress and reforms will continue to be slow.

Value chain financing merits institutionalization of a much broader range of financial products to the private sector, including leasing services and simplified collateral requirements (e.g., using credit histories as substitutes comparable to collateral). In turn, this requires the operationalization of credit bureaus and capital markets to enable SMEs to raise funding outside banks and MFIs. While existing credit bureaus and databases make lending to SMEs less risky, the infancy of capital markets restricts access to nonbank financial resources for SMEs. According to data from the NBT, there has only been one corporate bond issuance since Tajikistan's independence—by Bank Eskhata as described earlier. Other than that, there is no corporate bond issuance or transaction record in Tajikistan. Moreover, treasury securities are issued by the Ministry of Finance and the NBT, while the maturity of these securities is too short (often ranging between 18 and 91 days) and the pricing mechanism is inefficient because the securities with the same maturity issued by the NBT and the Ministry of Finance have significant differences in yields (both are guaranteed by the state). A derivative market has not been developed in Tajikistan.

Affordable and long-term local currency lending is hampered by persistent volatility and depends on the strength of regulation and monetary policy instruments employed by the NBT. The cost of credit is largely conditional on the risk appetite of financial institutions, the key policy rate, and the extent of NPLs. Therefore, SME finance along the sectoral value chains would be promoted via a coherent and robust reform implementation in the banking sector, including the elimination of NPLs, as well as raising the financial institutions' risk appetite through credit guarantee schemes. Such risk-sharing facilities are often available through IFIs and multilateral development banks in a limited scope and on a limited scale, but funding should be further pooled to maximize value for money and induce economies of scale.

### 7.7.1 | Policy Recommendations

1. **Invest in business incubation and acceleration facilities:** Enabling smaller firms and start-ups to grow through incubation and acceleration facilities, which offer professional business advisory services and finance, will help address the challenges faced by Tajikistan in generating jobs, increasing productivity, and creating a diversified economy. In fact, most entrepreneurial effort remains underfunded and overlooked. The SME sector can thus drive job creation, in particular for returning labor migrants or their families.<sup>49</sup> While the numbers of returning labor migrants are modest, most of them would safely return given adequate employment opportunities back home. Therefore, promoting SME finance through acceleration facilities offers a way out of poverty for aspiring entrepreneurs through greater incomes and welfare improvements. They would offer standard packages, ranging from foundation courses to more advanced training, to provide start-ups and SMEs with a deep understanding of the skills and knowledge required throughout the entire business life cycle. A general mentoring service and specialist advice would allow SMEs to receive continuous guidance during the first few months of running their business. Furthermore, incubation and acceleration services would offer ample networking opportunities with fellow SMEs and match with potential investors, which is invaluable on the way to growing as a business and contributing to the development of value chains in key economic sectors. Currently, existing incubators are located mainly in the capital, Dushanbe, and are not financially sustainable. The rollout of these facilities outside of the capital is essential for SME growth.
2. **Encourage the creation of associations of angel investors and crowdfunding platforms:** In the presence of prohibitively costly financing available from banks and MFIs, this should be regarded as one of the most viable alternatives to traditional bank lending. Unfortunately, these efforts are still in their infancy and funding for early-stage firms—specifically for start-ups—can be accessed only through grant-based start-up competitions funded by international development partners. The barriers to developing such modes include (i) the absence of adequate legislation and regulation allowing for the operationalization of crowdfunding in Tajikistan; (ii) underdeveloped capital markets; (iii) a high degree of risk in equity investment in local businesses; and (iv) a lack of awareness and understanding of crowd-funding by the vast majority of local SMEs.

<sup>49</sup> An estimated 1.8 million Tajik citizens neither work nor study at the present time (World Bank 2017).

Policy makers could provide assistance through: (i) revision of the current Tax Code to provide tax exemptions or incentives for angel investing and crowdfunding activities (e.g., tax breaks or holidays, elimination of certain taxes, and other forms of incentives); (ii) reduction or temporary elimination of inspections of relevant businesses; (iii) strengthening crowdfunding in the agribusiness sector (through logistics, transportation, and other value chain areas) within the new concept of digital economy; and (iv) encouraging development partners to support self-sustainable storage, warehouses, and refrigeration facilities on a business-to-business and business-to-government basis.

The aforementioned policy areas are realistic if they are conveyed by the highest-level government official through the Address by the President of the Republic of Tajikistan to the Parliament, the Consultative Council on Improvement of Investment Climate under the President of the Republic of Tajikistan, and other highest-level platforms with a clear roadmap and action plan based on specific, measurable, achievable, relevant, and time-based goals.

3. **Improve the financial literacy of entrepreneurs and corporate governance standards of SMEs:** This action merits particular focus given the notable increase of the nonperforming loans in financial institutions over the past few years. Financial literacy is prioritized by the Government of Tajikistan and is evidenced by the NBT's draft Concept on Financial Literacy, which is publicly accessible and will be approved by the government in 2019. Risk management, strategic and business planning, and accounting and financial management are the skills that are critical for entrepreneurs to get back on their feet in the presence of significant macroeconomic risks and an unfavorable business environment. At the other end of the spectrum, SMEs' corporate governance standards—for example, transparency disclosure, succession planning in family-owned businesses, financial reporting, and conflicts of interest—should improve; otherwise SMEs will continue to miss out on borrowing opportunities.
4. **In select niche sectors (or subsectors), assess the feasibility of establishing credit unions:** A credit union would be owned by representatives of SMEs and be mandated to provide them with financial services. As such, it would not be in the position to provide credit to the more profitable borrowers outside its mandated sector (or subsector), thereby reducing adverse credit selection pressures. Staff would also have detailed knowledge and understanding of the sector's characteristics and needs. This would allow the credit union to make intelligent credit decisions based on deep knowledge of



its sector (or subsector) and its management. The reduction in information asymmetry would result in more accurate risk assessment and more favorable lending conditions. The credit union would also be able to provide the sector (or subsector) with financial services and tools that are specifically geared to their needs. While traditional lenders might forgo such provisions due to limited knowledge about the sector (or subsector) or a perceived lack of profitability, the union would face neither of these constraints.

5. **Encourage business associations to crowd in investor interest in storage, warehousing, and refrigeration facilities:** A chronic lack of investment in storage, warehousing, and refrigeration facilities is often named as the most critical problem for SMEs—except for taxation and customs—and is mainly caused by higher risks, the absence of proper investment vehicles, and a cumbersome business environment. Keeping agricultural produce refrigerated, including dairy and meat, can greatly improve its quality. Agribusiness contains a number of commercially attractive value chain development propositions—for example, dairy, meat, apricots, lemons, cherries, and melons—and local SMEs’ export potential will remain limited until adequate resources are invested in the development of refrigeration and storage facilities. Other emerging value chains in Tajikistan—for example, construction materials—require investment in storage and warehousing to withstand corrosion and decay. Neighboring countries—the Kyrgyz Republic and Uzbekistan—are ahead of the game and thus benefitting from access to large markets in the Russian Federation and Kazakhstan, as well as the PRC’s Xinjiang province. Tajikistan’s business associations should step up and reach out to potential investors at home and abroad.
6. **Improving the transparency of existing financing facilities:** The only financing facility for SMEs, which has never been nurtured and subsidized by international development partners, is the government’s Entrepreneurship Support Fund (ESF). The ESF<sup>50</sup> represents a sustained government effort to offer credit lines to firms and reportedly disbursed over \$16 million in concessional loans to the private sector in 2016. The ESF was created in part to help the government to implement the State Program to Support Entrepreneurship 2012–2020. However, investors in the past have been

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<sup>50</sup> The fund was set up in February 2015 in the form of a state-owned enterprise and is accountable to the State Committee on Investment and State Property Management. Its loan portfolio is replenished from the state budget through the Ministry of Finance. The President’s address in October 2017 stated that the ESF disbursed about \$200 million to finance 154 projects in 49 locations across the country. The President pledged to boost the ESF’s credit portfolio to TJS1 billion (\$112.7 million) by 2020.

reluctant to pool funding through the ESF due to a lack of transparency in the screening and funding of SMEs, and inflexible governance arrangements. The ESF structure and governance arrangements should change for it to meaningfully contribute to SME growth and attract nonstate equity investment, which would ease the fiscal burden and significantly increase the credibility of Tajikistan's largest funding facility for SMEs. In particular, the size and composition of the ESF's financing should be calibrated to markets. To enhance participation in domestic and regional value chains, the ESF should target SMEs with complex production processes and high potential for productivity gains. Moreover, the ESF's audited financial reports should be publicly available; and the ESF should establish a structure for joint monitoring and evaluation, as well as reporting (which would allow crowding in financing from external sources).

**7. Improve the effectiveness of the consumer rights protection unit:**

Despite the establishment of a consumer rights protection unit in 2015, the NBT needs to expand its capacity through the creation of a legislative framework—for example, through new consumer protection law, such as with regard to a dispute resolution mechanism—and the approval of institutional arrangements for its enforcement. Clear, mandatory, and standard procedures should be followed in providing information to consumers (including SMEs) on prices, terms, and other features of financial services. Therefore, new consumer rights protection legislation will need to require financial institutions to provide clear, understandable, and timely information to individual and corporate borrowers.

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**Appendix 1a: Global Indices on Economic and Business Performance  
for Tajikistan, 2010–2018**

	2010	2011	2012	2013	2014
<b>GCI, value/rank<sup>a</sup></b>	3.53/116	3.77/105	3.80/100	NA	3.93/91
Strength of auditing and reporting standards	3.75/124	3.73/125	3.74/125	NA	3.85/116
Macroeconomic environment	3.25/131	3.97/120	3.82/120	NA	4.70/69
Prevalence of trade barriers	3.68/124	3.85/122	3.99/100	NA	3.72/133
Prevalence of foreign ownership	3.42/128	3.47/130	3.64/125	NA	3.35/125
Burden of customs procedures	3.56/104	3.60/99	3.68/91	NA	3.56/98
Intensity of domestic competition	4.01/123	4.08/116	4.23/107	NA	4.32/122
Affordability of financial services	3.39/118	3.57/108	3.88/88	NA	3.97/83
Financing through local equity market	2.71/109	3.00/100	3.11/88	NA	3.01/97
Ease of access to loans	2.51/84	2.82/64	3.14/49	NA	3.63/22
Venture capital availability	2.51/69	2.71/57	2.89/50	NA	3.16/38
Soundness of banks	4.01/125	4.42/118	4.59/100	NA	4.39/94
Financial market development	NA	3.32/119	3.35/124	NA	3.40/113
ICT use by local entrepreneurs	1.50/108	1.63/108	1.49/119	NA	1.55/113
Local supplier quantity	4.00/126	4.32/104	4.52/88	NA	4.77/48
Value chain breadth	NA	3.06/110	3.48/77	NA	3.52/97
Business sophistication	3.13/126	3.38/112	3.71/90	NA	3.83/82

*continued on next page*

**Appendix 1a: Continued**

	2010	2011	2012	2013	2014
<b>DB, score/rank<sup>b</sup></b>					
Ease of doing business, global score	44.2/152	44.4/147	45.8/141	44.6/143	52.1/138
Starting a business, score	80.7/136	86.8/70	87.6/77	85.5/87	85.8/106
Dealing with construction permits, score	49.4/178	50.1/177	50.9/180	51.1/184	60.9/168
Getting electricity, score	NA	36.0/178	38.8/181	39.0/186	34.6/178
Registering property, score	68.2/87	68.5/90	70.7/82	71.3/78	60.3/70
Getting credit, score	18.8/168	12.5/177	12.5/180	12.5/159	35.0/116
Protecting minority investors, score	56.7/59	56.7/65	66.7/25	66.7/22	66.7/56
Paying taxes, score	20.7/165	20.6/168	20.6/175	23.8/178	38.8/169
Trading across borders, score	4.2/178	4.1/177	3.9/184	3.9/188	43.6/188
Resolving insolvency, score	40.6/64	41.5/68	39.2/79	32.0/81	32.4/149
	2015	2016	2017	2018	
<b>GCI, value/rank<sup>a</sup></b>					
Strength of auditing and reporting standards	4.03/80	4.12/77	4.14/79	-	
Macroeconomic environment	3.87/114	4.15/96	4.15/96	-	
Prevalence of trade barriers	4.64/78	4.31/89	4.10/103	-	
Prevalence of foreign ownership	3.96/112	4.12/96	4.12/92	-	
Burden of customs procedures	3.49/121	3.52/120	3.52/121	-	
Intensity of domestic competition	3.89/73	4.20/64	4.20/65	-	
Affordability of financial services	4.59/107	4.73/97	4.73/99	-	
Financing through local equity market	3.97/82	4.01/54	4.01/51	-	
Ease of access to loans	3.01/101	3.00/103	3.00/102	-	
	3.63/22	4.11/59	4.11/50	-	

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### Appendix 1a: Continued

	2015	2016	2017	2018	
Venture capital availability	3.26/35	3.29/36	3.29/42	–	
Soundness of banks	4.52/89	4.33/96	4.33/94	–	
Financial market development	3.38/110	3.49/105	3.49/105	–	
ICT use by local entrepreneurs	1.48/117	1.55/119	1.78/114	–	
Local supplier quantity	4.74/40	4.80/31	4.80/34	–	
Value chain breadth	3.49/98	3.58/92	3.58/86	–	
Business sophistication	3.80/78	3.84/74	3.87/75	–	
<b>DB, score/rank<sup>b</sup></b>					
Ease of doing business, global score	54.8/130	56.1/128	57.0/123	57.1/126	
Starting a business, score	90.3/57	86.6/85	90.5/57	90.7/60	
Dealing with construction permits, score	61.0/152	61.2/162	61.2/136	61.3/135	
Getting electricity, score	34.8/177	35.2/173	35.0/171	34.7/173	
Registering property, score	60.8/102	62.0/97	63.5/90	63.9/91	
Getting credit, score	40.0/109	40.0/118	40.0/122	40.0/124	
Protecting minority investors, score	66.7/29	66.7/27	66.7/33	66.7/38	
Paying taxes, score	42.8/172	58.1/140	61.8/132	61.4/136	
Trading across borders, score	57.1/132	57.1/144	57.2/149	59.1/148	
Resolving insolvency, score	32.2/147	31.8/144	31.9/148	30.9/146	

DB = Doing Business, GCI = Global Competitiveness Index, ICT = information and communication technology, NA = not available.

<sup>a</sup> The WEF's GCI values correspond to a scale from 1 (worst) to 7 (best) across 137 economies in 2017.

<sup>b</sup> The World Bank's DB scores correspond to a distance-to-frontier scale from 0 (lowest performance) to 100 (highest performance) across 190 economies in 2018.

Sources: World Economic Forum (WEF), GCI reports and online database; and the World Bank's DB reports and online database.

### Appendix 1b: Global Indices on Economic and Business Performance for Tajikistan, 2010–2018

	2010	2011	2012	2013	2014
<b>CPIA, rating<sup>a</sup></b>					
Building human resources	3.0	3.5	3.5	3.5	3.5
Business and regulatory environment	3.0	3.5	3.5	3.0	3.0
Debt policy	3.5	3.5	3.5	3.5	3.5
Economic management	3.7	3.8	3.8	3.8	3.3
Financial sector	2.5	2.5	2.0	2.0	2.0
Policy rights and rule-based governance	2.5	2.5	2.5	2.5	2.5
Public sector management and institutions	2.8	2.9	3.0	3.0	3.0
Structural policies	3.2	3.2	3.2	3.0	3.0
Trade	4.0	3.5	4.0	4.0	4.0
<b>LPI, score/rank<sup>b</sup></b>					
Customs	1.90/147	NA	2.43/85	NA	2.35/115
Infrastructure	2.00/127	NA	2.03/138	NA	2.36/108
Ease of shipment	2.42/127	NA	2.33/135	NA	2.73/92
Logistics services	2.25/125	NA	2.22/130	NA	2.47/113
Ease of tracking	2.25/141	NA	2.13/143	NA	2.47/119
Timeliness	3.16/98	NA	2.51/146	NA	2.74/133
<b>WGI, score/rank<sup>c</sup></b>					
Government effectiveness	-0.92/19.1	-0.95/17.1	-0.93/18.0	-1.06/14.7	-0.78/22.1
Regulatory quality	-1.02/17.2	-0.98/19.4	-1.00/17.5	-1.06/15.2	-1.02/14.9
Rule of law	-1.21/10.4	-1.23/10.3	-1.20/9.9	-1.25/9.4	-1.01/13.9
Control of corruption	-1.29/4.8	-1.22/8.1	-1.28/6.6	-1.28/7.1	-1.13/12.5
<b>CPI, score/rank<sup>d</sup></b>					
CPI, score/rank	21/154	23/152	22/157	22/174	23/152
<b>HDI, score/rank</b>					
HDI, score/rank	0.634/193	0.637/194	0.642/192	0.646/192	0.645/195

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# Appendix 1b: Continued

	2015	2016	2017	2018
<b>CPIA, rating<sup>a</sup></b>				
Building human resources	3.5	3.5	3.5	–
Business and regulatory environment	3.0	3.0	3.5	–
Debt policy	3.5	3.0	2.5	–
Economic management	3.3	3.0	3.0	–
Financial sector	1.5	1.5	1.5	–
Policy rights and rule-based governance	2.5	2.5	2.5	–
Public sector management and institutions	2.9	2.8	2.9	–
Structural policies	2.8	2.7	2.8	–
Trade	4.0	3.5	3.5	–
<b>LPI, score/rank<sup>b</sup></b>				
Customs	NA	2.06/153	NA	2.34/134
Infrastructure	NA	1.93/150	NA	1.92/150
Ease of shipment	NA	2.13/130	NA	2.17/127
Ease of shipment	NA	2.12/151	NA	2.31/133
Logistics services	NA	2.12/143	NA	2.33/116
Ease of tracking	NA	2.04/144	NA	2.33/131
Timeliness	NA	2.04/159	NA	2.95/104

*continued on next page*

**Appendix 1b: Continued**

	2015	2016	2017	2018
<b>WGI, score/rank<sup>c</sup></b>				
Government effectiveness	-0.85/19.7	-1.03/13.9	-1.12/12.9	–
Regulatory quality	-1.02/13.9	-1.09/12.0	-1.06/12.0	–
Rule of law	-1.06/13.5	-1.15/10.6	-1.35/8.2	–
Control of corruption	-1.13/11.5	-1.15/12.0	-1.33/7.7	–
<b>CPI, score/rank<sup>d</sup></b>	26/136	25/151	21/161	–
<b>HDI, score/rank</b>	0.645/196	0.647/127	0.650/127	–

CPI = Corruption Perceptions Index, CPIA = Country Performance and Institutional Assessment, HDI = Human Development Index, LPI = Logistics Performance Index, NA = not available, WGI = Worldwide Governance Indicators.

<sup>a</sup> The World Bank's CPIA ratings correspond to a scale between 0.0 (low performance) and 6.0 (high performance).

<sup>b</sup> The World Bank's LPI scores correspond to a scale between 0.00 (very low) and 5.00 (very high) across 160 countries in 2018.

<sup>c</sup> The World Bank's WGI scores correspond to a scale between –2.50 (weak) and 2.50 (strong), and a percentile rank among 200 countries (ranging from 0 (lowest) to 100 (highest) rank).

<sup>d</sup> Transparency International's CPI scores correspond to a scale between 0 (highly corrupt) and 100 (very clean) across 180 countries in 2017.

<sup>e</sup> The United Nations Development Program (UNDP) HDI scores correspond to a scale between 0.000 (very low) and 1.000 (very high) across 189 countries in 2017.

Sources: The World Bank's online database (<http://data.worldbank.org/cpia>) and Transparency International.

# SME Finance in Uzbekistan: Challenges and Opportunities

Dildora Tadjibaeva

## 8.1 Introduction and Overview of SMEs' Role in the Economy and SME Finance

### 8.1.1 | SMEs' Role in the Economy

Uzbekistan is the most densely populated country in the Central Asian region, with one-third of the population under the age of 29 and half residing in rural areas. As 800,000 people under the age of 29 join the labor market every year, job generation is an urgent and challenging priority.

The development of private micro and small enterprises and entrepreneurship has often been declared as a priority by Uzbekistan's president. It is recognized now that small business is a driving force for economic growth, an increase in gross domestic product (GDP), and the primary solution to acute social problems such as unemployment, poverty—especially among women and youth—and poor quality of life.

Small businesses in Uzbekistan include individual entrepreneurs and micro and small enterprises.<sup>1</sup> The size of an enterprise is defined by the number of employees, without considering a revenue component or the ownership structure. The threshold number of employees varies by sector (Table 8.1).

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<sup>1</sup> The definition of small business is stipulated in Article 5 of Law N 69-II, enacted on 25 May 2000 and amended on 2 May 2012, which states that small business includes individual entrepreneurs, micro firms, and small enterprises (Government of Uzbekistan. 2000. The Law of the Republic of Uzbekistan N 69-II on Guarantees for Freedom of Entrepreneurial Activity; Government of Uzbekistan. 2012. Presidential Decree No. 328 on Measures for Further Improvement of the Business Environment and to Provide Greater Freedom of Entrepreneurship).

**Table 8.1: Definition of Small and Medium-Sized Enterprises**

Category	Number of Employees
Individual	1–3 employees
Micro enterprises	Up to 20 employees
Small enterprises	Up to 200 employees

Source: Ministry of Economy of the Republic of Uzbekistan.

There is no legal definition for medium-sized enterprises in the legislation. However, according to the draft resolution,<sup>2</sup> the government intends to amend the legislation and expand the scope of prerequisites required to qualify for being treated as a small business, effective from 1 January 2019. According to draft proposals, the following entities will be classified as small and medium-sized businesses:<sup>3</sup>

- individual entrepreneur;
- micro firms with an average annual number of employees of not more than 25;
- small enterprises with an average annual number of employees of not more than 100; and
- medium-sized enterprises with an average annual number of employees of not more than 250.

The current definition cannot distinguish between privately owned autonomous small enterprises and state-owned enterprises and has no limits for turnover nor for balance sheet total. This is not in line with international practice.

According to international practice, only privately owned enterprises with a share of state bodies smaller than 25% are regarded as SMEs. As a result, some state-owned small enterprises and enterprises with little staff but huge turnovers or large assets and are currently included in the small enterprises sector. Statistics that are based on the current definition overstate the SMEs' share of GDP, employment, and exports.

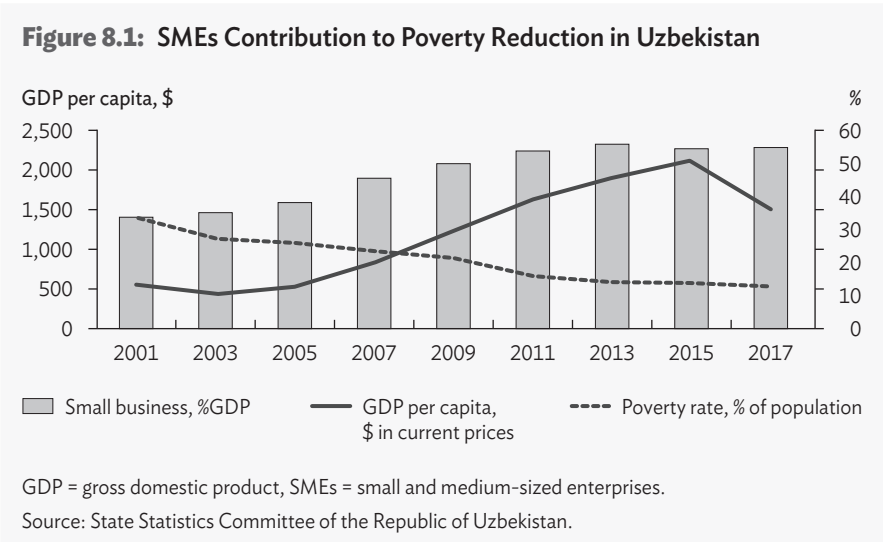
<sup>2</sup> <https://regulation.gov.uz/ru/document/639>.

<sup>3</sup> Draft President Resolution on measures to further stimulate the expansion of small businesses and private entrepreneurship in order to create competitive companies. <https://regulation.gov.uz/uz/document/639> (accessed 26 September 2018).

In international practice, the definition of SMEs, aside from staff size, includes annual turnover and/or sales or is industry specific. Preservation of the industry-specific differences is necessary subject to certain tax (e.g., stimulation of individual industries) or statistical (e.g., comparison of labor productivity) tasks set by the state.

Using an SME definition for tax purposes in Uzbekistan hinders job creation and growth. In addition, defining SMEs by number of employees is difficult due to part-time work, casual work, or temporary work becoming more widely used by employers.

Figure 8.1 illustrates the poverty rate decrease from 33.6% in 2001 to 12.3% in 2016, which, in many ways, can be attributed to a rise in small and medium-sized businesses, albeit in the informal sector.



The importance of SMEs in the economy is determined by four commonly used indicators: (i) number of enterprises; (ii) employment; (iii) domestic output; and (iv) exports (Vandenberg, Chantapacdepong, and Yoshino 2016).

Uzbekistan’s SMEs have contributed significantly to job creation and economic well-being since 2000. This trend has further accelerated since 2010, following a new set of presidential decrees and government programs initiated after the financial crisis.

SMEs' contribution to GDP increased to 54.9% in 2017 from 38.2% in 2005, which indicates that SMEs play a significant role in the country's economy. The value added by SMEs in total value added by enterprises rose to SUM120 trillion compared with SUM5.4 trillion in 2005 (Figure 8.2). The value added of SMEs in Uzbekistan is less than half than in emerging countries (\$113,000 vs. \$394,000).<sup>4</sup>

The share of SMEs' exports in the total country export performance increased to 27.2% in 2017 from 6% in 2005. SMEs' imports accounted for 50% of total imports in 2017. The SMEs' share in investment rose from 13.4% in 2001 to 34.8% in 2017. While value figures show positive net exports, the vast majority of SMEs are import-oriented (particularly in trade and manufacturing sectors) (Figure 8.2).

As of 1 January 2018, over 229,600 small business entities were registered in Uzbekistan, which constitutes 90% of all registered and functioning legal entities. Taking into account the shadow economy, the number of SMEs may be higher: the share of the shadow economy is estimated to be 50%, which reduces reported GDP by up to \$16 billion–\$17 billion (Buyuk Kelajak 2018).

Within the SME sector, micro-enterprises make up 91.8% of all registered businesses, and small firms around 8.2% (18,900 units). Between 2010 and 2018, the total number of SMEs increased by 51% (Figure 8.3). SME development is predominately driven by micro-enterprises. Micro-enterprises employ eight people, on average, and represent an important share of the working population.

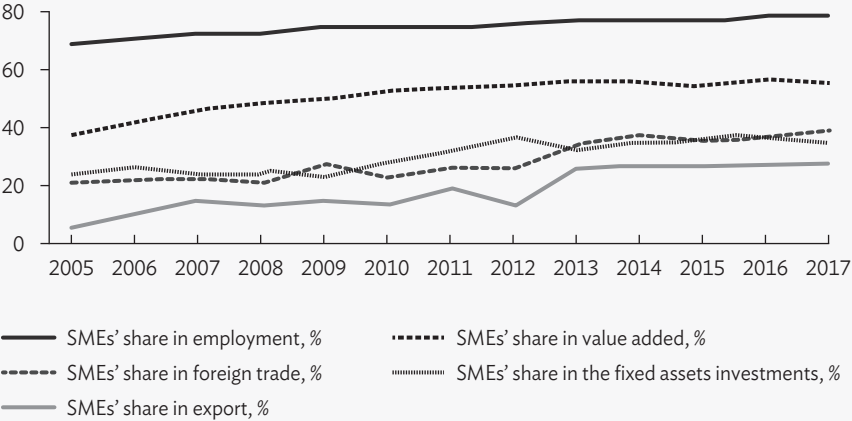
The low growth of small enterprises during 2010–2017 may indicate that SMEs face difficulties of an unfavorable business environment and access to finance. In addition, a significant share of small businesses works under a simplified taxation scheme, which, on the one hand, facilitates business, but, on the other, discourages business growth (due to limits on the number of workers).

Uzbekistan has a high rate of unemployment—around 7% in 2017 with an estimated one in 10 people aged 20 to 24 not looking for a job because they do not believe they can find one. Unemployment rates for youth are about 18%, twice the overall rate (World Bank 2019b).<sup>5</sup> Low employment prospects have led to high levels of outmigration, with one in five males becoming an international migrant and this rate is even higher among young men.

<sup>4</sup> Concept of the Development Strategy of the Republic of Uzbekistan. <http://uzbekistan2035.uz/uzbekistan-2035/>.

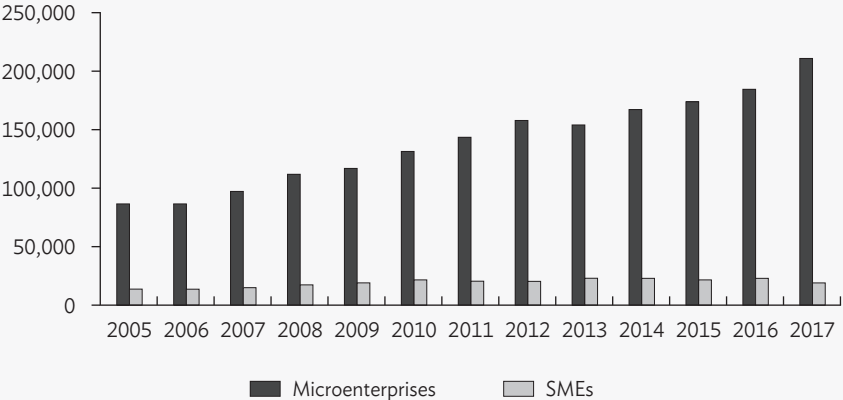
<sup>5</sup> <http://documents1.worldbank.org/curated/en/866501562572675697/pdf/Uzbekistan-Toward-a-New-Economy-Country-Economic-Update.pdf>.

Figure 8.2: SME Sector in Uzbekistan



SME = small and medium-sized enterprise.  
Source: State Statistics Committee of the Republic of Uzbekistan.

Figure 8.3: Number of SMEs (excluding farmers and *dehkan* farms)



SMEs = small and medium-sized enterprises.  
Notes: A *dehkan* farm is a family small-scale farming enterprise engaged in the production and sale of agricultural products on the basis of the personal labor of family members on the household plot granted to the head of the family for life-time lease. See Law on *dehkan* farm. <http://www.lex.uz/acts/6634>.  
Source: State Statistics Committee of the Republic of Uzbekistan.

According to official data, SMEs are the biggest source of employment, as they now provide 78% of jobs, compared to 50% in 2000. Nearly three out of every four employed persons in Uzbekistan work in small businesses and more than 60% of those jobs are in rural areas (Tsereteli 2018). More than 62% of those employed are individual entrepreneurs, and small businesses and micro firms employ only about 16%. Uzbek migrants are included in sectoral employment data, mainly in employment in agriculture and other sectors. Most of the migrants (around 70%–75%) come from rural areas, and, in some cases, they are counted as employed in the agricultural sector and the migrants from urban areas are accounted in the statistics on employment in other sectors.

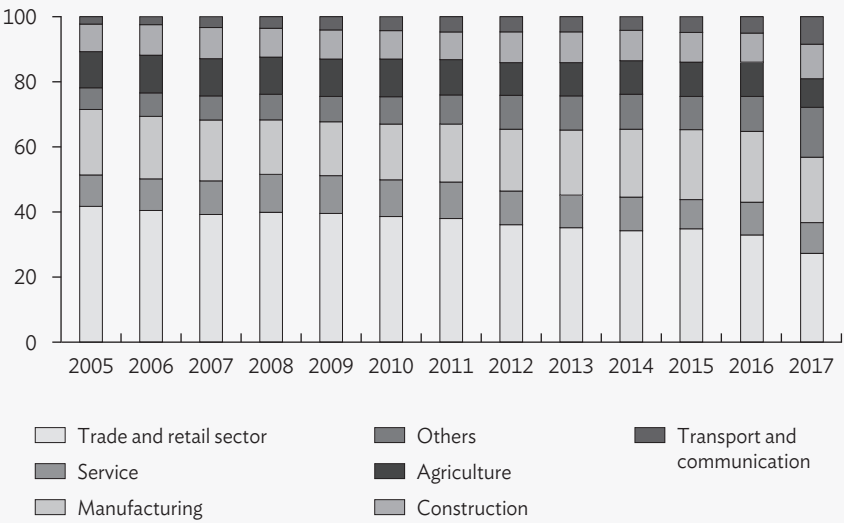
However, official statistics do not provide all necessary data to provide a credible picture. Therefore, the official data should be assessed critically. For example, the number of individual entrepreneurs is not available, and the State Statistics Committee only collected data on SMEs with a legal entity status. Analysis of the open sources did not reveal any data on the number of individual entrepreneurs.

Uzbekistan has a low density of 7.1 SMEs per 1,000 people, lagging developed countries 44 SMEs per 1,000 people and developing countries 17 SMEs per 1,000 people (Buyuk Kelajak 2018).

Figure 8.4 illustrates that approximately 28% of SMEs are engaged in retail and wholesale trade, followed by manufacturing (20.3%), construction (11%), transport (9%), and agriculture (9%). The modest figure of 9% in agriculture is controversial, since about 80% of the sector's contribution to GDP is accounted for by small-scale entrepreneurs, suggesting that a significant portion of 160,000 collective and *dehkan* farms are potential small and microfinance borrowers. Considering individual, small, and micro-enterprises, and small-scale agriculture, the total number of potential borrowers is in the range of 800,000. With fewer than 300,000 borrowers currently served, there is an enormous unmet demand for small and microcredit financing. The sectoral analysis of small business demonstrates that a long-term trend of reducing SMEs in trade and agriculture is associated with a poor regulatory environment and the impact of economic factors. One such factor is the government's ongoing monopoly in the agricultural sector. Since there is no private ownership of land, farmers cannot own agricultural land, nor are they entitled to make their own choices of what to grow, therefore there are not many SMEs involved in this sector. However, if the agricultural sector liberalizes and diversifies, shifting from cotton and wheat monoculture to more diverse agricultural produce, coupled with legal guarantees for private ownership for land, the number of SMEs and value chains in agriculture will soar significantly.

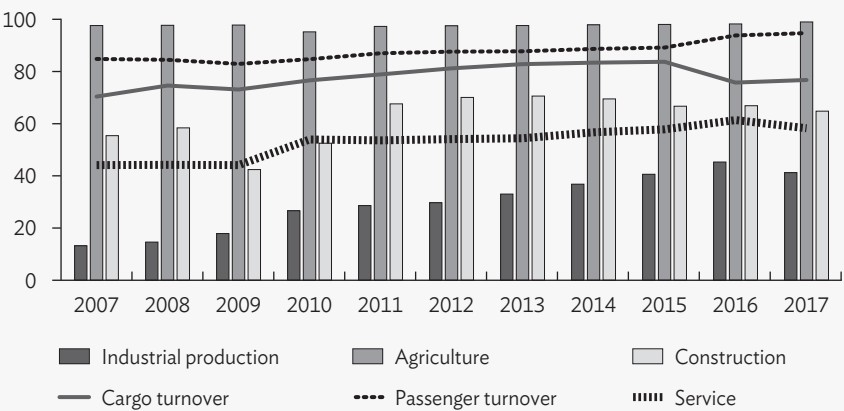


**Figure 8.4: SME Distribution by Sector (%)**



SME = small and medium-sized enterprise.  
Source: State Statistics Committee of the Republic of Uzbekistan.

**Figure 8.5: SME Share in Domestic Output (%)**



SME = small and medium-sized enterprise.  
Source: State Statistics Committee of the Republic of Uzbekistan.

There is an increase in the share of large retail chains, which displace small businesses in the retail trade. On the other hand, government regulation gradually limits the list of activities for individual entrepreneurs to conduct trade in construction goods. The share of SMEs in construction has increased significantly in recent years due to the implementation of the State Program of Affordable Housing.

SMEs are also active in the service sector (retail and catering). In foreign trade, the small business share was below 10% in 2007–2008, and currently only 4.7% of small businesses participate in foreign trade activities.

### 8.1.2 | SME Sources of Finance

There is a limited choice for SMEs in terms of sources of finance. Sources of SME finance in Uzbekistan are classified as informal and formal. Informal sources of financing include personal savings, friends, relatives, business partners, and unregistered moneylenders. Primary sources of finance are self-financing, such as the profit of the enterprise, reserve financing, and capital increase by the founders' contributions.

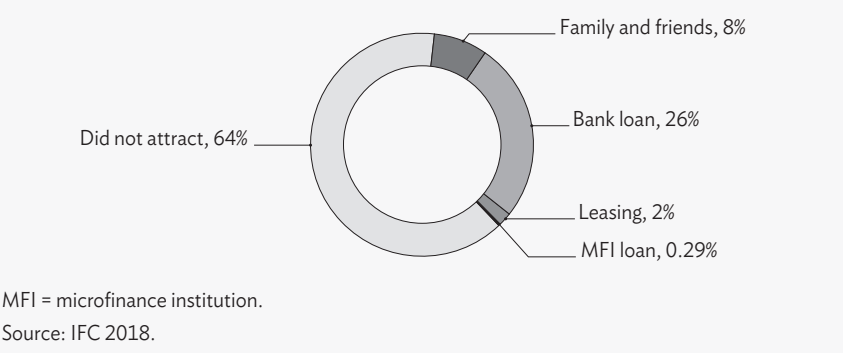
Evidence from enterprise-level surveys suggests there is more room for growth to extend financial services to smaller enterprises. According to a World Bank and International Finance Corporation Survey conducted in 2018,<sup>6</sup> 64% of surveyed firms in Uzbekistan reported using bank financing and 8% used family and friends' support. Nevertheless, a large proportion of Uzbek SMEs finance their growth internally—64% reported self-financing (Figure 8.6).

Among micro and small businesses, there are low levels of financial leveraging: Almost two-thirds of businesses do not attract financing. Banks almost exclusively are the only formal source of financing in Uzbekistan. The majority of respondents who participated in the in-depth interviews claimed that they would register their informal business in order to take a bank loan, which provides an opportunity to develop this segment.

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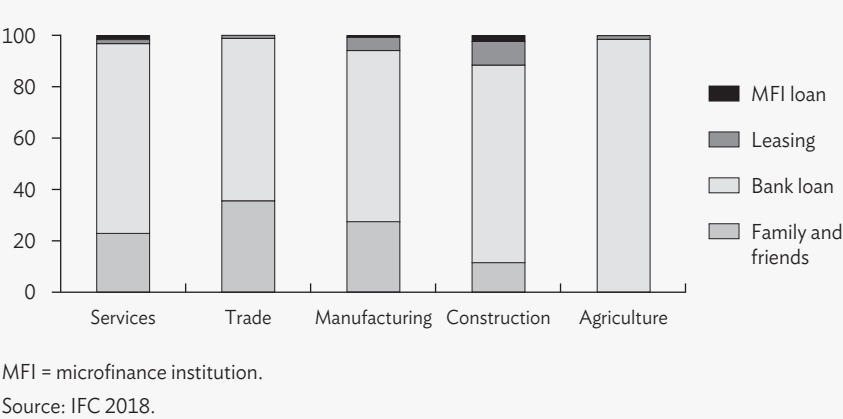
<sup>6</sup> Quantitative survey to identify the use and experience of registered small enterprises and individual entrepreneurs with financial services and test their awareness and use of digital financial services and a qualitative survey through focus groups to capture the same for unregistered entrepreneurs. Where: four urban and peri-urban areas of Tashkent, Namangan, Samarkand, and Karshi cities. Total sample: 1,026 respondents for the quantitative survey and 16 for the qualitative survey.

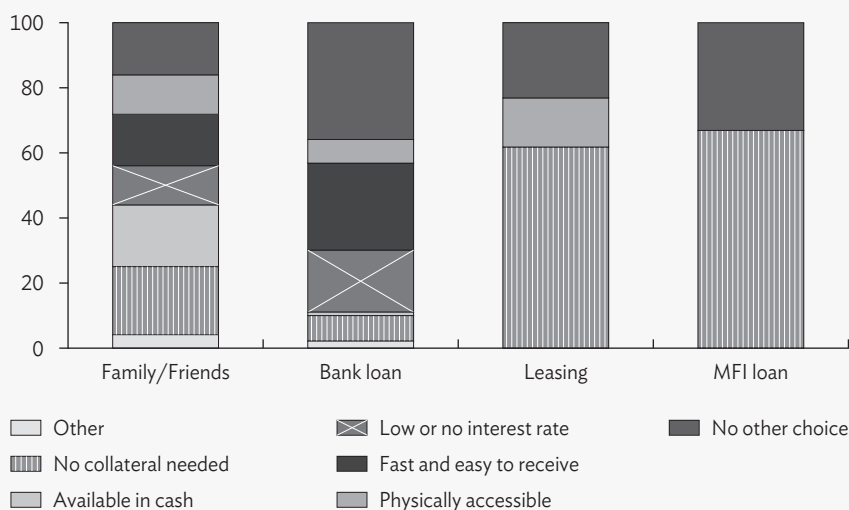
Figure 8.6: Source of Finance



About 21% of the respondents stated that the biggest reason for choosing family and friends was that collateral was not needed and the money was available in cash (19% of total respondents); 37% of the respondents noted that they had no choice other than to go to the banks. Respondents noted that only banks can provide the requested amounts. Around 67% of the respondents used microfinance institutions’ (MFIs) services because they are fast and easy to deal with, and 33% of the respondents noted there is no choice except an MFI loan. For trade and services, the most important item that was quoted was the availability in cash; for agricultural producers, no collateral required and low interest rates are the most important (government-supported programs are available) (Figure 8.7).

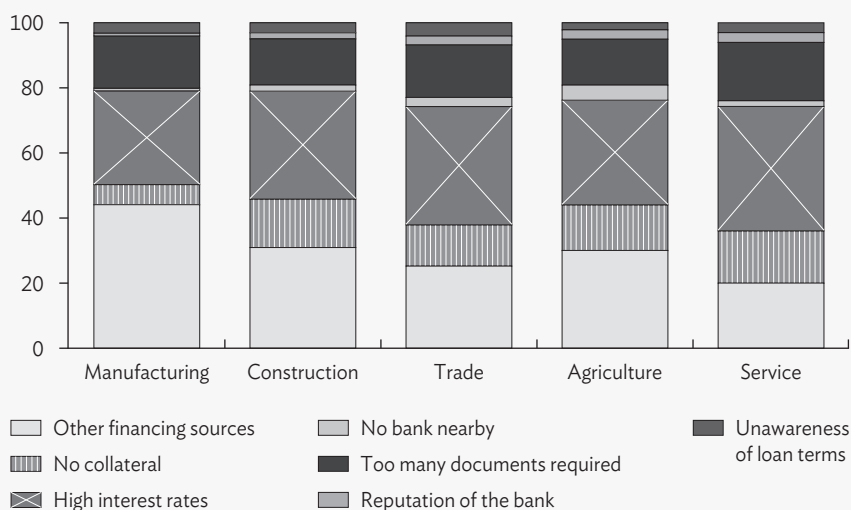
Figure 8.7: Source of Financing by Sector (%)



**Figure 8.8: Reason for Choosing Source of Financing (%)**

MFI = microfinance institution.

Source: IFC 2018.

**Figure 8.9: Reason for Not Applying for a Loan from a Financial Institution by Sector (%)**

Source: IFC 2018.

SME finance is principally performed by two types of financial institutions being channeled through 28 commercial banks, including the specialized Mikrokreditbank and 37 microcredit organizations.

The banking sector's limited capacity for financial intermediation remains a key barrier to the development of the private sector, and in particular to SMEs. Banks continue to be dominated by a handful of state-owned banks (86% of the assets), and they lack competition and transparency. Government-controlled banks still support the government's economic priorities through subsidized loans offered to specific sectors and investment purposes. Total bank loans as a percentage of GDP increased from 26.4% in 2016 to 44.4% in 2017. Overall, more than 75% of total sector loans account to state-owned banks, focusing on state-owned large corporations and strategically important industries. These banks are controlled and regulated by the state, mainly through the Ministry of Finance, the Central Bank of Uzbekistan (CBU), and the Uzbekistan Fund for Reconstruction and Development.

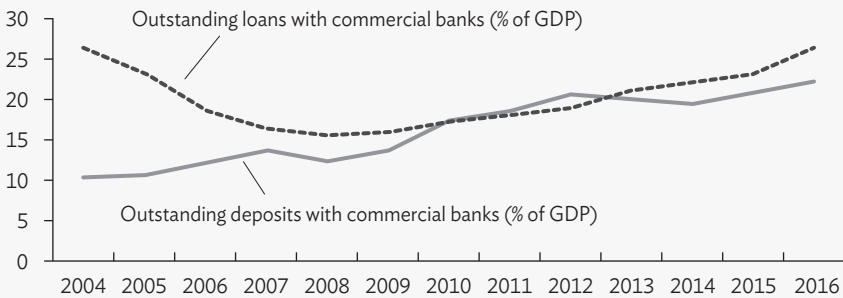
The penetration of banking services is gradually increasing due to the development of infrastructure, but a substantial part of the population is still not provided with basic banking products.

The low level of penetration of banking services hinders the development of the banking sector due to the lack of sources of cheap liabilities—the deposits of the population. Currently, only SUM0.55 of deposits of individuals fall on SUM1 of cash.<sup>7</sup> Although there are 36 branch outlets per 100,000 adults (IMF 2017), which exceeds the Commonwealth of Independent State countries; however, as a ratio to GDP, the level of deposits in Uzbekistan is half that of the Russian Federation or Georgia.

Figure 8.10 shows that Uzbekistan's financial depth indicators have not improved in 2004–2016, and are low compared to countries at similar levels of development. Credit to GDP ratio remained intact in 2004–2016. Deposits slowly increased over the same period, and accounted for 22.1% of GDP in 2016 compared to 10.4% in 2004. By comparison with other countries in the region, the level of deposit penetration in Uzbekistan is low.

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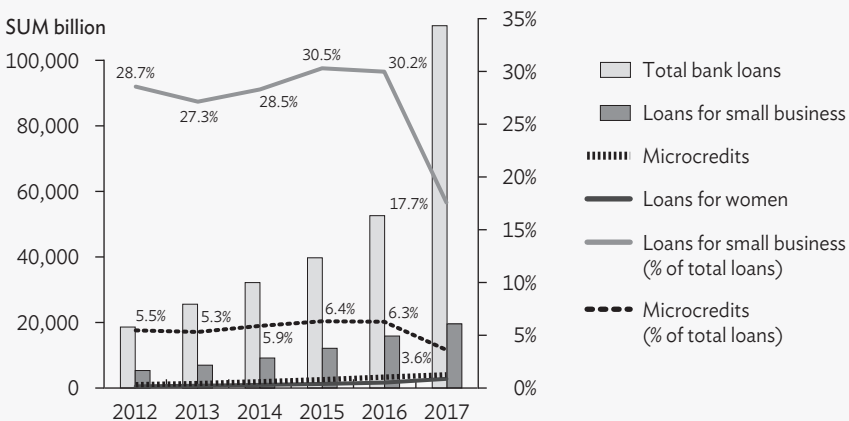
<sup>7</sup> Development Strategy Framework of the Republic of Uzbekistan by 2035.

**Figure 8.10: Financial Depth—Comparison 2016**

GDP = gross domestic product.

Source: IMF Financial Access Survey 2017.

Small business loans and microcredit as a percentage of GDP slightly declined from 8.0% to 7.9% and from 1.7% to 1.6%, respectively. The decline was related to the reduction of shares of the loans for small business and microcredits in total bank loans. The share of small businesses in the loan portfolio is growing due to a decline in the corporate segment and currently accounts for 18% (Figure 8.11).

**Figure 8.11: SME Finance**

SME = small and medium-sized enterprise, SUM = Uzbekistan sum.

Source: Central Bank of Uzbekistan.

Table 8.2: SME Bank Lending Portfolio

	2012	2013	2014	2015	2016	2017
Total bank loans, SUM billion	18,601	25,562	32,161	39,718	52,611	110,572
Loans for small business, SUM billion	5,346	6,982	9,158	12,113	15,870	19,565
<b>Microcredits, SUM billion</b>	<b>1,023</b>	<b>1,366</b>	<b>1,907</b>	<b>2,527</b>	<b>3,326</b>	<b>4,015</b>
Loans for women, SUM billion	492	698	960	1,255	1,647	2,782
Loans for small business (% of total loans)	28.7%	27.3%	28.5%	30.5%	30.2%	17.7%
<b>Microcredits (% of total loans)</b>	<b>5.5%</b>	<b>5.3%</b>	<b>5.9%</b>	<b>6.4%</b>	<b>6.3%</b>	<b>3.6%</b>

SME = small and medium-sized enterprise, SUM = Uzbekistan sum.  
Source: Central Bank of Uzbekistan.

The shares of small business loans and microcredit in total bank lending declined in 2017 from 30.2% to 17.7% and from 6.3% to 3.6%, respectively (Table 8.2). The decrease was related to a sharp increase in the sum value of loans to large state companies because of revaluation, and the callback of loan applications by small businesses after the sum devaluation in September 2017, due to their business plans having been based on half the foreign exchange rate.

Despite total loan portfolios soaring between 2016 and 2017 to more than double, the increase in the amount of loans and microcredit for small business for that period was less than moderate. Microcredit constitutes a significant portion of loans (about 20%), which gives evidence of the impossibility of receiving traditional bank loans.

The hike in the growth rates of small business loans and microcredit in 2014 was 39.6% and 31.2%, respectively. Then the growth rates plummeted and fell to 20.7% and 23.3% in 2017 due to the large state banks’ increased corporate lending portfolios over that period (Table 8.3).

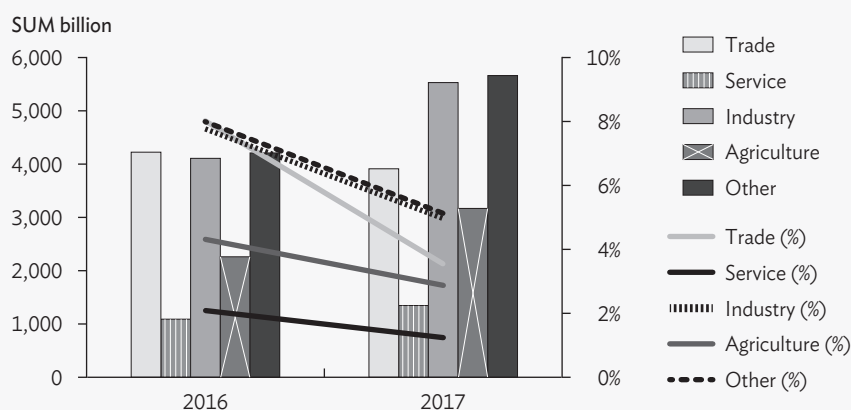
Figure 8.12 shows that there was almost no change in the sectoral structure of small business loans over 2016–2017. While the share of industry and agriculture increased from 26% to 28% and from 14% to 16%, respectively, the share of trade fell from 27% to 20% and small business loans to the service sector stayed at 7% of total lending to small business.

**Table 8.3: Profile of Small Business and Microfinance Lending by the Banks**

Small Business and Microfinance Loans as % of GDP	2012	2013	2014	2015	2016	2017
Microfinance (up to \$20,000)	1.1%	1.1%	1.3%	1.5%	1.7%	1.6%
Small business	5.6%	5.9%	6.3%	7.1%	8.0%	7.9%
Small business loans in total loans (%)	2012	2013	2014	2015	2016	2017
Microfinance (up to \$20,000)	5.5%	5.3%	5.9%	6.4%	6.3%	3.6%
Small business	28.7%	27.3%	28.5%	30.5%	30.2%	17.7%
Growth rates of small business and microfinance loans (%)	2012	2013	2014	2015	2016	2017
Microfinance (up to \$20,000)	NA	33.5%	39.6%	32.5%	31.6%	20.7%
Small business	NA	30.6%	31.2%	32.3%	31.0%	23.3%
Loans for small business and microfinance (amount), SUM billion	2012	2013	2014	2015	2016	2017
Microfinance (up to \$20,000)	1,023	1,366	1,907	2,527	3,326	4,015
Small business	5,346	6,982	9,158	12,113	15,870	19,565

GDP = gross domestic product, SUM = Uzbekistan sum.

Source: Central Bank of Uzbekistan.

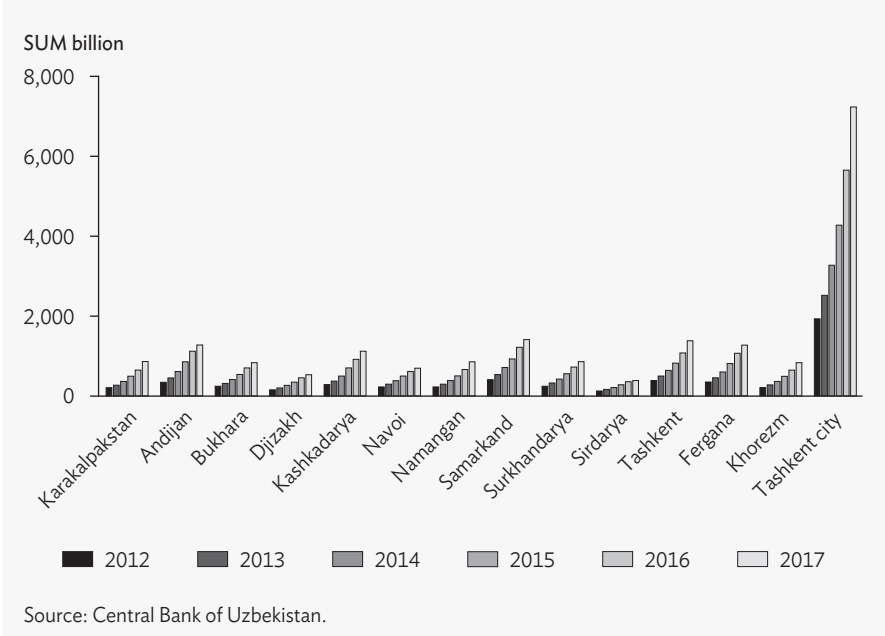
**Figure 8.12: SME Lending by Sector**

SME = small and medium-sized enterprise, SUM = Uzbekistan sum.

Source: Central Bank of Uzbekistan.



**Figure 8.13: Small Business and Microfinance Lending Distribution by Region**



As Figure 8.13 illustrates, there is a disproportionate regional distribution of SME loans: small business lending in Tashkent city kept its leading position over 2012–2017 due to most small businesses being concentrated in the capital. Following Tashkent city, significant volumes of small business loans continue to be disbursed in the Samarkand, Tashkent, Andijan, and Fergana regions.

Out of \$13.4 billion in bank loans, only \$0.89 billion were allocated in the form of microloans, covering less than one-third of an existing demand from micro and small businesses. Based on the survey, the potential market for micro and small business finance can be estimated at \$5.5 billion (Table 8.4). This is consistent with the International Finance Corporation (IFC), SME Finance Forum, and World Bank MSME survey, estimating the current micro, small, and medium-sized enterprise (MSME) financing gap of Uzbekistan at \$11.8 billion (Table 8.5).

**Table 8.4: Demand Assessment**

	No.	% Bankable	Net Demand (No.)	Estimated Average Loan Size (\$)	Estimated Net Demand (\$)
Registered operating SMEs	229,600	39%	89,544	29,086	2,604,500,219
Farm enterprises <sup>a</sup>	132,356	NA	NA	NA	NA
<i>Dehkan</i> farms <sup>b</sup>	4,769,000	30%	1,430,700	2,000	2,861,400,000
Unregistered individual entrepreneurs minus <i>dehkan</i> farms	531,000	10%	53,100	1,000	53,100,000
<b>Total</b>					<b>5,519,000,219</b>

NA = not available, SMEs = small and medium-sized enterprises.

<sup>a</sup> large individual farms, averaging 60–100 hectares and producing cotton and wheat under the state order system.

<sup>b</sup> *dehkan* smallholders averaging 1 hectares and producing livestock and horticulture products.

Source: IFC 2018.

**Table 8.5: MSME Demand for Finance in Uzbekistan**

Potential Demand for Finance	Micro, \$ million		SME, \$ million		MSME, \$ million	
Current Supply	85	5%	1,647	14%	1,732	13%
Finance Gap	1,631	95%	10,159	86%	11,790	87%
Total	1,716	13%	11,806	87%	13,522	100%

MSME = micro, small, and medium-sized enterprise, SME = small and medium-sized enterprise.

Sources: World Bank; IFC 2017.

**Mikrokreditbank** was established in 2006 by a special Presidential Decree<sup>8</sup> with the purpose of “further expanding the provision of financial resources for the development of small business, private entrepreneurship and farming, the creation of new jobs by spurring individual labor activity, family business and home-based business, and the provision of access to microfinance services to broad strata of the population, especially in rural areas.” Due to its large network (85 branches and 110 point of services), the bank was able to increase the total number of customers to 341,607 in 2017.

<sup>8</sup> Decree of the President of the Republic of Uzbekistan No. UP-3750 dated 5 May 2006 on Establishment of the Joint-Stock Commercial Bank Mikrokreditbank.

A new regulation issued in 2018<sup>9</sup> provides for extending Mikrokreditbank's tax exemption until 1 January 2023 (together with Halq Bank), increasing the Mikrokreditbank's charter capital in 2018–2019 by SUM600 billion (\$73 million), as well as mandating a number of other exemptions and privileges—for example, free advertising of Mikrokreditbank's and Halq Bank's socially oriented financial products by mass media and 50% discount on advertising commercial products.

Interest rates are competitive as the bank is mandated by the government to provide preferential loans to SMEs. This has resulted in interest rates averaging 5% per annum, which are well below the inflation rate of 14.4% in 2017, meaning that the bank lends below costs and also in negative real terms (Table 8.6).

The losses are assumed eventually by the state because the government is the ultimate beneficial owner (State Assets Management Agency). By the end of 2017, the number of outstanding loans amounted to SUM1.3 trillion (\$180 million), of which only SUM313.8 billion was concessional (microfinance) lending, demonstrating that, despite specialization, the vast majority of business is not directed at SMEs.

Mikrokreditbank takes various types of collateral, but does not include future cash-flow considerations. The bank offers a narrow range of credit products to SMEs like other commercial banks. Equity finance, factoring, and longer-tenure loans are not offered.

Due to the bank's collateral requirements, SMEs may be denied credit, despite having sufficient cash flow or purchase orders, or may be limited only to short-term credit facilities and not the type of financial products they need.

Microcredit organizations are regulated mainly by two laws: the Law on Microfinance and the Law on Microcredit Organizations, which were adopted in September 2006. The framework Law on Microfinance<sup>10</sup> provides key definitions and outlines basic rules for the provision of microfinance services. In particular, it allows the provision of microfinance services to both banks and nonbanks: the latter include microcredit organizations (MCOs) and pawnshops.<sup>11</sup>

<sup>9</sup> Resolution of the President the Republic of Uzbekistan No. PP-3694 dated 4 May 2018 on Measures for Improving the Financial Condition and Further Improvement of the Activity of the Joint-Stock Commercial People's Bank of the Republic of Uzbekistan and the Joint-Stock Commercial Bank Mikrokreditbank.

<sup>10</sup> Law of the Republic of Uzbekistan on Microfinance. No. ZRU-50 dated 25 August 2006.

<sup>11</sup> The law also mentions "other credit organizations", but currently there are no entities with this status in Uzbekistan.

**Table 8.6: Mikroreditbank's Programs**

Program	Target Group	Size (min. wages)	Term	Other
Mikroreditbank: Basic program	<ul style="list-style-type: none"> <li>• SME</li> <li>• Private business</li> <li>• Farmers</li> <li>• Individuals</li> <li>• Family business</li> <li>• Home-based business</li> </ul>	<ul style="list-style-type: none"> <li>• 500 for microcredit</li> <li>• 2,000 for microleasing</li> </ul>	24 months	Interest rates based on bank policy
Mikroreditbank: New jobs creation and low income	<ul style="list-style-type: none"> <li>• Unregistered entrepreneurs</li> <li>• Micro firms</li> <li>• <i>Dehkans</i></li> <li>• Low income</li> <li>• School graduates</li> </ul>	<ul style="list-style-type: none"> <li>• 50 for unregistered</li> <li>• 100 for micro firms, low-income, graduates</li> <li>• 500 for expansion</li> <li>• 15 for group loans (to each member)</li> </ul>	<ul style="list-style-type: none"> <li>• 24 months for all except group loans</li> <li>• 1 year for group loans</li> </ul>	–
Mikroreditbank own offering 1: Concessional MSME	MSME start-up	200	18 months	Interest rate 3%
Mikroreditbank own offering 2: MSME for expansion and working capital	MSME	500	18 months	Interest rate 50% of CBU refinancing rate
Mikroreditbank own offering 3: Microleasing	MSME	2,000	3 years	Interest rate 5%

CBU = Central Bank of Uzbekistan, MSME = micro, small, and medium-sized enterprise, SME = small and medium-sized enterprise.

Source: Author's elaboration.

In 2018, there were 76 nonbanking financial institutions, including 36 MCOs and 46 pawnshops operating in the country.<sup>12</sup> Microcredit organizations cannot take deposits, and they are allowed to offer three microfinance products, namely, microcredit, microloans, and microleasing. The differences between these types of services relate to the size of the products and their purpose, as well as microfinance product recipients and a few other conditions; they are summarized in Table 8.7.

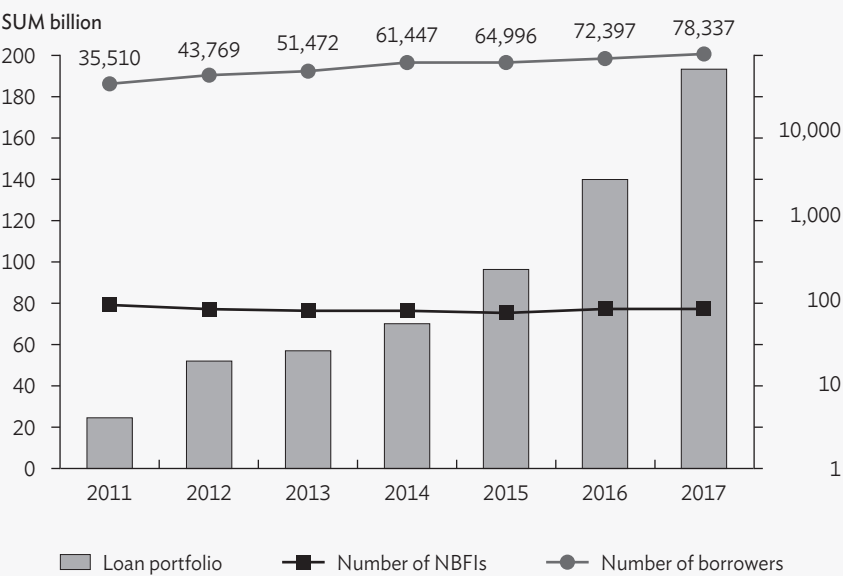
<sup>12</sup> Registry of Microcredit Organizations. <http://cbu.uz/uzc/kreditnye-organizatsii/mikroreditnye-organizatsii/>.

Table 8.7: Definition of Microfinance Services in Uzbekistan

	Microloan	Microcredit	Microleasing
Size	Up to 100 minimum wages <sup>a</sup> (approx. \$3,000)	Up to 1,000 minimum wages (approx. \$22,000)	Up to 2,000 minimum wages (approx. \$44,000)
Purpose	Not defined	Entrepreneurial activity	Entrepreneurial activity
Recipients	Natural persons	Registered businesses/entrepreneurs	Registered businesses/entrepreneurs
Conditions	Maturity Returnability May be interest free	Maturity Returnability Interest-bearing	Maturity Returnability Interest-bearing

<sup>a</sup> From 15 July 2018, the minimum wage size is established at SUM184,300 (approx. \$22).  
Source: Law on Microfinance of the Republic of Uzbekistan. <https://lex.uz/docs/4550926>.

Figure 8.14: Nonbanking Financial Institution Lending



NBFI = nonbanking financial institution.  
Note: Nonbanking financial institutions include microcredit organizations and pawnshops registered by the Central Bank of Uzbekistan.  
Source: Central Bank of Uzbekistan.

A recent World Bank study of opportunities for enterprise competitiveness in Uzbekistan suggests that smaller enterprises and unbanked markets are finding value from microcredit institution services.

A demand-side analysis of SMEs in Uzbekistan likewise points to limitations in their eligibility and appetite for bank services. A lack of real-estate collateral, limited financial capacity, and lack of credit history constrain these firms' access to formal bank credit, but the need for finance is currently addressed by microcredit institutions.

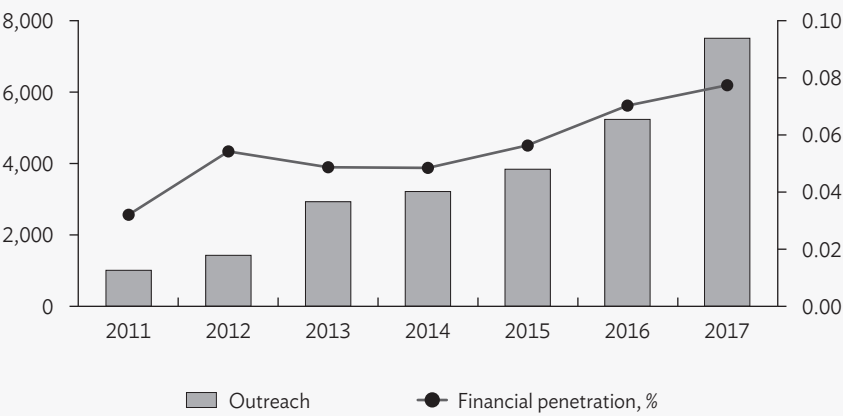
Commercial banks provide microcredit at concessional rates but require high rates of collateral and provide only noncash credit. Borrower requirements to access bank microcredit seem overly burdensome for the target borrowers, who may not be able to meet these requirements (provide financial statements, business plans, documented proof of repayment capacity, formal collateral, notarized confirmation of agreements, etc.). Commercial microfinance is not well developed either through banks or MCOs. All microfinance activities, both concessional and commercial, are strictly regulated.

Although MCOs offer simplified credit in cash and without collateral, they have low financial capacity and small loans. There is a gap between these two providers, and hence the financial needs of businesses (small and medium-sized) and entrepreneurs are not currently accommodated.

The microfinance market consists of 78,337 active borrowers. Following the Central Bank of Uzbekistan's requirement to increase the capital up to SUM2 billion (\$250,000), the MCOs were able to attract more capital financing and doubled their loan portfolio over 2015–2017. The outreach of microcredit organizations has shown a positive tendency since 2012, as well as financial penetration increasing from 5% to 8% over 2011–2017 (Figure 8.15).

The average size of microloans reduced from SUM5.3 to SUM4.5 million (equivalent to \$662–\$562) due to the growth of outreach in rural areas, while the average size of microcredit and microleasing increased by around 1.5 times from 2016 to 2017, which resulted in the increase of MCOs' capital and encouraged interest from small businesses (Figure 8.16).

**Figure 8.15: Microfinance Outreach<sup>a</sup> and Financial Penetration<sup>b</sup>**

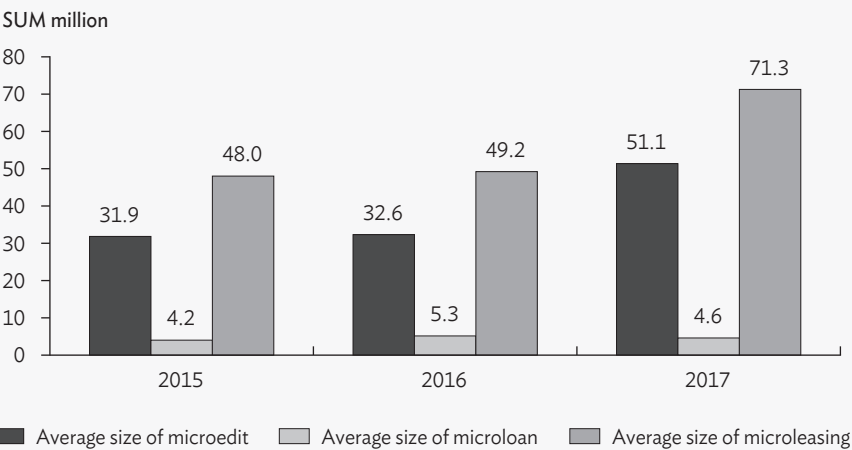


<sup>a</sup> In this context, microfinance outreach is considered as breadth of outreach. The breadth of outreach is captured by two variables: number of clients reached and number of loans provided.

<sup>b</sup> MFI penetration: number of borrowers served in a country with the entire population and with a share of the population defined as “poor.”

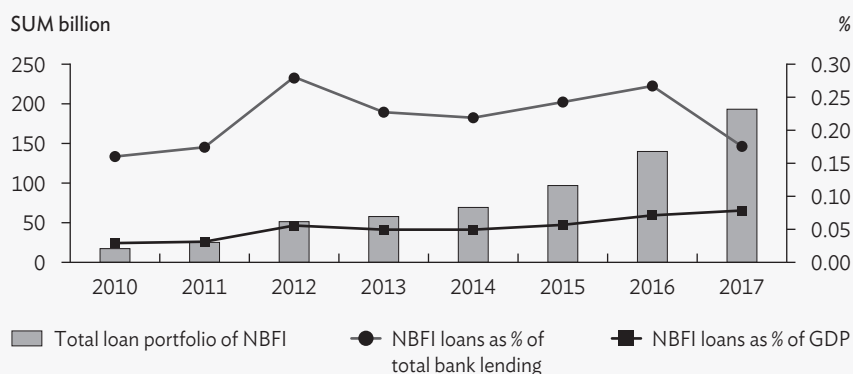
Source: Central Bank of Uzbekistan.

**Figure 8.16: Average Size of Microfinance Services**



SUM = Uzbekistan sum.

Source: Central Bank of Uzbekistan.

**Figure 8.17: Nonbanking Finance Institution Loans in Bank Lending**

GDP = gross domestic product, NBF = nonbanking financial institution, SUM = Uzbekistan sum.

Source: Central Bank of Uzbekistan.

MCOs are credit-only institutions that are not allowed to mobilize deposits or borrow from the general public; thus they pose no systemic risks for the financial system. MCO regulations focus heavily on prudential requirements, which seems excessive for these institutions. Similarly to banks, borrower requirements to access MCO products seem overly burdensome (in particular, collateral requirements similar to bank loans). Like banks, MCOs are limited in issuing cash-flow-based and uncollateralized microcredits—the features that are key for traditional microlending. It is an unlevel playing field—and they do not enjoy any of the benefits accorded to banks engaged in the provision of microfinance services (such as access to government funding and tax exemptions on microfinance activities with a social focus).

The government may want to consider developing a mechanism of linking MCOs to banks as they could play a complementary role to that of banks in terms of reaching customers that may not be accessible to banks. Even though MCOs are technically allowed to receive loans from banks for further on-lending, strict collateral requirements limit MCO borrowing from banks, and thus an alternative mechanism may be necessary.

**Leasing.** Leasing is another source of SME finance. Leasing provides a viable substitute for loans to finance equipment. Leasing costs more than bank lending but fewer guarantees are required from the borrower.

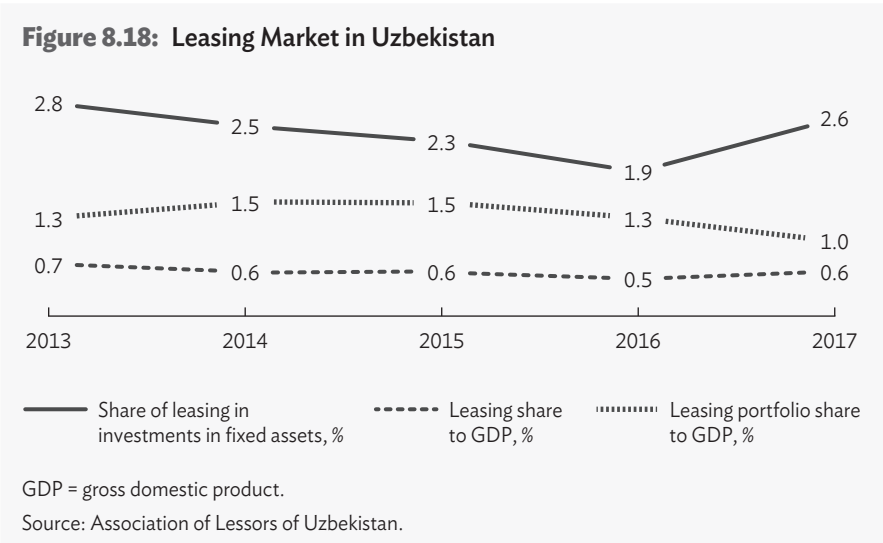


As of 1 January 2018, there were 126 officially registered lessors, of which 104 are leasing companies, the majority of which are state owned and 24 are commercial banks. The largest players in the Uzbek leasing market are state-owned companies including Uzagroleasing, the largest leasing company focusing on agricultural equipment, Uzmelyomashleasing company leases irrigation equipment, and Uzavtosanoat is involved in leasing commercial vehicles.

The clientele for leasing in Uzbekistan includes a growing array of service sectors, including large construction companies (which are engaged in building construction, power plants, and road development, for example), transport companies, chemical companies, medical service providers, manufacturers, and traders.

The leasing companies are primarily focused on providing high-tech equipment as part of the state program implementation of modernization of state-owned industrial enterprises. As Table 8.8 illustrates, 78.2% of the leasing portfolio belongs to the leasing companies, the volume of leasing transactions in 2017 comprised SUM2.68 trillion (\$337.5 million).

However, the leasing share to GDP during 2013–2017 amounted to less than 1%, that is less than half the median leasing volume of countries in the same income range as Uzbekistan (Figure 8.18). In this context, it seems that the sector is underdeveloped for the size of Uzbekistan’s economy.



**Table 8.8: Leasing Services Market, 2017**

	Leasing Portfolio (SUM billion)	Market Share	Volume of New Leasing Deals (SUM billion)	Market Share
Leasing companies	2,098	78.2%	963.8	62.0%
Commercial banks	585.1	21.8%	589.8	38.0%

SUM = Uzbekistan sum.

Source: Association of Lessors of Uzbekistan.

There is no licensing of leasing services, except for commercial banks that provide leasing services who are licensed as banks. There is no obligatory ratio of leased asset value to collateral value and no regulation on interest rates. Lease objects are exempt from property tax and lease payments are exempt from value-added tax; small enterprises had a holiday from lease profit tax until January 2017. Leasing contracts must be greater than 12 months' duration.

Although the regulation of leasing companies is fairly light, banks face some constraints in undertaking leasing operations. The CBU limits leasing activity to no more than 25% of banks' Tier-1 capital, making leasing relatively more costly for banks. Many banks split the activity into a child-company to avoid this limitation. Leasing companies owned by banks benefit from easier access to low-cost funding.

At the same time, the leasing market faces some growing pains that require further development, and some improvements in the legal framework would help. Like microcredit organizations, leasing companies often struggle to find long-term funding and there is a disproportional regional distribution of leasing services: compare the share of Tashkent city of 30% with regions that have from 3% to 9%.

In addition, there is a lack of knowledge among many potential customers about how leasing works and its potential benefits. One leasing company has conducted a market analysis and estimates that 80% of the potential market does not understand the product (the same company derives more than one-third of its customers through deals with suppliers). Also, clear and comprehensive rules for priority over property are needed.

In order to further promote growth of leasing, it is advised to consider building up a secondary market for leased objects and amending the Leasing Law to allow for secondary leases. Adoption of the law will provide a major boost to the industry. The regulator can support leasing further by relaxing regulations defining eligible objects to allow for greater variety of equipment and machinery.

**Foreign investments and external assistance programs.** International financial institutions (IFIs) such as the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the World Bank, the IFC, and KfW (German bank) have been actively providing credit lines to SMEs as well as more targeted business groups such as women businesses and horticulture farms. Given a high interest rate environment, significant unmet demand for SME finance, and limited government subsidy programs, funding from the international financial institutions is very important in Uzbekistan (Table 8.9).

**Table 8.9: International Financial Institutions Credit Lines to SMEs**

Name of Project	Donor	Time Frame	Budget
1. Small and Medium Enterprise Development Project	ADB	2001–2006	\$50 million
2. Small and Microfinance Development Project	ADB	2003–2010	\$20 million
3. Second Small and Microfinance Development Project	ADB	2010–2014	\$50 million
4. Small Business and Entrepreneurship Project	ADB	2014–2016	\$50 million
5. Small Business Finance	ADB	2017–2021	\$100 million
6. SME Finance – National Bank of Uzbekistan	EBRD	2017	\$70 million
7. Regional Small Business Program (RSBP)	EBRD	2018	€1.6 million
8. SME Finance – Ipoteka bank	EBRD	2018	\$25 million
9. SME Finance – Hamkorbank	EBRD	2018	\$20 million
10. SME Finance – Ipak Yuli Bank	EBRD	2018	\$20 million
11. SME Finance – Davr Bank	EBRD	2018	\$5 million
12. MSME Finance – Ipak Yuli Bank	International Finance Corporation	2018	\$15 million

ADB = Asian Development Bank, EBRD = European Bank of Reconstruction and Development, MSME = micro, small, and medium-sized enterprise, SME = small and medium-sized enterprise.  
Source: Author’s elaboration.

Among multilateral donor institutions, ADB has been the most active in financing SMEs through two partner commercial banks—Hamkorbank and Ipak Yuli Bank—over the past decade. Within the framework of these projects with participating financial institutions (PFIs), funds for SMEs' working capital and fixed assets financing were channeled to developing agriculture, production, and services in rural areas to create jobs. The capacity of PFIs in credit underwriting and analysis also improved so that more than 6,000 micro and small enterprises were trained in financial literacy. Capacity building from these projects suggests that PFIs need to be provided with longer-term funds for lending to small businesses, rural outreach, risk management, and continuous enhancement of their entrepreneurial capacity.

Currently, the EBRD is one of the IFIs actively lending to SMEs through commercial banks. The EBRD currently provides five credit lines for SMEs totaling around \$140 million and large-scale technical assistance to strengthen the institutional capacity of the partner banks on MSME lending. Their support has added impact by encouraging other private banks to continue lending, expanding their portfolios to benefit businesses. The EBRD is involved in improving the competitiveness of small enterprises in Uzbekistan through its Business Advisory Services and the Enterprise Growth Program. The EBRD jointly with the European Union launched the Regional Small Business Program in 2018 aimed at transferring know-how in financing MSMEs throughout Central Asia. This is a platform for SMEs and financial institutions to exchange information and knowledge. The project will equip financial institutions in Uzbekistan with new digital business tools for effective work with small businesses.

In addition, international financial institutions also consider providing assistance to improve the wider lending environment by supporting regulatory frameworks and developing overall lending infrastructure, and introducing digital technologies to upgrade and expand lending to small businesses.

### **8.1.3 | Uzbekistan Regulatory Framework, Tax Regimes, and Financial Infrastructure**

Uzbekistan is in its second year of a wide-ranging, market-oriented program of reforms in accordance with the National Development Strategy, a 5-year action plan for 2017–2021 period. The government is making three fundamental shifts to the economy: from a command-and-control to a market-based economy; from a public sector-dominated to a private sector-driven economy; and from being inward-looking and isolationist to becoming outward-looking and open. These reforms are taking place amid growing external imbalances and a youth bulge that cannot be tackled without more jobs from the private sector (Tashkent Times 2017).

This initiative sent a clear signal on priorities: the private sector will be the key driver for economic growth and job creation in Uzbekistan going forward. Currency liberalization, as noted above, has been a major step toward an effective and enabling business environment. On 5 September 2017, the CBU unified Uzbekistan's exchange rates and President Mirziyoyev promised to maintain freely floating market rates thereafter. The Uzbek sum immediately dropped from the official rate of SUM4,210 per \$1 to SUM8,100 per \$1, so that the black market shank, albeit not entirely. If reforms in this area continue to be rigorously implemented, a market exchange rate will remove the single largest obstacle to the efficient operation of a market-based economy in Uzbekistan. While recent reforms to foreign exchange restrictions and the currency devaluation have substantially improved the business environment for SMEs, a number of challenges exist to expanding or establishing new SMEs.

**Taxation.** The tax system of Uzbekistan is developing in line with the country's course of reforms. Currently, Uzbekistan is implementing tax policy reform,<sup>13</sup> the goal of which is to reduce the tax burden on the economy, and eliminate imbalances in the tax burden between small and large businesses. The Tax Policy Improvement Concept aimed at the radical simplification of our extremely complicated tax system by reducing the number of taxes and tax regimes; unifying tax payment rules for different categories of taxpayers; simplifying tax reporting; abolishing a number of inefficient tax and customs breaks; and introducing a procedure for permanent benefits in the Tax and Customs Codes. Table 8.10 describes the tax rate changes from 2017 to 2019.

From 1 January 2019, a simplified procedure for calculating and paying value-added tax has been introduced for SMEs with a turnover of up to SUM3 billion.

In addition, the procedure is a transitional measure, which will be introduced before 1 January 2021, and the procedure for calculation and payment is voluntary.

In addition, Uzbekistan introduced a modern form of tax control—tax monitoring—which provides for an extensive information exchange between tax authorities and conscientious taxpayers, with the provision of comprehensive assistance in solving current tax issues.

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<sup>13</sup> Decree of the President of the Republic of Uzbekistan on Measures to Radically Improve Tax Administration, Increase the Collection of Taxes and Other Mandatory Contributions dated 18 July 2017.  
Degree of the President of the Republic of Uzbekistan on Tax Policy Improvement Concept, UP No. 5468 dated 29 June 2018.

**Table 8.10: Taxation System in Uzbekistan**

	2017	2018	2019
Profit tax	7.5%	14%	12%
Tax on dividends	10%	10%	5%
Personal income tax	23%	22.5%	12%
Simplified VAT for small business	–	–	4%–15% <sup>a</sup>
VAT	20%	20%	20%
Unified social tax	15%	15%	12%
Single tax payment for small business and private entrepreneurship	5%	5%	4%
Property tax for legal entities	5%	5%	2%
Tax on social infrastructure	8%	Abolished	

VAT = valued-added tax.

<sup>a</sup> The tax rate depends on types of activities.

Source: State Tax Committee 2018.

Due to these efforts, Uzbekistan's tax ranking improved by 14 positions from 2018's results: Uzbekistan took 64th place in the Paying Taxes 2019 tax ranking (PWC 2019).

According to the study, the total tax rate of Uzbekistan is 32.1%, which represents the proportion of taxes and contributions to the company's profits.

This indicator is lower than the average for the countries of Central Asia and Eastern Europe (32.8%), and also significantly lower than the average for the countries of the Organisation for Economic Co-operation and Development (OECD) (40.2%).

In terms of the annual amount of time required to tax compliance, Uzbekistan's indicator (181 hours) is inferior to OECD countries (162 hours), but it is ahead of most of the countries of Central Asia and Eastern Europe (the average for the region is 220 hours).

The number of tax payments per year is 10. For the countries of Central Asia and Eastern Europe, this figure is 16 payments, while for OECD countries—11 payments. The world average is 24 payments per year.

The measures taken to improve taxation have significantly reduced the tax burden on small businesses, which entailed the development of production, expansion of investment activities, increased employment, reduced the taxpayer's compliance, and increased the efficiency of tax administration.

**Customs policy.** Customs reform in 2018 has significantly simplified and sharply reduced the costs related to foreign trade. Uzbekistan significantly cut its import tariffs, to attenuate the ensuing inflation and enhance competitiveness. As observed earlier, import tariff rates for about 8,000 out of 10,800 items were reduced (tariffs were eliminated for about 5,000 items) to mitigate the adverse effect on import-intensive companies (and prices) and to improve the competitiveness of the economy. As a result, the simple average tariff was reduced from 15.2% to 6.3%, whereas the trade-weighted average went from 13.9% to 5.9%, as not all groups saw their tariffs reduced homogeneously. This broad reduction in tariffs has provided a strong stepping stone for an ambitious agenda on trade liberalization; the authorities are taking initial steps to broaden their reach and reinitiate their World Trade Organization accession process. The customs procedures will be streamlined and improved to lower costs and administrative burdens for exporting SMEs after the adoption of a new edition of the Customs Code in 2019.

**Licenses and permits.** Due to the reform,<sup>14</sup> a new Law on Permit Procedures was adopted, pursuant to which 7 licenses and 35 permits were abolished. Procedures of issuing licenses and permits were significantly simplified. Fees for licenses and permits decreased significantly.

**Public services.** Uzbekistan established the Agency for Public Services under the Ministry of Justice in order to provide public services to business entities according to the One-Stop Shop principle.<sup>15</sup> Small businesses can obtain 16 types of public services, such as business registrations, permits, and licenses, through 194 one-stop centers. These measures were aimed at abolishing the requirement to visit other government agencies, eliminating red tape, and reducing the cost of doing business.

<sup>14</sup> Decree of the President of the Republic of Uzbekistan UP-5409 on Measures to Further Reduce and Simplify Licensing and Permitting Procedures in the Sphere of Entrepreneurial Activity, and Improving the Conditions of Doing Business, dated 11 April 2018. [http://lex.uz/Pages/GetPDFView.aspx?lact\\_id=3676962](http://lex.uz/Pages/GetPDFView.aspx?lact_id=3676962).

<sup>15</sup> Resolution of the President of the Republic of Uzbekistan PP on Additional Measures on Improving Mechanisms of Rendering State Services to Business Entities, of 1 February 2017 N IIII-2750. [https://www.norma.uz/sobraniya\\_zakonodatelstva/sobranie\\_zakonodatelstva\\_n\\_5\\_f\\_June\\_2,\\_2017](https://www.norma.uz/sobraniya_zakonodatelstva/sobranie_zakonodatelstva_n_5_f_June_2,_2017).

These reforms led to an improvement in Uzbekistan's ranking in the World Bank's 2019 *Doing Business* Report, from 166th position in 2012 to 76th in 2018.

The country has improved its rating in only four indicators. Uzbekistan climbed by one place in Dealing with Construction Permits, two places in Registering Property, and three places in Trading Across Borders (World Bank 2019a).

The country also made trading across borders faster by introducing an electronic application and payment system for several export certificates, reducing the time for export documentary compliance. Uzbekistan still needs to improve its ranking in several areas such as Getting Credit (60th), Resolving Insolvency (91st), Dealing with Construction Permit (134th), and Trading across the Borders (165th).

**Financial infrastructure.** As discussed earlier, the Government of Uzbekistan introduced a number of reforms to enhance the financial infrastructure in the country. Substantial progress was made in upgrading the legal and regulatory framework for financial infrastructure. Upon adoption of the Law on Sharing Credit Information in 2011, the first local, private credit bureau, the Credit Information and Analytical Center, was established, which is also a positive sign for the development of the financial market. There is substantial empirical evidence that private credit bureaus are correlated with easier access to finance, while the existence of public credit registers does not show an impact on access (Love and Mylenko 2003). The Credit Bureau is licensed and supervised by the CBU, and currently includes information from 28 banks, 76 nonbank financial institutions, and one leasing company. Reporting is mandatory, and requires prior consent of the borrower. There is no limit on the size of loans reported. This helps increase the reliability of information on legal entities. The bureau covers 8.1 million natural persons and 647,000 legal entities (Figure 8.19).

From year to year, the number of requests received by the Credit Bureau from financial organizations is increasing, which is due to a significant increase in the volume of lending to the population within the framework of state programs for the entrepreneurship development and rural housing program, as well as the expansion of retail banking by commercial banks (Figure 8.20).

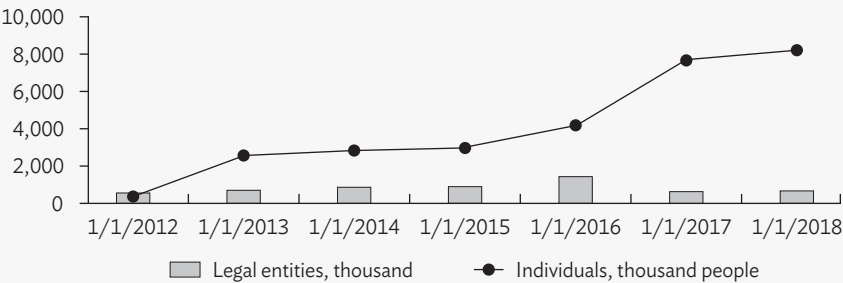
In order to realize the potential value of credit information in Uzbekistan, the international credit rating agency (CRIF) (Italy)<sup>16</sup> signed a strategic partnership agreement with the Credit Information Analytical Center (CIAC) to develop a credit bureau in Uzbekistan.

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<sup>16</sup> <https://www.crif.com>

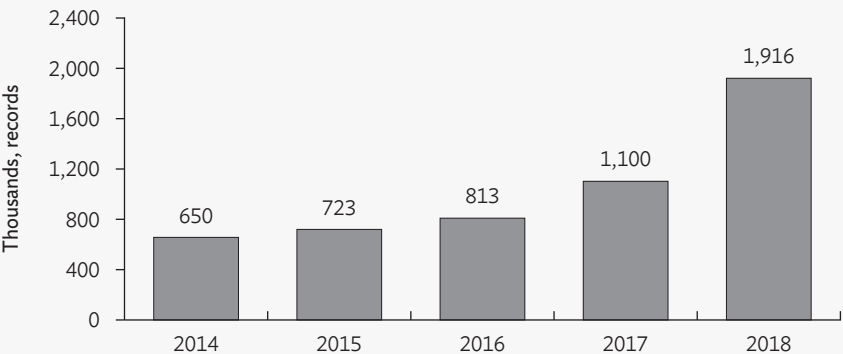


**Figure 8.19: Credit Bureau Coverage**



Source: Credit Information and Analytical Center 2018.

**Figure 8.20: Database of Credit Histories**



Source: Central Bank of Uzbekistan 2019.

This initiative is part of the Financial Infrastructure Project in Uzbekistan implemented within the framework of the World Bank Group–IFC Finance & Markets Global Practice. Under the agreement, CRIF owns 35% of the share capital of the private–public partnership company.

CRIF is committed to transferring technology, knowledge and experience to CIAC as well as providing efficient services to improve the credit assessment process in the country. The partnership between CRIF and CIAC aims to facilitate the introduction of state-of-the-art services to analyze credit risks.

**Secured transactions.** As part of the IFC, the Azerbaijan and Central Asia Financial Inclusion project on strengthening financial markets infrastructure supported the drafting of a legal framework on a secured transaction system. The Law on Collateral Registry was enacted in 2014. The publicly accessible, unified, online registry was launched in 2015 under the CBU. This established the types of security and creditors' rights to be notified to the registry, and provides quick notification of secured creditors' status to parties claiming an interest.

Over 418,000 registrations have been made by the users in the Collateral Registry, 157,000 registrations have been made in connection with the fulfillment of the collateral obligations and over 85,000 registrations have been excluded from the Collateral Registry. Also, more than 38,000 statements were provided by the Collateral Registry to its users.<sup>17</sup>

The commercial banks made 94.5% of the entries in the Collateral Registry and 5.4% were made by microcredit organizations.

## 8.2 Status of Financial Inclusion for SMEs

Financial inclusion is crucial to enabling Uzbekistan's population of all backgrounds to have equitable and affordable access to vital credit and savings. However, the financial inclusion sector is nascent and remains in the very early stages of progress, with numerous constraints impeding the expansion of access to financial services, particularly amongst households. In September 2018, Uzbekistan joined the Alliance for Financial Inclusion—a global network of financial sector regulators from more than 90 countries.

Strong progress has been made on financial sector development, especially between 2011 and 2014<sup>18</sup> but there is still room for development. The Global Findex 2017 demonstrates the low level of access and usage of financial services in Uzbekistan compared to the lower-middle income countries and Europe and the Central Asia region (Ahunov 2018) (Table 8.11). It should be noted that 37.1% of the population have a bank account; in reality, they are holders of payroll debit cards. Importantly, the list of transactions conducted by these cards is limited.

<sup>17</sup> Central Bank of Uzbekistan. 2018. <https://www.garov.uz/ru/news/otchet-o-deyatelnosti-gosudarstvennogo-unitarnogo-predpriyatija-zalogovyyj-reestr-pri-centralnom-banke-respubliki-uzbekistan-za-2017-god>.

<sup>18</sup> World Bank Global Findex data 2017.

**Table 8.11: Financial Inclusion in Uzbekistan**

Indicator (% age 15+)	UZB		TAJ	KGZ	KAZ	ECA	Lower-Middle Income
	2014	2017	2017			2017	2017
Financial institution account	40.7	37.1	47.0	39.9	58.7	65.1	56.1
Saved at financial institution in past year	1.8	2.3	11.3	3.0	13.9	14.4	15.9
Borrowed from financial institution in past year	2.2	2.4	15.5	10.2	28.2	24.2	9.8
Made or received digital payments	37.8	34.2	43.9	36.1	53.9	60.4	29.2
Used mobile phone or Internet to access account	NA	6.7	8.3	5.8	18.2	23.1	8.3
Use an account to receive private sector wages	NA	3.0	6.3	5.2	16.3	21.2	5.5

ECA = European Central Asia, KGZ = Kyrgyz Republic, KAZ = Kazakhstan, NA = not available, TAJ = Tajikistan, UZB = Uzbekistan.

Source: World Bank Global Findex data 2017.

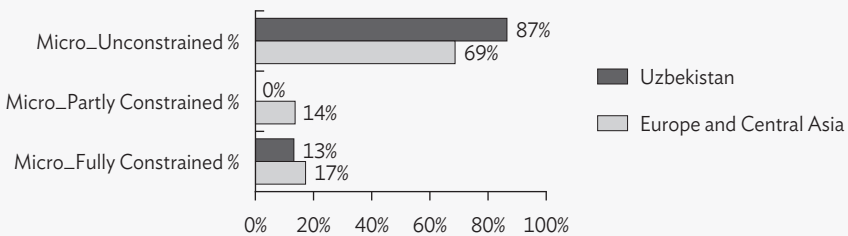
Inclusion indicators clearly show a lag compared to neighboring countries. Uzbekistan scores significantly lower in crediting, savings, accounts held by the poorest 40%, account remittances and receiving private sector wages. Digital payments have been spurred by distribution of payment cards for government wages; 17% of adults with an account opened their first account to collect public sector wages. There has been substantial growth in access to credit by SMEs in the past years, approaching the regional average indicators, but demand-side analysis shows that most enterprises in this segment still operate without credit and, according to survey results, only around one quarter of SMEs have a bank loan and more than 80% finance their investments through internally generated funds, a share that is significantly higher than in other countries in Central Asia (EBRD 2018).

Lack of public trust in the financial system poses a real threat to its deepening and broadening, as it deprives the system of the funding support required for its development. As the 2018 IFC, SME Finance Forum, and World Bank survey stated, 72% of micro and small entrepreneurs avoid keeping their savings in a bank, with the main reasons for not using the deposit services of the banks being having no trust in banks (28%) and an inability to draw cash 22% (225).

The majority of entrepreneurs stated that they would rather personally monitor their savings than keep them in banks.

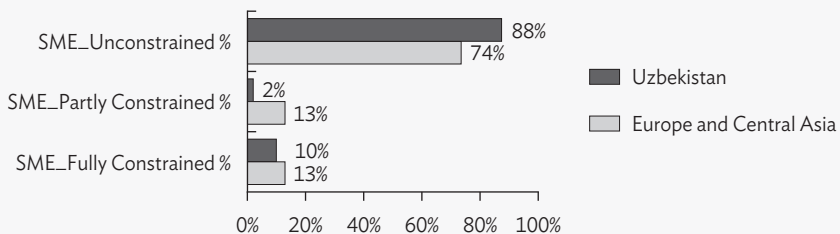
According to the MSME Finance Gap Report 2017, credit-constrained firms are classified in two categories: fully credit constrained and partially credit constrained. About 13% of surveyed microenterprises and 10% of surveyed SMEs are defined as fully credit-constrained firms, i.e., those that have no source of external financing. The latter include both those whose applications for loans were rejected and those that were discouraged from applying either because of unfavorable terms and conditions, or because they had no confidence their applications would be approved (Figures 8.21 and 8.22). The terms and conditions that discourage firms include, among others, complex application procedures, unfavorable interest rates, high collateral requirements, and insufficient loan and maturity size (World Bank 2017).

**Figure 8.21: Financially Constrained Microenterprises**



Source: World Bank 2017.

**Figure 8.22: Financially Constrained SMEs**



SMEs = small and medium-sized enterprises.

Source: World Bank 2017.

Of the SMEs surveyed (IFC 2018), 2% are determined as partially credit-constrained firms, e.g., those that have external financing, but were discouraged from applying for a loan from a financial institution and firms that applied for a loan that was then partially approved or rejected. Nearly 87% of surveyed Uzbekistan MSMEs indicated that they do not have any difficulties accessing credit or do not need credit since they have sufficient capital either on their own or from other sources. This also includes firms that applied for loans that were approved in full.

### 8.3 Financial Knowledge and Skills of SME Entrepreneurs

There has been no study conducted on assessing financial literacy in Uzbekistan. The only evidence comes from Standard & Poor's 2014 Global Financial Literacy Survey, which shows that Uzbekistan has a much lower financial literacy rate (21% of the adult population are financially literate) compared to other economies in transition (Ahunov 2018).

There is no comprehensive financial education program led by a government agency. However, the government has addressed the problem of inadequate financial literacy in some political documents, such as the Welfare Improvement Strategy 2013–2015<sup>19</sup> and Strategy for Action 2017–2021.

There have been several initiatives supported by international organizations to enhance the financial literacy of various groups of the population jointly with nongovernment organizations and commercial banks. These initiatives included a variety of programs at the national level while also targeting specific groups, including students and youth, women, migrant families, small-farm holders, communities in remote areas, and vulnerable groups of the population. However, there are no data on how the project outcomes affected financial behavior of the project beneficiaries and the economy.

During the International Conference Financial Inclusion and Financial Literacy as a Pillar of Sustainable Economic Development, held on 23 November 2018, it was announced that the new project is launched with the support of the Alliance for

<sup>19</sup> [http://www.nationalplanningcycles.org/sites/default/files/country\\_docs/Uzbekistan/wis\\_spbn\\_2013-2015eng.pdf](http://www.nationalplanningcycles.org/sites/default/files/country_docs/Uzbekistan/wis_spbn_2013-2015eng.pdf)

Financial Inclusion and the World Bank aimed at supporting the CBU on drafting the financial inclusion strategy, including the national strategy on financial literacy.<sup>20</sup>

Recently, a new program was launched by the Chamber of Commerce and Youth Foundation for promotion entrepreneurship among business-minded youth.<sup>21</sup> The program includes training, coaching, and mentoring, as well as consulting services for youth business start-ups in business plan development and preparing the loan documentation required by the banks.

The funding provided by the National Project Management Agency to the amount of SUM50 billion (\$6 million) will be channeled through four banks.

## 8.4 Barriers to SME Finance

Despite ongoing reform,<sup>22</sup> Uzbekistan's economy is still viewed as one of the most restricted economies, and ranks 152nd among 178 countries, according to the Heritage Foundation Index of Economic Freedom 2018 (Miller, Kim, and Roberts 2018). Uzbekistan is ranked 37th among 43 countries in the Asia and the Pacific region, and its overall score is below the regional and world averages.

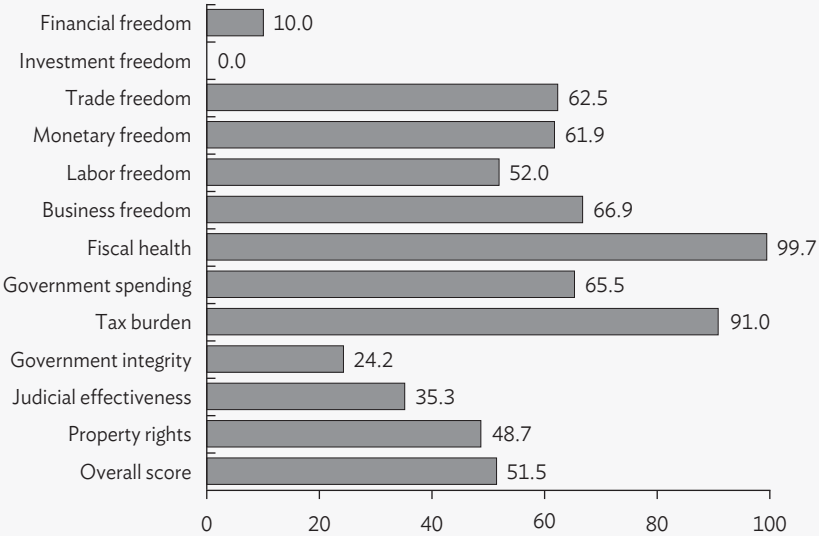
One of the lowest ranks on investment freedom can be explained by insufficient property rights stipulated by obsolete provisions of primary legislation (Constitution, Civil Code, Land Code, etc.) and inadequate regulatory framework for commercial activity. The high corruption (Transparency International 2017) (ranks 154th) and very low rule of law and regulatory quality indicators (World Bank 2018) significantly determine the investment climate. Rule of law is a necessary condition to improving financial inclusion and underpins many of the more granular concerns detailed later on. Public trust in an impartial judicial system is crucial to a business environment.

<sup>20</sup> [http://www.uza.uz/ru/society/finansovaya-dostupnost-i-gramotnost-factory-ustoychivogo-eko-26-11-2018?ELEMENT\\_CODE=finansovaya-dostupnost-i-gramotnost-factory-ustoychivogo-eko-26-11-2018&SECTION\\_CODE=society&print=Y](http://www.uza.uz/ru/society/finansovaya-dostupnost-i-gramotnost-factory-ustoychivogo-eko-26-11-2018?ELEMENT_CODE=finansovaya-dostupnost-i-gramotnost-factory-ustoychivogo-eko-26-11-2018&SECTION_CODE=society&print=Y)

<sup>21</sup> <https://ru.sputniknews-uz.com/society/20180628/8691273/V-Uzbekistane-budut-vydavat-besprotsentnye-kredity-na-podderzhku-startapov.html>

<sup>22</sup> Decree of the President of the Republic of Uzbekistan. 2012. On Measures for Further Cardinal Improvement of the Business Environment and Greater Freedom of Entrepreneurship. Dated 18 July 2012; Decree of the President of the Republic of Uzbekistan. 2015. On Measures to Ensure Reliable Protection of Private Property, Small Business and Private Entrepreneurship, Removal of Obstacles for their Accelerated Development. Dated 15 May 2015.

**Figure 8.23: Uzbekistan Ranking According to Index of Economic Freedom, 2018**



Source: Heritage Foundation 2018.

As Figure 8.23 illustrates, financial freedom is very low due to heavy government intervention in Uzbekistan’s financial sector. Large state-owned banks (10 out of 28) hold nearly 85% of industry assets, with the largest state-owned bank holding a 25% share. Until recently, state-owned banks operated mainly as agents of government programs, and disproportionately lend to state-owned enterprises (over 50% of their portfolios).

The CBU actively regulates the interest rates on loans and “recommends” interest rates on deposits. As a result, bank interest rates are often below real inflation.

Another example of government intervention is supporting economically insolvent enterprises by securing financial recovery from commercial banks.<sup>23</sup>

<sup>23</sup> Decree of the President of the Republic of Uzbekistan on Measures to Further Improve the Financial Stability of Enterprises of the Real Sector of the Economy, No. 4053 of 18 November 2008.

A number of factors affecting the development of small businesses were highlighted by the SMEs in Fergana Valley during the focus group discussions in July 2018. Such factors can be summarized as high transaction costs, both formal and informal; lack of financial literacy; difficulties in accessing start-up capital; high cost of banking services; and stringent conditions for loans.

Banks are limited to a narrow range of credit products to SMEs, with many enterprises not seeing banks as relevant to their financing needs. Due to collateral requirements by banks, SMEs may be denied credit despite having sufficient cash flow or purchase orders, or SMEs may be able to access only short-term credit facilities and not the type of financial products they need. For instance, such standard banking services as equity finance, factoring or longer-tenure loans are not offered (ADB 2014).

It should be noted that, due to the absence of nationwide data collection and analysis of SME financing needs, the level of government awareness of SME financing needs is quite low. The absence of impartial and professional research/studies of SME financing needs inevitably leads to an untargeted and inadequately allocated state support.

**Supply-side constraints** affect the willingness to lend to SMEs, the suitability of products and services to meet the needs of SMEs, and the sources of finance in the market. The contributing factors to these constraints are presented below, based on focus group discussions with SMEs.

(i) *High cost of bank credit*

Around 80% of the total number of the entrepreneurs interviewed indicated a high interest rate on loans as the main problem for SME development. The market rates of credit for small businesses are in nominal and real terms high, due to high administrative costs of originating loans resulting from overly regulatory requirements for documentation of loans and high credit risk. But given the high deposit rates and the weak currency, nominal rates for small loans in local currency between 28% and 36% are justified. The Central Bank refinancing rate is 16%. There are high rates for foreign currency loans (12%–16%). The interest rates are not affordable for any medium- or long-term production investment.

(ii) *Delivery mechanism*

The channels for financial service delivery do not meet the needs of small businesses, particularly outside the city of Tashkent. Along with high costs of financing, the banking sector has limited capacity for developing alternative channels for service delivery.



The focus group discussions led to an overall view that SMEs would prefer to do most of their banking through online and mobile platforms. During individual interviews, SMEs reported they would like to get loans online, rather than making a trip to a bank branch. Costs of transportation and time spent accessing financial services are additional limiting factors, especially for women entrepreneurs. Due to the lack of information and communication technology infrastructure (ITU 2017),<sup>24</sup> the banks are not able to provide distance services.

(iii) *High collateral requirements and cost to collateral registration*

Data from the Collateral Registry suggest that over 98% of all loans issued since 2015 have been secured by hard collateral (real estate, fixed assets—94% of all loans) or cash deposits (4%). Other forms of loan security have not been widely used. This is problematic for microfinance borrowers who do not have acceptable collateral.

According to global statistics (Bowman 2016), collateral was required in an average of 78.9% of all loans, and in Uzbekistan, collateral was required in 96.5% of loans (international practice is 80% of loans), with an average of 175% loan-to-value ratio compared with 128% for large companies.<sup>25</sup>

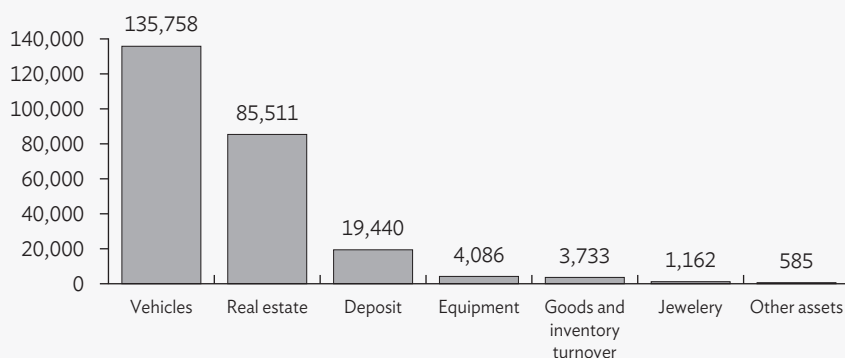
As demonstrated in Figure 8.24, banks are using the limited range of collateral to secure a loan, which increases the impact of the high collateral requirements on SMEs' eligibility to borrow, and the overall process remains time-consuming for the borrower. The process of registering collateral is comparatively hard; for example, the client has to personally register movable collateral, and then leave the original receipt with a notary. Immovable securities need to be notarized, with some notaries requesting proof of insurance and requiring the client to arrange and pay for an evaluation of the collateral's value by a third party.

Banks offer third-party guarantors, but they are difficult to find for first-time borrowers, as they are often considered a high risk. Insufficient collateral limits the size of loans and constrains entrepreneurs' access to larger loans for business expansion and capital investments.

Alternative sources of collateral and security, such as future cash flows, business reputation, third parties, or group guarantees, are rarely considered acceptable. In stakeholder and focus group discussions, insufficient collateral was cited as the single greatest impediment to borrowing.

<sup>24</sup> Uzbekistan ranks 95th in the ICT Development Index (2017).

<sup>25</sup> <https://tradingeconomics.com/uzbekistan/value-of-collateral-needed-for-a-loan-percent-of-the-loan-amount-wb-wb-data.html>

**Figure 8.24: Assets Used as Collateral in Uzbekistan**

Source: IFC Movable Assets Lending in Uzbekistan 2017.

(iv) *Lack of alternative sources of SME financing*

This is a significant factor affecting the credit situation for SMEs. Banks are not able or willing to meet the full demand for enterprise finance and SMEs need different types of finance. An imperfect legislative and regulatory environment hinders alternative sources of SME finance and the development of nonbank financial institutions, venture funds, crowdfunding, capital markets, and inter-firm financing mechanisms. All these institutions could play a larger role in SME financing than they do, operating in underserved areas and filling in important financing gaps based on proximity and flexible operations. The major constraint on these services developing is excessive government intervention in banks' activities and an overregulated banking system.

(v) *Overregulated financial sector*

Uzbekistan's banking system is highly regulated through an opaque and complex series of regulations. Many of these regulations are formal legislation from the legislative body, but others are guidance from the executive branch in the form of decrees and proclamations. As a result, loan and credit extension is highly regulated and there is no possibility of financial innovation. Existing regulations and the banknote shortage place legal and practical restrictions on cash transactions while SMEs—mainly individual entrepreneurs engaged in trade—need cash loans or at least loans that can be used for payments at card terminals. Only allowing direct transfers from the bank to the lender's supplier is very inflexible, especially for inventory finance.

*(vi) Product and services segmentation is weak*

Very limited financial services and products are adapted to different stages of SME growth (e.g., newly established, young and growing, maturing or mature, etc.). SMEs that are using similar products, notwithstanding their financing needs, are often different. Apart from the fact that start-up financing is extremely limited, so start-ups usually apply to microcredit organizations for microloans or private moneylenders lending at higher interest rates. It can be difficult for SMEs to mature into competitive, growth-focused businesses because financial markets are not particularly well organized to offer a continuum of financing options (e.g., trade credit, factoring, leasing, equity, etc.) that firms can use to develop their business.

*(vii) Lack of SME financing expertise*

Many state-owned banks have inadequate expertise in analyzing undocumented cash flows of businesses, so their lending processes and products are not adapted for the pattern of those cash flows. The supply side is not the only source of constraints limiting access to finance, and there is no lack of negative sentiment in the SME community about the lack of financing.

## 8.4.1 | Demand-Side Constraints

*(i) Low financial literacy and business skills*

SMEs lack adequate training, knowledge, and skills for effective business management, preparation of realistic business plans and debt management. This leads to weak business risks management, an increase in the cost of doing business, and limits access to bank loans. Small businesses have limited access to business development services that contribute to the efficiency, profitability, and expansion of their activities. Weak financial literacy, especially among women's small businesses and low-income groups, limits their access to financial services and constrains their entrepreneurial capacity.

*(ii) Limited knowledge of the availability and impact of business development services (BDS)*

Around 60% of surveyed SMEs in Uzbekistan could not name any private BDS provider and almost none were aware of the existence of third-party providers, such as nongovernment organizations or business associations (CER 2013). This is especially true for SMEs operating in the regions, where 70% of SMEs do not know any private BDS providers. Public-private dialogue, and especially the role of business associations in promoting BDS, remains limited.

Moreover, the perception of an overall poor quality of services offered by certified BDS providers, as well as of poor capacity of government-related bodies, leads to a limited use of such providers.

(iii) *Lack of knowledge on financial products, markets, technology, and legislation*

This affects the efficiency of SME businesses and limits their access to finance. Misperceptions about the banks, and the financial system in general, appear to have led to a lot of negative sentiment about banks among SMEs. SMEs often lack market information, such as on prices and trading volumes, which limits their ability to prepare reliable business plans and forecast cash flows. This challenge is very significant due to the absence of an online portal for SMEs on new legislative changes or incentives provided by the government.

## 8.4.2 | Gender Constraints

While access to finance remains a business constraint for both men and women, evidence seems to suggest that women face higher hurdles, particularly for those who own micro and small enterprises. According to ADB's Uzbekistan Gender Assessment Update (ADB 2018), besides existing constraints, women-owned SMEs face a mix of other challenges that combine to make the situation even more aggravated for them.

These include gender bias, socioeconomic constraints, and lack of access to business networks. For example, women can have trouble posting adequate collateral because of the way in which their marital property (collateral) is often registered—e.g., as joint property or in their spouse's name alone. They can face negative prejudice from lenders about their capacity and commitment to succeed in the “tough” world of business. They can sometimes have difficulty in building reputational collateral or demonstrating a consistent track record running their business as a result of family obligations, such as taking care of children, which may cause them to take a time off. They also lack access to business networks that are often male-dominated and/or poorly organized.

It should be noted that there is no official definition of women-led businesses and a lack of comprehensive reporting of sex-disaggregated data on MSME ownership makes it difficult to conduct gender analysis of the characteristics of MSMEs in order to increase the number (and share) of women-owned MSMEs and implementing strategies to remove barriers to the growth of existing women-owned enterprises, such as through actions to strengthen their production and product quality, business management skills, and capacity to access markets, including supplier arrangements with large-scale enterprises.

## 8.5 Status of Domestic and Global Value Chains in Uzbekistan

Agriculture is one of the sectors of Uzbekistan's economy, contributing 25% to the country's GDP, and providing a third of national employment and almost half of total export earnings. Uzbekistan continues to be the major supplier of fresh and processed fruit and vegetables to regional and global markets.

Horticulture is an important part of agricultural production, although the subsector accounts for only about 16% of aggregate arable lands, in contrast to grains (47%) and cotton (37%). Selling fruit and vegetables is among the most profitable activities for both *dehkan* (smallholder farms)<sup>26</sup> and more commercial farms. The economic importance of the subsector is therefore significant, considering that it accounts for more than 35% of the agricultural export value. Uzbekistan has become a major producer of horticultural products in the region, placing the country among the world's top 10 exporters in several categories of fruit, vegetables, and nuts. According to the Food and Agriculture Organization (FAO) statistics, Uzbekistan's exports of dried apricots are the second largest in the world, while exports of fresh apricots from Uzbekistan are the fourth largest, plums the seventh largest, cabbage the eighth, and raisins the ninth largest worldwide. The country is the sixth-largest producer of cherries, and 17th in apple production; production of peaches and grapes from Uzbekistan is the 10th largest in the world (FAO 2018).

Despite delayed returns and higher investment costs, horticultural crops generate revenues to farmers that are significantly higher than wheat and cotton (World Bank 2017).

The government has also made further efforts to liberalize the horticulture sector by adopting a new resolution,<sup>27</sup> which allows horticulture farmers and agricultural enterprises to sell their products directly in domestic and foreign markets.

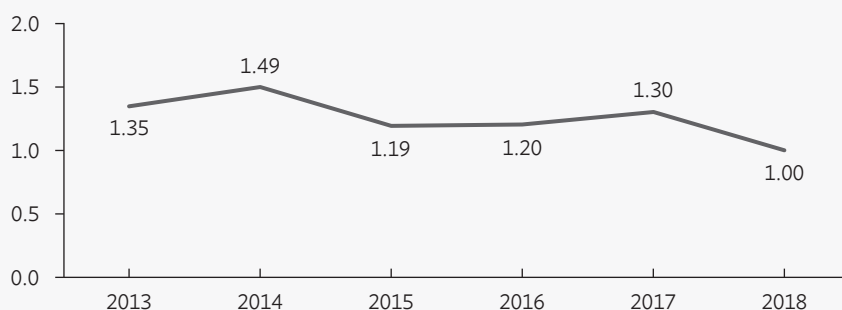
<sup>26</sup> *Dehkan* farms (smallholder farms) are small family-based agricultural producers, who grow and sell agricultural products, which are produced on a parcel of land allocated to the head of the family for lifetime lease as a personal merit. *Dehkan* farms numbered 4.8 million as of 1 January 2019.

<sup>27</sup> Resolution of the President of the Republic of Uzbekistan No. PP-3077 dated 21 June 2017, on Measures on Further Supporting Domestic Exporter Organizations and Improvement of External Economic Activity had opened up a new stage in the advancement of production and exporting the agricultural output in Uzbekistan.

By 2020, the government aims to have converted over 200,000 hectares into horticulture production, away from cotton and wheat.<sup>28</sup>

According to the Ministry of Agriculture, Uzbekistan has trade ties with more than 80 countries and exports 180 different varieties of fresh and processed fruits and vegetables. Uzbekistan annually exports fresh and dried fruit and vegetable products in the amount of about 700,000 tons. Uzbekistan exports only 5%–6% of all produced fresh agricultural products. In terms of value, this indicator varies depending on the conjuncture of the main markets. The main markets for Uzbek products are Kazakhstan (67% of total exports), the Russian Federation (17%), Afghanistan (5%), the Kyrgyz Republic (2%), and other countries (9%). Horticultural export revenues have more than tripled, from about \$500 million in 2006 to almost \$1.2 billion in 2016 (World Bank 2018) (Figure 8.25).

**Figure 8.25: Value of Exports of Horticulture Produce Nationwide (\$ billion)**



Source: Ministry of Agriculture and State Committee of Statistics.

Uzbekistan exports to the Russian Federation and Kazakhstan because of proximity and lower quality thresholds, though margins are far higher in Europe and East Asia. Uzbekistan aims also to expand the marketing of fresh and processed horticulture products to other countries, including Japan, the Republic of Korea, Saudi Arabia, the United Arab Emirates, as well as the European Union countries.

<sup>28</sup> Decree of the President of the Republic of Uzbekistan No. PP-2460 of 29 December 2015 on Measures for Further Reforming and Development of Agriculture for the Period of 2016–2020.

During 2017–2021, the production of food products is expected to increase by 140%, including fruit and vegetables and grapes by 140%.

Exports of fruit and vegetable products in 2021 will increase by 230% compared to 2016, and the export of fruit and vegetable processed products by 200%.

The main players of the horticulture chain include growers, market consolidators or brokers, wholesalers or traders, exporters, processing companies, supermarket chains, retail markets, transportation enterprises, market administration, and others (Hellin and Meijer 2006).

Growers include: (i) a large group of rural smallholding households (*dehkans*), (ii) private (or commercial) farms, and (iii) agricultural enterprises (agrofirms). *Dehkan* farms, according to the State Statistics Committee, account for more than 90% of horticulture production, while occupying 65% of total sown area under vegetables (excluding melons), 43% under melons, and 20% under fruit crops (including grapes).

*Brokers or consolidators:* They are responsible for properly harvesting, sorting, grading, and packing as per customers’ demand.

*Wholesalers:* Local wholesale markets, specialized trading companies, wholesale logistics centers to collect and transport products to the chain supermarkets in the cities.

*Exporters:* National and private enterprises.

*Processing companies:* Horticulture products processing companies, specialized in either extracting, drying, caning, and processing.

*Supermarket chains:* Food supermarket enterprises and large retail networks (Korzinka, Makro, etc.).

*Transportation:* Large to single-owner transportation enterprises are involved in the transportation of horticulture products from sites of production to processing centers, wholesale markets, and then to retail distribution and export terminals.

Table 8.12 presents the strengths, weaknesses, opportunities, and threats (SWOT) analysis of the horticulture value chain based on survey of value chain players.

**Table 8.12: SWOT Analysis of Horticulture Value Chain**

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Different varieties (22 species of fruit, 37 varieties of grapes, and 17 species of vegetables)</li> <li>• Abundant fruit and vegetables for further processing</li> <li>• Opportunity to produce organic fruit</li> <li>• Lower cost of main inputs, including fruit and vegetables</li> <li>• Favorable climatic conditions for growing fruit and vegetables; 300 sunny days per year</li> </ul>	<ul style="list-style-type: none"> <li>• Unstable supply of gas and electricity to the production lines of agroprocessors</li> <li>• Lack of auxiliary inputs, such as packaging and labels</li> <li>• Lack of quality control, certification, and market research</li> <li>• Low availability of adequate infrastructural facilities</li> <li>• Outdated irrigation systems</li> <li>• Limited access to good-quality land, specialized horticulture machinery, appropriate inputs, access to either equity, or long-term debt financing</li> <li>• Lack of refrigerated facilities and logistics</li> <li>• Lack of agriculture insurance scheme</li> <li>• Lack of effective transport links to the potential world food markets</li> <li>• Difficulties with implementation of quality control in the processing sector</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• Areas significantly increased due to gradual shift from the traditional crops (cotton and wheat)</li> <li>• Large production base offering a vast potential for agroprocessing activities</li> <li>• Economic growth of potential importer countries and increased demand for organic food will enhance export potential</li> <li>• Economic relations with developed countries can help to receive advanced technologies</li> <li>• Implementation of tax benefits will help to get access to new export markets via attracting large foreign companies</li> <li>• Improving the attractiveness of rural areas through the development of infrastructure will boost transfer of business in rural areas</li> </ul>	<ul style="list-style-type: none"> <li>• Lack of vertical and horizontal cooperation among value chain participants</li> <li>• High inventory carrying cost and high package cost</li> <li>• Possible natural disasters, particularly seasonal droughts, aging cost</li> <li>• Climate change</li> </ul>

SWOT = strengths, weaknesses, opportunities, and threats.

Source: Author's elaboration.



There is a need to support the existing initiatives and to further facilitate the development of different promising sericulture and cotton value chains, the livestock value chain (meat and dairy production), and the bee-keeping value chain, all of which are expected to contribute to the significant growth of rural jobs, food security, and exports.

## 8.6 Value Chain Financing Analysis

Value chain finance refers to the flows of funds to and among the various links within a value chain. It relates to any or all of the financial services, products, and support services flowing to and/or through a value chain to address the needs and constraints of those involved in that chain, be it to obtain financing, secure sales, procure products, reduce risk and/or improve efficiency within the chain (USAID 2016).

Due to a lack of expertise in value chain financing of the commercial banks and existing regulatory limitations, the ability of SMEs to integrate into global value chains is limited (OECD 2013). The international financial institutions initiated value chain financing on the request of the Government of Uzbekistan aimed at developing several agriculture value chains. According to the World Bank estimates, the demand for investments in the horticulture value chain is of \$1 billion<sup>29</sup> while there is also a high demand for credit in the livestock value chain.<sup>30</sup>

As mentioned earlier, the key problems for development of the horticulture value chain, as well as other agricultural produce value chains (like meat and milk, processed food, water, juices and beverages, etc.) lie in very poor progress in the change of policies in the agricultural production sector. Further challenges include a lack of market mechanisms, as evidenced by the government monopoly over agricultural land, and the absence of efficient reforms of the entire sanitary and phytosanitary (SPS) system. The absence of efficient food chain practices based

<sup>29</sup> Project appraisal document on a proposed loan in the amount of \$150 million to the Republic of Uzbekistan for a horticulture development project (International Bank for Reconstruction and Development 2014).

<sup>30</sup> Project appraisal document on a proposed credit in the amount of \$120 million equivalent and a proposed loan to the amount of \$30 million equivalent to the Republic of Uzbekistan for a livestock sector development project (International Development Agency and International Bank for Reconstruction and Development 2017).

on international standards and the New and Global Approach “from field to fork,” deters the process of the development of the value chain in the agricultural sector. Yet, the prospects for development are quite high, provided that the government takes concrete steps towards the modernization of the SPS system, revising its SPS laws and removing prevailing government intervention in production processes. The private sector cannot develop with such a dominant government role, and, as a result, no real prospects for value chain financing will emerge.

The projects described in Table 8.13 focus on developing the business models of value chains, improving the quality and volume of agricultural production and post-harvest handling and production, facilitating market linkages, and linking educational institutions with private sector demand.

**Table 8.13: International Financial Institutions’ Projects  
Financed Value Chain Development**

International Finance Institution	Target Groups	Timeframe	Budget
International Fund for Agriculture Development (IFAD) Horticulture Development Project	Smallholder farmers, processors, and service providers in the horticultural subsector	2013–2017	\$30 million
World Bank Horticulture Development Project	Small <i>dehkan</i> farms with up to 5 ha of household plots per farm, and private farms with land size not less than 5 ha per horticultural farm	2015–2021	\$183 million
World Bank Horticulture Development Project phase 2	Small <i>dehkan</i> farms with up to 5 ha of household plots per farm, and private farms with land size not less than 5 ha per horticultural farm	2018–2021	\$500 million <sup>a</sup>
Asian Development Bank (ADB) Horticulture Value Chain Development Project <sup>b</sup>	Farmers and large agriculture enterprises	2017–2021	\$154 million
ADB Horticulture Value Chain Development Project phase 2	Farmers and large agriculture enterprises	2018–2021	\$198 million <sup>c</sup>
ADB Horticulture Value Chain Infrastructure Development Project	Horticulture clusters	2019–2023	\$197 million <sup>d</sup>

*continued on next page*

Table 8.13: Continued

International Finance Institution	Target Groups	Timeframe	Budget
World Bank/European Union Livestock Value Chain Development Project <sup>e</sup>	Smallholder farmers (farming households and <i>dehkan</i> ) and private farms and firms engaged in livestock production and processing	2017–2023	\$150 million
IFAD Dairy Value Chains Development Program	Small <i>dehkan</i> farms and commercial dairy farms	2016–2023	\$24 million
United States Agency for International Development Agriculture Value Chain Development Project	Farms, <i>dehkan</i> farms	2007–2011 2011–2015 2015–2018	\$14 million

ha = hectares.

<sup>a</sup> See <https://www.uzdaily.com/articles-id-45518.htm>.

<sup>b</sup> See <https://www.adb.org/projects/47305-002/main>.

<sup>c</sup> See <https://www.adb.org/news/adb-strengthens-support-uzbekistans-horticulture-sector-198-million-additional-financing>.

<sup>d</sup> See <https://www.adb.org/projects/documents/uzb-51041-002-rrp>.

<sup>e</sup> See <http://documents.worldbank.org/curated/en/128331504722189404/Uzbekistan-Livestock-Sector-Development-Project>.

Source: Author’s elaboration.

## 8.7 Policies to Promote SME Finance

The Government of Uzbekistan is committed to SME development, and, as was discussed in earlier sections, has undertaken significant reform measures to improve the enabling environment, and encourage its expansion with the objective of creating jobs. Efforts have been made to address the various challenges confronting SME development, as the main creators of new jobs and employment opportunities. Improving their access to finance, as well as their access to business development services, has been a key priority on the government’s agenda.

Government programs supporting SMEs include interest rate subsidies on loans and fiscal incentives (tax holidays, tax and customs duties exemptions), as well as direct lending to targeted industries such as manufacturing. An example of such a program is the State Program on Localization for the production of quality competitive import-substituting products.

State support for SME development, including access to finance, is specified in the Law on Guarantees of Freedom of the Entrepreneurial Activity (new edition)<sup>31</sup> of 2 May 2012 No. 328 and the Law on Family Business<sup>32</sup> of 26 April 2012 No. 327. According to these laws, the main areas for SME state support are as follows:

- Formation of favorable legal and regulatory business environment
- Financial and investment support and provision of subsidized lending and guarantees
- Assistance for creation and development of support infrastructures
- Business information and consultancy support
- Export promotion
- Support for introducing innovations and modern technologies
- Support for participation in public procurement

Despite the efforts of the government over the past years to increase private sector participation in the economy, there is still no comprehensive SME support policy framework. Current SME support policy measures are based on 138 President Resolutions and Decrees, 280 Resolutions of the Cabinet of Ministers, and 646 legal acts of various ministries and government agencies. As survey participants noted, they encountered situations of legal collisions when one legislative act contradicts another, thereby reducing the effectiveness of state support measures. Therefore, there is a need for an SME development strategy that will stipulate state support measures and indicate the responsible institutions for implementing them.

The current SME support ecosystem in Uzbekistan involves many stakeholders representing public institutions, nongovernment organizations, and international development organizations.

Several government agencies are responsible for formulating, financing, and implementing policies and activities aimed at supporting the development of SMEs in Uzbekistan (Table 8.14).

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<sup>31</sup> <http://lex.uz/docs/2006777>

<sup>32</sup> <http://www.lex.uz/acts/2004954>

Table 8.14: SME Support Institutions

Policy Level	Institutional Level	
<ul style="list-style-type: none"><li>• Government institutions</li><li>• Ministry of Economy and Industry</li><li>• Ministry of Investment and Foreign Trade</li><li>• Ministry of Innovation Development</li><li>• National Agency for Project Management</li><li>• Antimonopoly Committee</li></ul>	<ul style="list-style-type: none"><li>• SME support government institutions</li><li>• Entrepreneurship Development Support Fund</li><li>• UzTrade</li><li>• Small Businesses and Private Entrepreneurship's Export Promotion Fund under NBU</li><li>• UZAgroexport</li></ul>	<ul style="list-style-type: none"><li>• Business support organizations</li><li>• SME support institutions (financial and technical assistance)</li><li>• International organizations (ADB, EBRD, EU, UNDP, USAID, World Bank, etc.)</li><li>• Business NGOs, such as Chamber of Commerce, Business Women Association</li></ul>

ADB = Asian Development Bank, EBRD = European Bank for Reconstruction and Development, EU = European Union, NGO = nongovernment organization, SME = small and medium-sized enterprise, UNDP = United Nations Development Programme, USAID = United States Agency for International Development.

Source: Author’s elaboration.

The local governance offices (*khokimiyats*) are responsible for implementing SME policies at regional and local levels. It is acknowledged that the coordination of SME policies is weak at both national and regional levels. Duplication of functions and overlapping initiatives are frequent. Resources to the SME sector are being directed through various channels. Apart from the special State Fund for Entrepreneurship Development, the Ministry of Innovation Development and Mirzo Ulugbek Innovation Center<sup>33</sup> are conducting a program on promoting entrepreneurship in scientific, technical, and innovative fields and creating the conditions for entrepreneurs to carry out research and innovation activities concerning innovative business.

Such state trading enterprises and entities as Uztrade, Export Promotion Fund for SMEs, and Export Promotion Bureau under Uzstandard Agency provide assistance to the SMEs in looking for international clients, export marketing, certification of products, and conducting the banking and customs formalities for exports.

<sup>33</sup> <https://muic.uz/>

The Ministry of Economy and Industry is implementing the SME development at regional and local development, including introducing innovations: products, technologies, etc. Recently, the State Committee on Investments launched the first online survey<sup>34</sup> to monitor the efficiency of government measures to improve the business and investment climate.

These agencies deal with different aspects of SME development, so there is significant overlapping. In addition, due to a lack of donor coordination, overlapping technical assistance is also observed at the national and regional level, where it affects international assistance. However, the institutional framework lacks a comprehensive mandate for an SME development agency to be the transmission chain of policies to SMEs—including, for example, facilitation.

One of the supporting policies and measures carried out by the government in 2017 is setting up the Entrepreneurship Development Support Fund,<sup>35</sup> which established the framework of the credit guarantee system for SMEs in supporting lending to SMEs and improving the financing environment. The guarantee fund will be placed in the State Fund for Support of Entrepreneurship Development, which was established under the auspices of the Cabinet of Ministers in August 2017 and became operational in early 2018.

During 9 months of 2018, the credit guarantee system provided 418 SMEs with a credit guarantee amount of SUM269.6 billion for loans disbursed in the amount of SUM740.2 billion. These partial guarantees are provided for up to 50% of the loan amount, which should not exceed SUM2 billion (equivalent to \$250,000).

The fund charged the commission 1% of the loan amount as a one-time payment for issuing the guarantees.

It is premature to make an assessment as to whether the operation of the credit guarantee system is effective, since the credit guarantee provided for subsidized loans disbursed through state-owned banks and the absence of an operational plan for ensuring the guarantee scheme sustainability.

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<sup>34</sup> [https://docs.google.com/forms/d/e/1FAIpQLSdaYG8Zfuq9SWs3HscpleRUKquDjL2o8sGMIw16oXUqUGAJ\\_w/viewform](https://docs.google.com/forms/d/e/1FAIpQLSdaYG8Zfuq9SWs3HscpleRUKquDjL2o8sGMIw16oXUqUGAJ_w/viewform)

<sup>35</sup> Resolution of the Cabinet of Ministers of the Republic of Uzbekistan No. 195 dated 19 May 2000 on Additional Measures to Promote Participation of the Commercial Banks in Small Business Development.

The results of the study demonstrate that the current approach to SME development lacks strategic focus and the institutions supporting SMEs lack coordination and have a limited understanding of stakeholders' roles and actions regarding implementation, monitoring, and evaluation policy objectives due to the lack of a single strategy.

The state financial support to SME is translated into subsidizing interest rates, according to the Law on Guarantees of Freedom of the Entrepreneurial Activity. The government has made several subsidized financing vehicles available for SMEs since 2000. The first vehicle is known as the Fund for Preferential Crediting. The government required state-owned and private banks to create this fund. To create it, the bank reserves up to 25% of its profits to be used for this purpose. The Fund for Preferential Lending permitted loans up to 5 years at 50% of the refinancing rate established by the Central Bank. In return, the government provided tax exemptions and other privileges for commercial banks to compensate for foregone revenues when interest rates on loans are subsidized.<sup>36</sup> The second vehicle is known as "banking microcredits." The concept of microcredits was introduced by the Central Bank in 2002. They set the maximum amount of a microcredit available to an SME both in local and foreign currency to \$5,000 for individual entrepreneurs and *dehkan* enterprises without legal entity status, and to \$10,000 for an SME with a legal entity status. Regardless of the source of financing (i.e., even if this is the bank's own capital not set aside for preferential lending) the rate on all microcredit cannot exceed the Central Bank's refinancing rate. One of the positive features of microcredit is that it may be issued up to 50% in cash. While microcredit may be attractive for an SME, it is not, however, very attractive for the bank, typically when making loans with their own resources.

There are no available data that show how SME access to finance has improved due to the government policy measures, the number of beneficiaries of subsidized lending programs, how this subsidized lending program impacted SME access to finance, and how demand and supply have changed over time. The lack of data also makes it difficult to monitor the effectiveness and efficiency of government reform measures—for instance, whether they have reached targeted beneficiaries and/or alleviated core barriers. As stated in a World Bank technical note, there is no evidence that subsidized loan programs have been effective in targeting low-income households, and there is the possibility that, in some cases, subsidized loans are being allocated to those who need the loans least (World Bank 2007).

<sup>36</sup> <http://lex.uz/docs/312605#694347>; <http://lex.uz/docs/312605>.

According to the 2018 International Monetary Fund report, about 60% of credit was allocated at preferential terms (IMF 2018). The CBU's refinancing rate reliably affects the terms of credit extended at commercial terms to the domestic-currency segment; this segment accounts for only about 20% of the outstanding credit stock. Lending at preferential terms depresses banks' profitability, and a less segmented credit market would therefore reduce the need for regular capital injections to maintain banks' capital buffers.

The existing practice of providing preferential loans creates unequal conditions for doing business, contributing to the destruction of the competitive environment. After all, enterprises that receive loans on preferential terms have competitive advantages over enterprises that are forced to pay very high interest rates for loans, or are forced to abandon borrowing, because they cannot afford such expensive loans.

In 2017, the Government of Uzbekistan abolished the previous practice that had been taking place since 2000. Currently, preferential loans are allocated to the amount of up to 150 times the minimum monthly wage (equivalent to \$3,420) as the start-up capital for newly registered individual entrepreneurs and family businesses without legal entity status in remote and inaccessible areas, as well as in areas with excess labor resources. The subsidized lending programs set interest rate benchmarks on loans that are below inflation rates. The government launched the state program "Every Family is an Entrepreneur." The first stage started in the Andijan region.<sup>37</sup> This new program is making a significant push for low-cost credit to households to spur economic activity that leads to self-employment and micro-entrepreneurship (Table 8.15).

The approaches are strongly focused on the supply of credit to asset—and equipment—induced entrepreneurship, including the supply to agribusiness-related home-based businesses (greenhouses, pedigree cattle, sheep, catfish fingerlings), as well as sewing machines and other equipment involved in small manufacturing of consumer products. The CBU sets up the targets for SME financing under this program.

The significant amount of low interest credit flowing to households under the program offers both an opportunity and a challenge to ensure that the program leads to the development of the micro-enterprise support ecosystem in addition to credit.

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<sup>37</sup> Resolution of the President of the Republic of Uzbekistan PP 3777 dated 7 June 2018. <http://lex.uz/docs/3772866>.



**Table 8.15: Financing Scheme under State Program “Every Family is an Entrepreneur”**

Beneficiary	Purpose	Loan Amount	Interest Rate	Term and Grace Period	Security
Individuals	Family business organization	Up to 150 times minimum wage (\$3,420) <sup>a</sup>	8% <sup>b</sup>	Up to 3 years with a grace period of up to 6 months	Recommendation of the head of the self-governance bodies  Banks insure the risk of loan defaults by themselves
SMEs (individual entrepreneurs, microfirms, and small enterprises)	Business start-up development and expansion	Up to 1,000 times minimum wage (\$22,810)			The guarantee of a third party or the State Fund for the Support of the Entrepreneurship Development under the Cabinet of Ministers, an insurance policy, a pledge, etc.
		Over 1,000 times minimum wage		Up to 5 years with a grace period of up to 2 years	The list of security determined by the legislation

<sup>a</sup> Minimum salary as of 1 October 2018 – SUM184,300; exchange rate \$1 = SUM8,079.28. <http://cbu.uz/uzc/arkhiv-kursov-valyut/>.

<sup>b</sup> [https://nrm.uz/contentf?doc=580536\\_postanovlenie\\_pravleniya\\_centralnogo\\_bank\\_a\\_ot\\_16\\_02\\_2019\\_g\\_n\\_310\\_o\\_vnesenii\\_izmeneniya\\_v\\_punkt\\_4\\_polojeniya\\_o\\_poryadke\\_vydeleniya\\_kreditov\\_v\\_ramkah\\_programmy\\_kajdaya\\_semya\\_-\\_predprinimatel\\_\(zaregistrirvano\\_myu\\_26\\_02\\_2019\\_g\\_n\\_3022-1\)](https://nrm.uz/contentf?doc=580536_postanovlenie_pravleniya_centralnogo_bank_a_ot_16_02_2019_g_n_310_o_vnesenii_izmeneniya_v_punkt_4_polojeniya_o_poryadke_vydeleniya_kreditov_v_ramkah_programmy_kajdaya_semya_-_predprinimatel_(zaregistrirvano_myu_26_02_2019_g_n_3022-1)).

Source: Resolution of the President of the Republic of Uzbekistan PP 3777 dated 7 June 2018. <https://lex.uz/docs/3772866>.

It should be noted that nonfinancial services, such as advisory services, business development, incubation, and market support, are underdeveloped—especially in rural areas. In addition to access to finance, available nonfinancial services are an important balance to the current efforts of the government’s support to SMEs. The State Committee on Investments allocated \$200 million to this program by attracting credit lines from international financial institutions. The funds are distributed to commercial banks through the National Bank of Uzbekistan.

As stated by the Chairman of the CBU,<sup>38</sup> the government plans to establish a special development fund, which will be financed by all state programs and perform subsidized lending, and the current practice of providing subsidized credit through commercial banks will be abolished.

In an effort to boost SME exports, the government created the Export Promotion Fund for Small Business and Private Entrepreneurship under the National Bank of Uzbekistan in 2013. The fund provides the following services: export marketing, support for the registration of export contracts with Uzbekistan's authorities, research on standards in target markets, legal services, and loans and financial services.

Taking into account the current economic reform, it is necessary to revise the SME finance policy framework and to provide tangible support to meet SME financing needs.

## 8.8 Conclusion and Recommendations

The Government of Uzbekistan views SMEs as a key sector for economic prosperity because of their potential to create jobs, decrease poverty, and ensure social and economic development. Analysis shows that SMEs create jobs in labor-intensive sectors, account for about 55% of the GDP, and provide almost 90% employment. However, in terms of access to finance, SMEs in Uzbekistan have lagged their counterparts in neighboring countries (Kazakhstan, the Kyrgyz Republic, and Tajikistan), as well as the European and Central Asian regions.

SMEs face many issues and barriers in accessing finance. The lack of financial products tailored to SMEs' needs, a shallow banking system, and the absence of alternative financing schemes are the major issues preventing SMEs from gaining greater access to external financing. In addition to inadequate financing opportunities, SMEs face onerous collateral requirements. As a result, SMEs have to borrow from financial institutions or use informal lending schemes at relatively high rates.

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<sup>38</sup> <https://www.gazeta.uz/ru/2018/11/24/banks/>

The financial market needs to be reformed to bring in more competition and make it accessible for SMEs. In this regard, there is an urgent need to improve the effectiveness of government SME financing through the restructuring and consolidation of subsidy programs in the government's development bank, and to eliminate interest rate subsidies for existing and sustainable enterprises.

An SME development agency should be established that regularly assesses SME financing needs and the effectiveness of policy measures. Policies must be reconsidered to create an enabling environment and level playing field for SMEs to access short-, medium-, and long-term finance. The government should develop a long-term vision for SME sector development, integrated into the overall social and economic development strategy of the country. The SME Development Strategy should adequately address gender inequalities, and the needs of women in business and gender aspects should be integrated into objectives, activities, and indicators to the SME strategy.

The experience of other developing countries, including neighboring Kazakhstan, shows that creating simple rules and a level playing field might be more important for creating a vibrant MCO sector than providing subsidized loans. Uzbek MCOs have had to develop in an overregulated environment. One of the most important obstacles they have to overcome is their inability to attract deposits and grow naturally as an intermediary between borrowers and lenders. MCOs in Uzbekistan have to rely on their founders for operational funds. One of the most important measures could be relaxing rules on accepting deposits for MCOs and disbursing credits in cash. Barriers to market entry and opening branches should also be reconsidered.

International financial institutions can become an important source of finance if the government introduces market-creating and market-expanding measures in the MFI sector. Given the mandate of IFIs to support SME development in their constituencies, they are interested in increasing their presence through lending and equity financing. These can take different forms such as direct lending to SMEs through MFIs, taking equity shares in MFIs, supporting start-ups and starting exporters, and, finally, cross-border trade facilitation.

SMEs do not have adequate or complete access to information regarding financing opportunities. Developing online platforms specifically tailored to the financing needs of SMEs could become a cost-effective way of providing access to such information. The platform should contain information on credit lines, leasing opportunities, financial guarantees, and grants. Through such platforms, further support could be provided on paperwork for loan applications and business plans.

The lack of MSME financial capabilities and business planning skills should be addressed by including activities in the design of the National Strategy for Financial Literacy and creating tailored tools to meet MSME needs.

The institutional capacity of the public credit guarantee fund should be strengthened by providing a partial guarantee and covering a percentage of the potential losses banks face when lending to SMEs. By doing so, the CGF will strive to achieve credit enhancement for SMES and thus facilitate access to growth capital with lower interest rates and longer maturities. The CGF should take a proactive approach in identifying clients, performing credit appraisals, and building the skills of partner financial institutions.

In the medium term, efforts should be made to build a whole ecosystem of SME finance, which includes venture capital companies, business angels, platforms for the emergence and communication of start-ups, and incubation and acceleration platforms. SME access to finance could be further improved by developing cash-flow-based lending, collateral alternatives, lending in cash, and better use of credit histories by developing credit scoring. In particular, removing certain prudential requirements for MCOs may include relaxing collateral requirements and removing the 10% of charter capital threshold on uncollateralized loan portfolio services. Providers should also be allowed to use goods for sale and future harvest as collateral (currently used for less than 0.1% of all loans), as these may be suitable options for many MSME finance borrowers.

In the long term, fundamental reforms on ensuring property rights and reducing government intervention and creating competitive financial markets should be implemented. In order to boost SME participation in value chains, it is important to stimulate specialization and cooperation of SMEs with large enterprises.

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