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PUBLIC AND SEMI-PUBLIC FINANCING OF SMALL-SCALE INDUSTRY IN ASIA

(A comparative analysis of institutions, policies and measures in the Republic of China, India, Japan, Republic of Korea, Malaysia, Pakistan, the Philippines, Singapore and Thailand)1/

by

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1/ Prepared in 1968 by Mr. Aburatani under a Special Service Agreement with UNIDO. The views and opinions expressed in this paper are those of the author and do not necessarily reflect the views of the Secretariat of UNIDO.

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INTRODUCTION

The capital of a country is made up of monetary savings collected through the financing institutions and Government postal savings, besides taxation and other involuntary savings by the Government. The total amount of financial resources available for industry varies from time to time and from country to country, but its ratio to gross national income is in the range of 30 to 60 per cent in the developed economies, and presumably 10 to 20 per cent in the developing countries of Asia.

In economies having organised financial markets, short-term working capital for business is provided principally by commercial banks, and long-term investment capital (in the form of bonds, debentures and shares) by the capital market grouping various kinds of financing institutions. The central bank can effectively regulate the flow of both short-term and long-term funds through its monetary and financial policy, having regard to the fiscal policy of the Government.

The capital market and various types of financing institutions are being progressively developed in the countries of the region, along with a system of central banking. However, they are not as yet fully developed. Commercial banks mainly facilitate short-term trade credit. Some of them belong to families of financiers and industrialists and work as a sort of financial department of the family enterprise and receive limited applications from the public. Due to the lack or underdevelopment of the capital market, long-term credit for private investment can generally be arranged only by merchant money lenders or relatives and personal friends at high interest rates. Money lenders are believed still to be important sources of industrial financing, besides their traditional role in subsistence and agricultural financing. To a limited extent, however, the people's monetary savings are mobilized as industrial capital through the financial mechanism.

Generally, in the developing countries of Asia and the Far East, the financing system developed on the basis of the British traditional principle of private laissez-faire banking. However, this principle gradually changed in the United Kingdom after the financial panics of the 1920s and 1930s and, after the last war, a similar change took place in the developing countries. With independence, national planning and mixed economy policies, varying degrees of government intervention became evident in Asian developing countries, ranging from nationalization of commercial banks in some cases to the establishment of strong ties between private banks and the central bank in other cases. Directors of commercial banks are sometimes designated by the Government or are required to be appointed with Government approval. The Government fiscal policy plays a considerable role in regualting the reservoir of local savings. Thus the development policy and its implementation are more effectively influenced by the Government fiscal policy than by the policy of the central bank. There is no country in Asia that has not established a sort of development bank with government contributions to its inital capital. In some countries fiscal policies provide incentive measures for development financing by private banks. As will be seen later, some development banks undertake the financing of small-scale industries.

The Development Bank, usually a governmental institution, aims at financing key industries and strategic sectors in order to implement the five-year or long-range development plan. It is provided with government funds and in many cases with foreign resources. The individual loan amounts are generally not small, and in some instances minimum limits of loans are prescribed. Long-term loans are often provided at favourable rates of interest. Loans are provided by the development bank in selected fields under criteria corresponding to the country's plan. The priorities of the loans granted by the development bank should correspond to those of the plan and are to a lesser extent governed by the applicant's financial position. The project-oriented development bank is indeed an executing agency of the Government development programmes. The commercial bank, on the other hand, advances loans under conventional principles of sound banking, i.e. in accordance with appraisal criteria of an applicant's financial and accountancy situation.

Recognising the importance of small-scale private enterprises, governments of the Asian developing countries have introduced or strengthened incentive measures to encourage local entrepreneurship, besides making arrangements for foreign financial resources to facilitate credit to the small-scale sector. Special schemes and institutions have been widely set up to facilitate financing of small-scale industries from around the latter half of the 1950s. The following reasons may account for the importance of small-scale industries in the region:

(i) they promote employment through labour-intensive techniques;

(ii) management is readily available for enterprises with small capital and simple techniques;

(iii) they may use local resources for the production of daily necessities (wage-goods) and of import substitutes;

(iv) small units may help in industrialising certain backward areas of a country;

(v) indigenous industries may be set up in backward and tribal areas;

(vi) some products may be manufactured for export; and

(vii) some small-scale industries may work as subcontractors of large key industries.

While the Government is responsible for implementing itself the part of the development plan concerned with the public sector, the plan for the private sector is often only a guideline, implementation depending on individual entrepreneurs. The different nature of the two sectors may often be blurred in a mixed economy. It is particularly difficult to implement the private sector investment plan earmarked for small-scale industries. Various encouragements and incentives for this sector are provided by the Government, among which public and semi-public financing schemes and institutions are predominant in Asian countries.

There is a technical reason for establishing a special machinery (other than the development bank) for the financing of small industries. The financing of small-scale industries involves usually smaller loans in larger numbers, with costly operational costs for the financing institution. Further, risks are usually greater than in the case of credit to big firms. It is therefore natural that commercial banks are reluctant to undertake this business. The development bank, which is an independent autonomous organisation, may also feel difficulties in making loans to small enterprises. Those development banks that do extend credit to small-scale industries have specific departments handling this business.

In many Asian countries, the Government plays a broad and sometimes a direct role in financing. In some countries, commercial banks are nationalised, all or part of the share capital being held by the Government. Some local institutions are assisted by international financing agencies, e.g. the World Bank and the International Finance Organization. Although some commercial banks may be classified in the category of public and semi-public institutions, the discussion will be focused on the financial departments of Government administrations and insitutions established by the Government and in which the Government holds all or part of the share capital and which have a declared policy of financing small-scale industries.

There is no common definition in the region of what constitutes small-scale industry. Many countries have definitions in terms of number of employees and/or amount of assets, sometimes in combination with installed electric power.[1/] However, these definitions are not necessarily applied by the governmental financing organisations. Instead, financing of small units may be subject to limitations on a single loan amount, as shown in Table I below. In actual practice an average small-scale industrial enterprise is likely to be an enterprise with capital assets of less than US$ 100,000, and the maximum limit of a loan for an enterprise is of the order of US$ 25,000. No definite demarcation is noted between medium-sised and small-scale enterprises, and loans are often made both to small and medium enterprises.

The public and semi-public financing institutions in the region have varied functions under their terms of reference: advancing loans, subscribing to shares and debentures. underwriting and guaranteeing. However the discussion in this paper is devoted to loan-making because, by and large, this function has been predominant in practice in all institutions and meets the most urgent need of small industries. In India, Japan and the Republic of Korea there are credit guarantee schemes. which, however, are not discussed in this paper.

1/ UN, ECAFE, Small Industry Bulletin No. 3.

Table I

Public and Semi-Public Financing Institutions for Small-Scale Industries in Selected Asian Countries

	Maximum limits on single loans
China, Republic of	
Small Business Division, Council for International Economic Co-operation and Development	From NT$ 200,000 (small loan) to NT$ 4,000,000
India	
State Financial Corporations	Rs. 1,000,000
National Small Industries Corporation	No limit for hire-purchase scheme[a]
State-Aid-to-Industries Programme	Rs. 100,000 Rs. 200,000
State Bank of India	No limit for liberalised scheme[a]
Japan	
Small Business Finance Corporation	¥ 30,000,000
People's Finance Corporation	¥ 3,000,000
Small Business Promotion Organisation	-
Korea	
Medium Industry Bank	Won 10,000,000

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a/ But only for enterprises which do not exceed the ceiling of the definition of small-scale industry, that is a maximum investment of Rs. 750,000 in machinery and equipment.

	Maximum limits on single loans
Malaysia	
Federal Industrial Development Authority	-
Malaysian Industrial Development Finance Ltd.	M$ 100,000
Majlis Amanah Rayaat (MARA)	-
Bank Bumi Putra	-
Pakistan	
Pakistan Industrial Credit and Investment Corporation	Rs. 100,000 to Rs. 250,000
Industrial Development Bank of Pakistan	Ditto
Small Industry Corporations (West and East Pakistan)	Ditto
People's Credit Scheme of the National Bank of Pakistan	Rs. 250 to Rs. 50,000
Philippines	
National Cottage Industries Development Authority (NACIDA), Department of Commerce and Industry	Pesos 1,000
Development Bank of the Philippines	₱ 2,000 - 10,000
Philippine National Bank	₱ 25,000
Singapore	
Light Industries Service, Economic Development Board	M$ 200,000
Thailand	
The Loans Office for Small Industries Development, Ministry of Industry	Baht 500,000
Industrial Finance Corporation of Thailand	-

I. INSTITUTIONAL ASPECTS

Direct Financing by Government Departments or Channelling of Government Funds through Financial Institutions

"State-Aid-to-Industries" legislation in the States of India is a system of direct government financing of small-scale industry. The system dates as far back as 1922, when it was first instituted in Madras. This type of financing is carried out by state governments with the support of the central government. At the outset this method of financing was not strictly reserved to small enterprises, but is now in full swing all over the states as a major policy instrument for the development of this sector. It is administered by the industry departments of the state governments. In Thailand, the Loans Office established only a few years ago as a bureau of the Ministry of Industry, is in charge of loan accommodation for small enterprises. The Loan Department of the Light Industries Services, one of the organisations attached to the Economic Development Board of the Singapore Government, is also of a similar nature.

In Japan, local governments may extend direct loans. In some cases, for example that of the hire-purchase scheme, they provide funds, leaving the lending operations to the care of private banks.

In India, Singapore and Thailand, the funds are provided by the Government, but the loans are generally channelled through a bank or other financing institution.

In India, a provisional arrangement is that applications for loans of less than a particular amount (Rs. 10,000 to Rs. 20,000) are taken up by the Director of Industries of a state under the government liberalised scheme for small-scale industries, whereas applications for loans exceeding this amount are dealt with by the

State Financial Corporation concerned if the applications are for medium or long-term credit. However, loan applications for working capital are usually handled by the State Bank or a co-operative bank. If the accommodation required is both for short and long or medium-term, the agencies concerned act in collaboration. A State Bank or a co-operative bank assists other financial institutions in evaluating the credit standing of the applicants. The Directors of Industries and the representatives of the Small Industries Service Institutes give such assistance by furnishing a technical report on the industrial unit.

In order to facilitate the implementation of the scheme each branch of the State Bank has entered into agency arrangements with State Financial Corporations under which the Bank acts as an agent in collecting credit reports, disbursing loans, collecting instalments, etc.

In 1959, the Bank entered into an agreement with the National Small Industries Corporation, under which small-scale industries securing orders from government sources with the aid of the Corporation, may receive 100 per cent advances from the Bank on the security of raw materials. The full amount advanced may be guaranteed by the Corporation.

In Singapore, government funds are channelled to small industries through commercial banks. The Light Industries Services (LIS) of the Economic Development Board deposits government funds to three commercial banks. Loan applications are submitted to LIS and lending is made by the commercial banks which are responsible for the recovery of loans. Loan risks, in principle, are borne by the lending banks with some exceptions.

In Thailand, government funds are deposited to the special account of the Krung Thai Bank, a government-sponsored commercial bank, which contributes its own resources on a matching basis to the account (the contributing ratio of the two was amended to 1 : 3 as from October 1969). Loan applications are accepted and examined by the Loans Office of the Government, whereas the bank provides loans after assessing collaterals, and is responsible for the redemption of the borrowings. The final decision on loans is made by the Loans Board, the members of which are designated by the Government. Loan risks are entirely borne by the Bank.

Financial aid to small enterprises through direct loans from the government, as compared with loans through external institutions, is desirable from the point of view of policy execution and utilization of government funds earmarked for the purpose. The most striking difference between direct government financing and institutional financing is that in the former case, overhead charges may not necessarily be added to the cost of loans. If overhead charges are absorbed in the general administrative expenses of Government, the cost of loans will certainly be reduced by that much to the advantage of the borrower. However, if government credit extends over a wide area and includes short- and long-term loans for various industries, it will often be beyond the capacity of public service personnel to operate the scheme efficiently. The Government's direct lending operations will therefore necessarily be confined to specific projects under certain conditions. Even when direct financing is limited in this manner, the persons administering it should receive special training and business methods rather than government administrative procedures should be followed. Where the government solicits the co-operation of private financial institutions in lending operations, the relationship between and respective obligations of the government department concerned and the financial institutions should be made very clear.

Self-Supporting Institutions

The government's financial aid to small enterprises is in many cases given by self-supporting institutions established independently of the government. The presidents and other officers of these self-supporting institutions may be appointed by the government. In some institutions, government officials hold the directorship concurrently. There are practical reasons for placing under government control the appointment of persons responsible for the administration and management of various institutions promoting and fostering the growth of small enterprises. There may be legal reasons too, since the government often holds all or the majority of shares of these institutions.

Self-supporting institutions generally bear the title of a corporation or a bank. They are established under special legislation and are granted privileges as far as taxation is concerned. As their title indicates, they are private law rather than public law corporations. This is true of the Small Business Finance Corporation and the People's Finance Corporation in Japan, whose capital is wholly provided by the Japanese Government. It is also true of certain banks engaged in development financing and of specialized financial institutions for small enterprises in many developing countries of Asia, which are financed wholly by the governments. Since the capital is provided by the government, profits are earned by the government and allocated either to a reserve fund or to government revenues.

In some cases, the capital funds of these self-supporting institutions are wholly furnished by government and in other cases supplemented by funds from other sources. Some development banks, e.g. the Industrial Development Bank of Pakistan (IDBP), operate with foreign investments in addition to domestic funds; in the case of the IDBP, small business financing is carried out through the Small Industries Corporations of West and East Pakistan.

Self-supporting institutions carry out varied activities. Some render financial aid as well as advisory services, e.g., the National Small Industries Corporation of India, and some engage in activities similar to those of ordinary banks, such as deposits and other general banking operations, e.g. the Medium Industry Bank of Korea.

Since self-supporting institutions follow the principle of standing on their own feet in doing business, they have a well-defined procedural framework withing which they can provide credit and other services to small entrepreneurs. As will be discussed later, their scope for financing and servicing is more limited than that of government departments. In extending financial aid to small enterprises, self-supporting institutions have to make some adjustments to normal banking and commercial criteria. On the other hand, if they depend on private sources of funds and foreign investments, they may have to follow more strictly conventional banking principles.

Some banks (for example, the State Bank of India and other nationalised commercial banks in India) are primarily designed to carry on general banking operations and act on a commercial basis even when they co-operate with the government in giving financial aid to small enterprises.

II. OPERATIONAL ASPECTS

Fund Resources

Government funds account for a major proportion of the funds supplied to small enterprises by public or semi-public institutions, but there are not a few cases where domestic private funds and overseas funds are also available. Examples of the latter are the State Finance Corporations of India, the Majlis Amanah Rayaat (MARA) of Malaysia, the

Medium Industry Bank of Korea and the Industrial Development Bank of Pakistan (IDBP). The government contributes initial funds at the time these institutions are established. Besides, it extends treasury funds in many cases on a long-term basis with or without compensation for supplementing the funds owned by the lending institutions. The volume of funds made available has much to do with the fiscal policy of the government, since government funds are derived from general revenues.

In addition, postal savings and pension funds are also used as loan resources, but in this case compensation has to be paid in the form of interest. Examples are in the Republic of China (Taiwan), Japan, Malaysia, Singapore and Thailand. In the case of Japan, additional financing is granted every year from these special accounts, and repayments are made to these accounts every five years.

Among government banks there are some which obtain private capital investments and some which raise initial funds by borrowing money from the central bank or by selling bank debentures (contingent debts) guaranteed by the government.

Some development banks carrying on small business financing as a sideline have foreign currency loans applied towards part of their fund resources as in the case of Pakistan. However, among financial institutions devoted to small business financing none at present, with the exception of the Medium Industry Bank of Korea and the National Small Industries Corporation of India, have foreign credit resources available for loans financing.

The question whether funds are with or without compensation (i.e. whether interest is to be paid on them by the institution) is a major factor in determining the interest rate which the institution concerned will charge on loans to small entrepreneurs. This cost, along with general administrative expenses, determines the cost of the funds lent. The size and extent of preferential financial treatment given to support the growth of small enterprises vary according to the conditions imposed to the financial institutions concerned. In the case of self-supporting institutions, preferential treatment to small industries will depend on the volume of treasury funds which the government can offer without compensation, because the direct costs of fund resources which the institutions own are the weighted average of the costs of the two types of funds - funds without compensation and funds with compensation. The input of treasury funds not only determines the volume of loans to small enterprises but also affects the rates of interest charged to them.

Besides the sources of funds mentioned above there also exist retained earnings (such as various reserves) and depreciation charges. In the case of institutions involved in deposit operations, deposits are naturally part of the funds available for lending. Few special institutions in Asian countries seem to complain about the shortage of fund resources, except in India, Japan and Korea, where there is an ever-increasing cry for additional funds to meet the increasing demand from small-scale clients. But it is generally true that many special institutions in Asia have not so far used fully their available funds and that few institutions have been in need of additional funds to meet increasing needs for loan. The following factors account for the situation: (a) many of these institutions have a relatively short history, (b) loan facilities are not widely known among the public, (c) field offices have not developed sufficiently to establish an effective network. The rather moderate interest of people in industrial ventures as compared with their interest in commercial activities may be a basic factor. The complicated and time-consuming procedures required for loan making at these institutions may also be one of the major reasons. It is necessary, therefore, to take a new look at the current loan conditions if the actual needs of small enterprises are to be met. On the part of institutions, constructive and progressive policies should be adopted, instead of conservative profit-motivated attitudes.

Government Guidance and Supervision

It is desirable that institutions operating on an autonomous basis should be freed from government intervention and given a free hand in management. However, since special institutions make loans to small enterprises as government agencies, it is only natural that they should be placed under the guidance of the government as regards policies and conditions. The volume of funds, in particular, is influenced by fiscal policy, and most institutions are given instructions on interest rates and other loan terms and conditions. The basic decisions on the management of these funds are approved by a committee which includes representatives of the government. It has already been mentioned in this connexion that government officials are represented on the Board of Directors of some institutions.

The government's guidance should be given in a general and indirect way, but the granting of individual loans should be left to the discretion of the institutions. The government, taking into account the needs of economic development and changes in the economic situation, should provide general guidance and advice and let the institutions respond to the actual demand from small enterprises. The government is the financial sponsor of the special institutions. It is therefore natural that the government should be interested in the sound management of these institutions and should carry out a degree of supervision with a view to ensuring healthy operation. There are, however, limits to such supervision. For example, as far as accounting is concerned, each institution keeps an independent auditor, who prepares an audit report for each accounting term. A duplicate audit by the supervisory government office should be avoided as far as possible.

In actual practice, the supervision of the special institutions is left, in various countries, to the care of the central bank. This is also the case with commercial banks.

The government should pay greater attention whether or not the special, institutions are managed soundly and operated in line with their basic objectives and give them necessary advice and assistance. Another matter in which care should be exercised by the government or the central bank relates to the holding of bonds by special institutions, since the absorption and holding of national bonds by the special institutions may reduce the amount of funds available for loans.

Relationship with the Central Bank

It has already been stated that some special institutions receive capital investments or loans from the central bank. Regarding the regulating function of the central bank, which it exercises through the official discount rate, the reserve deposit requirement rates and open market operations, there is, in many countries of this region where the organised financial system is not highly developed, a limit to the effective function of the central bank to regulate the supply and demand of credit. By and large, in this region, the fiscal policy of the government is more influential than the financial policy of the central bank.

It has been mentioned in the foregoing section that many special institutions are placed under the supervision of the central bank. Those classes of institutions which conduct ordinary banking business are naturally placed under the control of the central bank. They make deposits with the central bank and are at the same time allowed to obtain borrowings from the cantral bank. However, the bank-rate policy which the commercial banks follow as a result of the official discount rate of the central bank does not apply to the special financing for small enterprises. It is not incorrect to say that loan interest rates on special financing are not linked with the official discount rate. This point will be discussed further later on.

The Reserve Bank of India gives general guidance on small business financing through its Industrial Finance Department. In addition, it has formed the Credit Guarantee Organisation, which also guarantees small business financing.

Relationship of Special Institutions with Commercial Banks (City Banks) and the Securities Market

Some special institutions obtain capital investments from commercial banks (city banks) or float financial debentures, such as those of trust banks on the securities market. Needless to say, the yield on the floatation of financial debentures directly affects the costs of loan funds. Since most special institutions, except a few, do not handle short-term funds, they do not normally seek short-term call loans on the market. As things stand at present, in many countries of the region where both the financial and securities markets are only moderately developed, there is a limit to the co-operation which the special institutions can obtain from the markets. Furthermore, any heavy dependence of the special institutions on such co-operation may lead to competition with private financial institutions. There may also be a danger that such dependence will affect the discharge of the primary duties of the special institutions.

The special institutions have good reasons to make the most of the facilities of commercial banks (city banks). At present there are not a few examples (e.g. India, Singapore, Thailand), where the special institutions designate specific banks for carrying out the screening of applications, the undertaking of certain lending procedures, such as the creation of mortgages, and the collection of the funds lent. In every case, the special institutions make a final decision on the eligibility of applicants. Since special institutions lack expertise in financial techniques and are not provided with sufficient personnel, their dependence on the co-operation of commercial banks (city banks) in their financial operations is unavoidable. That they can make use of local branches of commercial banks (city banks) is to the advantage of small enterprises in the areas concerned.

Japan's People's Finance Corporation has established more than 100 offices across the land and designated about 800 financial establishments as their agents. This is aimed entirely at offering the best possible service to small enterprises located in different areas. This is also true of the State Bank of India and the other nationalised commercial banks in India.

When commercial banks (city banks) co-operate in loan processing, a decision on the loan application is made by the special institutions themselves. This is important since the special institutions then take into consideration their own policy in providing loans; otherwise there is the danger that such loans will be no different from those which commercial banks can provide. There should also be a full understanding between the special institutions and the commercial banks in respect of collateral.

Some countries, e.g. the Republic of China (Taiwan), Singapore and Thailand, have adopted the participation loan system whereby the funds of special institutions plus the funds of commercial banks (city banks) are pooled and used for loans. The special institutions must bear all risks for the portion provided on a participation basis and the difference between the low interest rate of the special institutions and the normal interest rate of commercial banks (city banks) must be compensated for in some way or other. In Taiwan, government funds are available at the interest rate of 10 per cent against the bank rate of 12.1 per cent, when the bank's own funds are used for one half of a certain loan. In Singapore, two banks use only the public funds and another bank uses its own resources in participating in the public funds applying similar remuneration as in Taiwan. The funds in Thailand are constituted of public and private resources on a fifty-fifty basis, 3 per cent interest being borne by the government. This makes it feasible for the institution to grant loans at 9 per cent interest against the average market rate of 12 per cent.

Participation loans are desirable from the standpoint of mobilising the funds of private banks for long- and medium-term lending and using effectively the limited public funds of special institutions. In order to accomplish this purpose, special measures to enable private banks to co-operate in special financing should be taken, otherwise there would be no alternative but to make loans on a commercial basis. The basic incentive is to reduce risk bearing. In the case of participation loans granted to small enterprises with government funds and private bank funds, private banks might be guaranteed by the government-sponsored credit guarantee system. As regards the difference between special and commercial interest rates, there is a system whereby the difference is covered by deposits of local governments' surplus funds at low interest. This is the case in Thailand where the Government deposits at 3 per cent and the designated bank advances at 9 per cent.

In addition to incentives for participating financial institutions, the special institutions also pay those banks commissions on lending procedures (at a certain percentage of their actual interest income).

Special financial aid may often raise the standing of small entrepreneurs in credit appraisal by commercial banks (city banks). Special financing may produce far-reaching secondary effects inasmuch as enterprises will sooner or later be in a position to secure loans from commercial banks (city banks) instead of special financing. It is desirable that special institutions co-operate with commercial banks (city banks) no matter whether in capital supply or lending procedures and avail themselves of the benefits involved. From this point of view, it is highly worthwhile linking special institutions to one or two specific commercial banks (city banks), which have a good understanding of small business financing and have those commercial (city) banks develop co-operation in providing personnel - the biggest bottleneck of special institutions. The State Bank of India is one of the nationalised banks, nevertheless it is an ordinary commercial bank. Besides handling State-Aid-to-Industries, the bank is making a great contribution as the nucleus institution for small business financing in India.

Types of Financing

The pivot of public and semi-public financing for small industries consists in loan-making. There are some other functions - underwriting of stocks issued by enterprises, subscription and underwriting of corporate bonds, credit guarantee, lease of equipment on an instalment basis, etc. Depending on the length of the repayment period, loans may be classified into three types - short-term, medium-term and long-term. Loans bearing a maturity of up to six months or one year are called short-term, while those with a maturity longer than the above period are collectively called medium- and long-term. It is difficult to make a hard and fast distinction between medium-term and long-term loans. In any country short-term financing falls under the activities of commercial banks, while medium- and long-term financing is under the charge of special banks, and in principle, is not handled by commercial banks. Classified by use, there are public funds and consumption funds (consumer credits). It is needless to say that the larger part of funds supplied under organised financing should be industrial funds applied towards filling the requirements of all industries (including small enterprises). (However, the persentage of consumer credit in organised financing is rising in step with the expansion of monthly instalment sales to individuals.) What the special institutions are trying to provide as aid is no more than medium- and long-term funds which commercial banks (city banks) hardly handle.

In the management of enterprises, it is working funds that cover current expenditures. Since these funds are needed for turnover, they can be procured under short-term financing from commercial (city) banks. In contrast, however, the equipment of enterprises newly or additionally installed is to be depreciated over many years with the profits earned therefrom. Hence, long-term financing becomes necessary for this purpose. Often, medium-term loans could be provided to new enterprises to meet their initial working capital requirements, since the first turnover of new enterprises will often be completed after an irregular period of business.

The period for which special institutions provide credit varies according to the use of funds and the nature of applications. In principle, the lending period should correspond with the period required for full repayment of the credit as calculated on the basis of the profits which the equipment will yield increasingly over each accounting term. All the special institutions have set the maximum lending periods by some categories as shown in the following table:

Table II

Loan Periods of Public Institutions

China, Republic of (Taiwan)		
Small Business Division, Council for International Economic Co-operation and Development		
	working capital loans	less than 2 years
	equipment loans	5 - 8 years
India		
State Finance Corporations		10 - 12 years
National Small Industries Corporation		
	hire-purchase	7 years
State-Aid-to-Industries Programme		3 years
Japan		
Small Business Finance Corporation		
	long-term working capital loans	1 - 3 years
	equipment loans	less than 5 years
Korea (Republic of)		
Medium Industry Bank		
	working capital loans	less than 1 year
	equipment loans	2 - 5 years

Malaysia		
Majlis Amanah Raynat (MARA)		less than 5 years
Malaysian Industrial Development Finance Ltd.		
	medium and long-term loans	5 - 15 years
	factory mortgage loan	5 - 10 years
	hire-purchase	less than 3 years
Pakistan		
Industrial Development Bank of Pakistan		5 - 10 years
Philippines		
National Cottage Industries Development Authority, Department of Commerce and Industry		less than 1 year
Development Bank of the Philippines		5 - 10 years
Philippines National Bank		
	short-term loans	less than 1 year
	medium-term loans	1 - 5 years
Singapore		
Light Industries Services, Economic Development Board		
	short-term loans	less than 2 years
	hire-purchase	less than 5 years
Thailand		
The Loan Office for Small Industries Development, Ministry of Industry		3 - 10 years
Industrial Finance Corporation of Thailand		2 - 10 years

Equipment - no matter whether newly constructed, or renovated and replaced, or additionally installed - serves to raise the production capacity of any enterprise, lowers the costs of manufacturing and processing per unit of product, and contributes to productivity. However, among such equipment there are some types of investment which, like dormitories for employees and antismoke and antiwater pollution facilities, will have no direct relation to the improvement of productivity and will rather raise the costs involved. Apart from infrastructure like roads, electricity, and water-supply facilities to be built with social overhead capital, investment in environment facilities cannot be listed among the ordinary profitable investment items of enterprises. From this point of view, almost all the countries in this region are endeavouring to create industrial estates with public investments. Yet it appears likely that investment in this kind of "equipment", to be made at the expense of individual enterprises in the period ahead (for example, the distribution sector), will become increasingly necessary. In our view, this should be handled separately by the special institutions or through separate long-term government funds provided for this purpose. In Japan, special preferential measures are applied to this kind of investment in respect of both interest rates and duration of financing. In India, funds for the industrial estate programme are provided on a long-term basis by the government or by institutional investors (e.g. the Life Insurance Corporation).

In cases where enterprises are established or new equipment is introduced in developing countries, a series of processes, such as the purchase of raw materials, production and processing, and marketing of finished products, are incorporated into the market economy. In not a few cases it takes some time before the enterprises can operate normally after the introduction of such processes. Actual revisions will become necessary in connexion with the installation of machinery, training of employees, production techniques, methods of handling raw materials and finished products. Raw materials expenses, wages, and other administrative expenses must be disbursed for a considerable time until earnings are derived. Funds of this nature cannot be procured through ordinary short-term financing. However, they do not require as long-term financing as equipment funds. These are the reasons for special institutions carrying on long-term equipment financing and at the same time providing in such cases financing for medium-term operating funds. Industrial financing should be conducted in line with the actual condition of the activities of enterprises. Especially, equipment financing for small enterprises should be provided, not for the purpose of equipment being kept idle as assets, but for the purpose of equipment being adequately operated. Funds of this nature should be provided as medium-term operating funds.

It has already been mentioned that, as a rule, special institutions do not handle short-term working funds which can be usually provided by commercial (city) banks. However, several institutions (Korea, the Philippines, Malaysia and India (State Bank)) carry on short-term financing as well. In Japan, short-term financing is mostly provided through trade credits in the form of promissory notes.

In those countries or regions of countries where the organized financing system is not fully developed, it is difficult for small enterprises which have a poor credit appraisal to obtain from commercial (city) banks the credit facilities through overdrafts or bill discounts. Some Asian countries (e.g. Republic of China and Korea) have private financial institutions specialising in small business financing, and in Japan institutions of this nature have made a striking development in recent years. In India many local (non-scheduled) banks provide working capital loans to small enterprises. The State Bank of India and the nationalised commercial banks also provide short-term credits to small-scale industries, under a liberalised scheme.

Where such specialised private institutions have not been developed, special institutions might consider undertaking the extension of short-term credit to small enterprises. However, a competition may arise between government-sponsored institutions and private commercial banks whose main business in short-term finance. Commercial banks should be encouraged to relieve the situation instead of competing with public institutions. If there are any surplus funds in any public financial institution, they may properly be allocated to long- or medium-term loans. Interest on short-term borrowings ought to be paid at the normal commercial rate. Non-commercial favourable interest on short-term loans might be nothing other than governmental subsidies for daily business.

If special institutions undertake the extension of short-term credit, it might be necessary for them to undertake deposit transactions. Expert ability in financial techniques would then also be required. Viewed from the current condition of special financing, it seems that short-term financing by special institutions should be confined to certain industrial categories and regions. Even in those cases, the special institutions should preferably have commercial banks act as their agents.

The hire-purchase scheme now being offered to small enterprises in many countries (India, Malaysia, Singapore, etc.), which provides for the acquisition of machinery and equipment in monthly instalments, cannot be called financing proper. In a broad sense, however, it may be included within the scope of financial assistance. Under this system, public institutions, instead of lending equipment funds to small enterprises, purchase the machinery and equipment wanted by the enterprises, lease them at a monthly rent, and make them the property of the enterprises after the expiry of a certain period. In the United States and other countries where the consumer credit system is in widespread use, it is well known that the instalment credit system is prevalent in connexion with the purchase of durable consumer goods, particularly automobiles and household electrical appliances. The hire-purchase system enables the authorities of lending institutions to control the use of funds lent, in the sense that there is no fear of funds being appropriated to other purposes. Small entrepreneurs enjoy the advantage that they are released from the need to raise initial investment funds equal to the total or the larger part of the required costs of the machinery and equipment. Machinery manufacturers or suppliers receive payment from special institutions. If small enterprises have a sufficient credit rating, it may be possible for them to conduct transactions on credit with manufacturers or suppliers of machinery and equipment, without seeking the facilities of special institutions. The hire-purchase system is regarded as particularly effective for supplying imported (foreign-made) machinery and equipment to small enterprises. The hire-purchase system involves complicated procedures and the duration of financing is also long. Since interest and annual depreciation expenses are added to the charges borne by enterprises, the financial burden might be higher than in the case of ordinary borrowings, unless any official subsidies are provided.

III, FINANCING PRACTICES

Inquiry and Information

When demand for funds occurs, special institutions make inquiries or hold consultations before accepting formal applications. This step is particularly indispensable in the case of new clients who have had no transactions in the past. Since special financing is different from bank financing, it is important for the special institutions to make efforts to enlighten the entrepreneurs on the nature of this particular type of financing. It would appear that the measures adopted by various countries to make the special financing system known far and wide are not althogether satisfactory. According to certain public-opinion polls conducted in Japan, the overwhelming majority of people obtained information about the special financing system from their business friends. Only a small percentage is accounted for by people who obtained information through such media as newspapers, radio, etc. Of course, there may be different circumstances in different countries. Yet, the above polls suggest that every country give due consideration to the selection of the means of information and publicity. Those who visit special institutions and banks for consultations and advice are often full of entrepreneurial spirit and have some problems to solve, which are not limited to financial problems. It is, therefore, desirable that special institutions and banks respond to inquiries in a spirit of kindness and give advice even on problems not specifically concerned with financing.

Fortunately, however, all countries have a specially organised system to give management guidance to small enterprises. Usually, small entrepreneurs first approach these guiding institutions. At their suggestions and with their introduction, they come into contact with special institutions. Care should be exercised to ensure that experienced personnel provide the visitors information to their satisfaction. Since those people who come for information and consultation are often new clients, it is possible that the problems they bring up will provide a useful feed-back to the special institutions.

Application for Loans

All institutions have their own specified application forms. A regular form is used irrespective of the size of the enterprise or the amount of loan applied for, but there is a case for using simplified forms. It is also desirable that the number of copies be reduced as much as possible. Some items mentioned in the application form may be clarified at the stage of credit analysis. Turning down an application simply because all items in the application are not properly filled in must be avoided. Applications are acceptable at all times of the year, but depending on the volume of funds available for lending, the institutions may have to suspend the acceptance of applications. In ordinary cases, applications are accepted after screening by the credit analysis section. In view of their nature, it is more important for the special institutions than for private financial institutions to bear in mind that all applications should be treated in a spirit of fairness and justice.

Summary and Assessment

The appraisal of individual applications is made with special reference to the following points: (a) whether they fall under the category eligible for financing by the institution concerned; (b) whether the projects for which funds are to be used are appropriate from the point of view of priorities in the country's plan; (c) whether borrowers have a sufficient ability to repay and whether their repayment schedule is appropriate; (d) whether applicants have a good credit standing. Thus, special institutions make a full survey of the project concerned and of the effects which the necessary funds will produce. A credit analysis is usually made through a combination of the following three methods: (a) inquiry by letter, (b) an interview, and (c) an on-the-spot survey of workshops. Generally speaking, the accounting departments of small enterprises are insufficiently staffed, and their account books are not scientifically maintained. Under these circumstances, it is difficult to form a judgement on their past business performance or obtain data from which a forecast can be made of their future prospects. It is therefore necessary that the process of credit screening should depend on a technical assessment of the prospects for the project as well as an evaluation of the entrepreneur's capabilities. The special institutions should have trained personnel to undertake this task.

It goes without saying that applications should be screened as far as possible from a purely objective point of view based on actual figures and that they should not be evaluated from personal feelings or special personal relationships. Various separate expert departments devoted to the survey and evaluation of such particular items as technical know-how, markets, etc. should form part of a special institution. Unlike big enterprises, small enterprises depend very heavily on the management ability of the owner-manager concerned, so that a comprehensive evaluation, inbluding this point, should be carried out.

It is desirable to obtain the co-operation of advisory and extension services, where they exist. Many countries have established both finance and service departments as a part of an extension service centre (e.g. the Light Industries Service in Singapore). While the screening of an application should be the responsibility of the loan department of a bank or a special institution, the technical viability, market prospects, entrepreneurial or managerial evaluation, etc. should be reviewed by a consultant or advisory centre.

The Small Business Promotion Corporation of Japan, established as a government agency in 1967, is designated to combine organically the financing of equipment carried out jointly by the central and local governments with the guidance and consultation services and to induce the finance and advisory services to co-operate in loan processing. Further, enterprises have to receive guidance on the execution of their project, and after obtaining the required facilities, are obligated to continue to receive guidance. The Corporation places the main emphasis on financing the construction of basic facilities for local enterprises - the so-called structural improvement facilities - rather than on individual equipment of enterprises.

The major role of this Corporation is to assist groups of small industries in achieving and facilitating close co-operation through establishing, e.g.: (a) an industrial estate, (b) a flatted building for workshops, (c) a wholesalers' centre, (d) joint facilities, (e) an accounting centre, (f) a supermarket, (g) a shopping centre, (h) merger of business, and (i) prevention of public hazards.

Concerted assistance through consultancy and finance is the principal feature of this Corporation's activities. On application by a group of small enterprises, the Corporation sends a team of private (hired) consultants or local government consultants, headed by a staff-consultant, to give guidance, and to make a survey on the potentiality of the proposed project. Under instructions from the Corporation, the loan division of a local government examines the feasibility of the proposed loan. Guidance on the layout of the planned facility may also be made by the Corporation. Up to 65 per cent of construction cost is financed by the Corporation with interest at 2.2. per cent per annum, due in 12 - 15 years, including an unredeemable period of 2 - 3 years. Even after completion of the projected construction, the Corporation will provide follow-up services for after-care and the maintenance of the facilities. Consultant services are given free of charge with the aid of government subsidies.

Training is another major function of the Corporation. The Corporation operates a training centre for small entrepreneurs where consultants, machinery, class rooms, and a dormitory are provided.

Loans Allocation

In principle, a decision on financing is made by the Board of Directors of a special institution, but often a decision is also made by its secretariat duly authorized under delegated powers. Apart from special cases or large loans, as the institution accumulates experience, the Board of Directors will delegate to the secretariat the authority to make a decision on individual loans. The Board of Directors will thereby be enabled to attend to wider problems, including questions of financial policy and the fund position of the institution. Whether a decision on loans is made by the Board of Directors or the secretariat, the most important problem is to provide adequate and timely loans. A public financial institution should not be unduly particular about the debt-equity ratio and about collateral of borrowing enterprises. Loans must be given with due regard to the fund position of the institution. The institutions must not at any time neglect the administration of funds, i.e., maintaining a proper balance between supplying capacity (including collections) and estimate of demand for funds. Monthly or at least quarterly lending programmes should be prepared, and allocations adjusted according to the programmes. The secretariat permitted to allocate loans must be given due authority in respect of the total amount of loans for a certain period. This is particularly necessary in cases where institutions give their local branch managers the authority to allocate loans in order to speed up the lending procedures. If, for some reason or another, the institutions should have a shortage of funds to make their loan commitments, they will be compelled to raise emergency funds or take measures to borrow from commercial (city) banks on behalf of applicants; otherwise the government as well as the special institution will lose its credit. Generally speaking, a good credit study is most important to a financial undertaking. This is especially true in cases where commitment fees are charged. Be that as it may, many special institutions in various countries authorise specified banks to handle loan disbursements. When their funds are deposited or pooled in trustee banks, a shortage of funds will not create any serious problem. Loans are usually made more on "deeds" than on "notes".

Collateral and Other Securities

In ordinary cases, special institutions should call for a guarantee of the debt extended. There are two kinds of guarantees - personal and physical. In many cases, however, both are required. Under the principle of sound financing followed by private financial institutions, the loans are granted after attaching the greatest importance to the guarantee offered. This is the reason why small enterprises with a meager guarantee capacity find it difficult to obtain the facilities of private financing. It is evident that the extent of guarantee required for financing by public institutions must be more liberal than that required by private financing institutions. A guarantor is held responsible for repayment of obligations on behalf of the borrower in the event that the latter has failed to repay his debt under the loan agreement. In such a case, the physical security is disposed of and the sales proceeds thereof are applied towards repayment of the debt. The guarantee offered is nothing but a means to protect secondarily the credit given to the borrower. In other words, the guarantee is a means of strengthening the sense of responsibility of the borrowing enterprises for repayment.

In various countries, the machinery and equipment bought with the proceeds of public loans are admitted as physical security. Public financing has certainly become more liberal as regards guarantee requirements than commercial (city) bank financing. There may still be room for relaxing the terms and conditions governing a personal guarantee. It is interesting to note that some public financial institutions (e.g. in India) do not call for physical security but are content with a personal guarantee alone. Japan's People's Finance Corporation and Singapore's Light Industries Service call for one personal guarantor or more in all cases where the amount of loan involved is below a certain limit. Many institutions delegate to private banks the procedures for raising personal and physical security. Measures to secure the co-operation of private banks are necessary to ease the terms and conditions of security. There may be a need to liberalise security requirements.

Collection of Loans

It is observed in many cases that the collection of loans is delegated to private banks to facilitate repayment by small enterprises. An instalment repayment method is adopted in many cases. This is one of the distinctive features of public financing. However, instalment repayment gives rise to a good deal of trouble to the financial agencies authorised to collect loans. For example, verification accounts may be necessary because while the principal is repaid in equal instalments the interest diminishes as the outstanding balance decreases. (Public financing differs from financing by commercial or city banks in that the interest on the total amount of loan for the period is not deducted at the time the loan is made, but is collected from time to time on the amount minus the repaid sum.) The State Finance Corporations of India charge an interest rate of 6.5 to 7.5 per cent per annum with a rebate of 0.5 per cent for prompt payment.

Collecting agents have to issue some kind of reminders to borrowers to ensure satisfactory repayments under the loan agreement. It is important that they provide continuous follow-up assistance for borrowing enterprises, because repayments are, in principle, to be made out of profits realised. The consultant service division of a special institution or extension service of the government should endeavour to follow up borrowing enterprises and give them pertinent advice. In the event that instalment repayments, when due, are not made, the collecting agents should seek the help of the service division of the special institutions or of the extension service.

IV. ADMINISTRATIVE ASPECTS

Staff-Shortage and Training

Financing of small enterprises relates to a broad range of industrial fields, from bamboo processing to sophisticated electronics. Clients are found through the whole area of a country. Financing of small industry requires special techniques of advancing credit with liberal terms and conditions and supplemented by technical assistance and supervision. It requires also managerial and accounting knowledge. Public financing, in particular, requires broad intelligence on the economic and industrial situation in the country. In view of these requirements many of the public and semi-public institutions in the region are confronted with staff shortage problems. Singapore's Light Industries Service has more than a hundred and fifty persons on its staff, but its loan processing work is carried out only by a few people in co-operation with the designated banks.

To meet the need for trained personnel for the public financing organisations, training programmes should be developed as a co-ordinated responsibility of the government and the institutions. Training in any sector is necessarily a long-range activity, because it takes time for investment in human resources to bear fruit. Professional education at the secondary and higher school level should of course be improved further. However, the scope of training and education required for development financing is very wide since it should cover both macro- and micro-economic aspects. Systematic training programmes should be formulated by the respective institutions in co-ordination with the formal school education.

Among training requirements for various personnel, the utmost need is for those of middle level and those who engage in the evaluation of proposed projects. Training programmes should first be focused on these two points. In-service training or daily on-the-job training is more important than academic training in class-room. As regards the training of personnel engaging in public financing, preference should be given to refining personality and attitude in addition to improving technical knowledge and extension methods. The managers and officials of financial institutions should serve their clients with broad and impartial views and attitudes. They must be sincere and incorruptible. Though it might be hard to attain these qualities through professional training, moral training should not be ignored in the training programmes.

In some countries the training institute (the Small Industry Extension Training Institute (SIET) of India is an example) offers training to bank personnel, entrepreneurs, as well as to industrial employees. In some countries national productivity centres conduct seminars on financial problems and invite the personnel of financial institutions to participate. Government institutions for small industry financing in Japan usually send some officers to the training institute of the Small Industry Promotion Corporation. However, the primary objective of these training courses is to upgrade industrial people, mainly small entrepreneurs and their employees. The officers of financial institutions may be encouraged to participate in these seminars where they will learn about the status and problems of small industries, the majority of which face financial problems. Nevertheless, this can hardly be regarded as sufficient. Eventually, the importance of drawing up training schemes specifically designed for the employees of public financial institutions will need to be recognised.

Foreign assistance in training personnel for development banks will be helpful. There are some training schemes for the personnel of central banks in the developing countries offered by the counterpart banks in developed countries. The World Bank assists on a multilateral basis in this field. The Asian Development Bank might also consider organising such a training programme in the region. Some private banks in Japan have been conducting training seminars for bankers from developing countries in Asia. Information on training of bank personnel should be exchanged between countries of the region in order to increase the availability of trained personnel in finance and related administration.

Efficiency of Processing

It is the general complaint of applicants to public financing institutions that their procedures are extremely complicated. For instance, many detailed items should be filled in the forms and several copies are required, and it takes a fairly long time (sometimes several months) to clear an application. It is difficult to assess the efficiency of a financial service. Individual applications involve consideration of various detailed points, some simple and some complicated, and are not amenable to uniform processing. However, it may be useful to estimate the average duration of processing an application. Making a review of the number of cases handled per head of staff per year might also be interesting. From such reviews no definite appraisal of efficiency could be made but some improvement in management could be obtained. In some institutions, the final decision on lending is made by a competent officer in the secretariat, e.g. the head or chief of the department, instead of being adopted by the board of directors. Where local branches are established the branch chief should be authorised to make final decisions on loan applications of a given amount or type, so that red-tape and time-consuming procedures are simplified and shortened.

Rate of Operating Expenses

The operating expense rate, which is discussed in more detail in the following chapter, is one of two major cost items in commercial and industrial financing. The level of interest rate depends largely on the current expenditure, composed mainly of personnel expenses: wages and salaries. In public financing, the operating expenditure should be kept as low as possible because the interest rate of public institutions should be lower than the ordinary rate. As a rule, the overhead charge rate should diminish as the total loan amount advanced increases over a certain period. However, a distinctive feature in the operation of public financing for small industries is that what increases is the number of applicants for loans of small amount. The processing of such loans is time-consuming, and involves higher administrative costs than in the case of established banks. Moreover, more favourable salary and other benefits than average might be necessary to recruit processing personnel. Admittedly the cost of processing or overhead charge per application might be higher in public financing than in the commercial banking business, and recourse to subsidisation may be the only solution to this problem.

Table III

Number of Cases and Amount of Loans to Small-Scale Enterprises in Selected Countries of Asia and the Far East, 1966 - 1968

Institution	Number of employees (Finance Division)	Total number of cases per year	Total amount committed per year	Per Head, Per Annum: Number of cases	Per Head, Per Annum: Amount in national currency
Malaysia					
Majlis Amanah Rayaat (MARA)	Central Office 18	(1967) 718	M$ 4,740,000	40	90,000
Malaysian Industrial Development Finance Ltd.	15 - 20	(1967/68) 66	M$ 5,500,000	3 - 4	260,000 330,000
Japan					
People's Finance Corporation	4,318	64,555	¥ 358,802,000	150	230,000
Small Finance Corporation	1,732	4,404	¥ 276,718,000	26	444,000
Philippines					
National Cottage Industries Development Authority ((NACIDA)	Central Office 10	(1967/68) 397	P 43,000,000	40	1,200
Singapore					
Economic Development Board (EDB)	25		(1966) M$ 7,800,000		100,000
Light Industries Service	4	35 60	M$ 900,000 M$ 1,500,000 a/	15	375,000
Thailand					
Loans Office	5	(1966/67) 86	B 22,000,000	17	220,000

a/ Estimate for a full year

Table IV

Rate of Operating Expenses of Selected Institutions [a/]
(1967)

Japan	
Small Finance Corporation	2.2 % (1966)
People's Finance Corporation	1.96
Korea	
Medium Industry Bank	8.04
Malaysia	
Malaysian Industrial Development Finance, Ltd. (MIDFL)	1.03
Philippines	
Development Bank of the Philippines (DBP)	2.81
Thailand	
Industrial Finance Corporation of Thailand (IFCT)	2.76

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a/ $\dfrac{\text{Expenses on Personnel, Supplies and Others}}{\text{Average outstanding operational funds}}$

Average = 1/2 (outstanding at previous year's end and that at current year's end)

V. INTEREST RATE IN RELATION TO CREDIT RISKS FOR SMALL INDUSTRY FINANCING: A BRIEF REVIEW OF THE JAPANESE SITUATION

Level of Interest Rate

In a free economy the resources available to industrial enterprises through industrial loans, are in the form of profit-bearing monetary capital. The interest on the loan paid by the borrower is part of the profits paid to the lender. From that standpoint, the maximum rate of interest for industrial loans made by the financial institutions or in the organized market should be commensurate with the industrial profit rate; if the interest rate exceeds the profit rate, borrowing becomes meaningless. The minimum rate of interest, on the other hand, is the cost of fund resources composed of the cost of ordinary bank deposits and the operating expenses of the bank. Where a financial market is established, the total demand for funds should meet the total supply at any given time. The interest rate will be determined somewhere between the average level of profits and costs of funds in the economy. Since there are several types of financing, short-term or long-term, with or without collateral and so forth, there are varied rates of interest in the market, but these are interrelated to each other.

Table V

Various Loan Interest Rates in Selected Asian Countries

(per cent per annum)

Country	Official money rates	Interest rates of commercial banks	Interest rates of special institutions for small-scale industry financing
China, Republic of (Taiwan)	rediscounts 10.8% loans on securities 13.3% (Apr. 1968)	discounts on bills 12% loans on securities 13.5% loans without securities 14%	Small Business Division, Council for International Economic Co-operation and Development 10-12% Bank of Communications 10-12%
India	5% (Mar. 1968)	short-term loan 8-8.5% long-term loan 7-9%	Loans under State-Aid-to-Industries Acts 2.5-5% State Finance Corporation 6-7% (1/2% rebatable when the repayment schedule is adhered to) National Small Industries Corporation 4.5-6% (plus service charges less than 5% of the value of the equipment on hire-purchase)
Japan	5.8% (Oct. 1968)	7.5-8%	Small Business Finance Corporation 8.2% People's Finance Corporation 8.2%
Korea	21.0% (Mar. 1968)	discounts on bills 24.0% loans on bills 26.0% loans for export 6.0%	The Medium Industry Bank ordinary loans 23.0% Government fund loans 16.0%
Malaysia		short-term loan 7.5% long-term loan 7.5-8%	Majlis Amanah Raayat, loan department 6-7% Malaysian Industrial Development Finance Ltd. 8-10%
Pakistan	5%	3-9%	Industrial Development Bank of Pakistan 7-8%
Philippines	7.5% (Feb. 1968)	loans without securities 11.5-14% loans on securities 8-14% overdrafts 10-12%	National Cottage Industries Development Authority 4% Development Bank of Philippines 6-8% Philippine National Bank 7-9%
Singapore		short-term loan 7% long-term loan 8-9%	Light Industries Services, Economic Development Board 8.5% (including commission of 1.5% for commercial banks)
Thailand	rediscounts 5% loans on government securities	10-14%	Loan Office for Small Industries Development, Ministry of Industry 9%

Components of the Interest Rate

In practice, risks against bad debts and risks against changing value of money and other risks should be taken into account in determining the interest rate. The margin of the bank should also be included. It is difficult to include in the interest a standard percentage for bad debt risks. The following shows the actual redemption rate of outstanding loans as at the end of 1967 in Japan.

Ordinary Bank	Specialised Bank for Small Industries (Mutual Banks)	Government Institution for Small Industries (People's Finance Corporation)
0.022%	0.042%	0.021%

This shows that the redemption rate of the specialised bank for small industries is twice the rate of the ordinary bank and of the Government institution for small industries. The following figures relating to Japan compare the interest yield rate to the deposit interest rate, the operating expense rate and the margin rate.

Rate for Outstanding Loans	Ordinary Bank		Specialised Bank		Difference	Share
		%		%	%	%
(1) Yielded interest rate	6.97 (100)		8.56 (122)		1.59	100
(2) Deposit interest rate		4.12		4.18	0.06	4
(3) Operating expense rate	6.97	2.58	8.56	3.49	0.91	57
(4) Margin rate (1-(2+3))		0.27		0.89	0.62	39

Source: 1967 Annual Report of the Banking Department, Ministry of Finance, Government of Japan

Note: Interest rate yielded = Interest rate actually gained

$$= \frac{\text{Loan interest and other income}}{\text{Average of operational funds outstanding}}$$

$$\text{Deposit interest rate} = \frac{\text{Interest paid against deposits}}{\text{Average of operational funds outstanding}}$$

$$\text{Operating expense rate} = \frac{\text{Overhead expense}}{\text{Average of operational funds outstanding}}$$

$$\text{Margin rate} = \frac{\text{Gross profit}}{\text{Average of operational funds outstanding}}$$

The table suggests that, in the case of small industry loans, much credit risk is involved in the interest rate actually gained by a bank in a year. The ordinary bank rate is 6.97 per cent against 8.56 per cent for the specialised bank, which is 22 per cent higher than the former. The difference has been identified by a survey conducted by the Japanese Small Business Agency, according to which the smaller the business in size, the higher the rate of interest. As regards the cost factors, the difference in interest rate on deposit is negligible, being 4.12 per cent for the ordinary bank against 4.18 per cent for the specialised bank. The striking difference in the operating expense rate between the two banks - 2.58 per cent against 3.49 per cent - appears to be reasonable if the difference in the nature of the respective business operations is taken into consideration. The margin rate, a part of which covers special risks, is 0.27 per cent against 0.89 per cent. If the specialised bank would take the same margin rate as the ordinary bank, the interest rate gained could be reduced by 0.62 per cent which is about 40 per cent of the yielded interest rate and is a measure of the special risk. To put it in general terms, when the interest rate of small industry loans is 20 per cent higher than the ordinary rate (as indicated by the Japanese Survey), 40 per cent of 20 per cent, viz. 8 per cent will be for the special risks of small industry.

Interest Rate in Public Financing for Small Industries

The level of the interest rate varies from country to country; however, the rate charged by the public institutions is lower than the prevailing commercial bank rate. While the commercial rate is changed upward or downward following the fluctuations of the Central Bank's official rate, the public financing interest rate does not usually follow the Central Bank rate, but is likely to be determined independently, in accordance with industrial policy. It is rather rigid, unchanged in the short term at least, irrespective of the economic conditions of loose money or tight money.

The level of public financing interest rate is dependent upon the industrial policy in the respective country. In some instances, e.g. India, the Government might even provide an interest-free fund to assist small industries. However, it should be noted that in the case of independent institutions the interest rate could be reduced only if support or subsidies are available. It is interesting to note that a Japanese Governmental corporation is subsidised when it offers a favourable rate not justified by the original fund cost. Public and semi-public financing might provide an interest rate lower by the risk percentage for small industry, i.e. by forty per cent of the excess of the specialised commercial bank rate over the ordinary bank rate.

Level of Interest Rate by Types of Institutions in Japan
(As of October 1968 Per Cent per Annum)

Official Rate	Ordinary Bank	Specialised Bank for Small Industries	Government Institutions
5.8	7.18	8.41	8.2

Taking the above Japanese case as an example, the difference between the ordinary bank rate and the specialised bank rate is 1.23 per cent. Forty per cent of the difference is 0.49 per cent. Specialised rate of 8.41 per cent minus 0.49 makes 7.9 per cent = 8 per cent which corresponds to 8.2 per cent of the Government institutions' rate.

Small Industries' Risks in Public Financing

Higher risks seem to be taken in the case of credit to small industries than to big business, but no definite difference can so far be ascertained: there is not statistical evidence of this in the limited history of public financing in the region. As shown in the preceding paragraph, the actual remuneration rate at the Japanese Government institution is higher than in the ordinary bank, the average clients of which are far bigger and more creditworthy. The monthly instalment repayment scheme may partly account for this. Also, Governmental financing appears to be a kind of marginal facility for people who have no other financing source. The Asian experience supports Davenport's [2] statement that "official development banks are usually lenders of last resort".

From the lender's point of view, loan collection appears to be more satisfactory when advisory services are provided in technical and managerial matters. The loan duration can be extended or the party can be refinanced when the advisory service recommends it. Closer understanding between both parties can facilitate repayment. Public financing authorities should therefore take into account human attitudes prevailing in a certain area and a certain business circle, which may influence both loan advancing and collection. The fact that the availability of finance for small industries is profoundly dependent upon the personality of the manager-owner cannot be over-stressed.

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2 R. Davenport - Financing the Small Manufacturer in Developing Countries, Stanford Research Institute, Menlo Park, California, 1967 Published by McGraw-Hill, New York, 1967

Table VI

Amount of Loans Outstanding in Special Financing Institutions in Selected Countries of Asia and the Far East

Country	Institution	Amount of Loans		Average Amount per Single Loan	
		US$ 1,000	As of End of	US$	As of
China, Rep.of (taiwan)	Small Business Division C I E C D	1,067	Jun 68	13,486	Jan - Jun 68
India	State-Aid-to Industries	31,000	Cumulative up to Mar 62	555-1,110	N.A.
	State Financial Corp.	10,500	Mar 62	18,889	N.A.
	N S I C	19,500	Cumulative up to Sep 62	8,000	N.A.
Japan	S B F C	1,570,311	Sep 68	17,433	Apr 67 - Mar 68
	P F C	1,212,456	Sep 68	1,847	Apr 67 - Mar 68
Korea	Medium Industry Bank	77,933	Jun 68	5,025	Jan - Jun 68
Malaysia	M A R A	3,394	Cumulative up to Aug 68	2,164	Jan - Dec 67
Philippines	N A C I D A	322	Sep 68	28	Jan - Sep 68
Singapore	L I S	3,675	Aug 68	8,447	Jan - Jul 68
Thailand	Loans Office	3,661	Sep 68	12,314	Oct 67 - Sep 68

N.A. = not available

VI. CONCLUDING REMARKS

Public and semi-public financing is an integral part of the package of measures for the development of small-scale industry. Since small-scale enterprises cannot easily obtain long-term commercial loans, public and semi-public financing complements commercial credit. When the market is quantitatively tight for one reason or another, public financing could help the small enterprises whose demands might remain unfilled from the market. Further public financing might induce commercial banks to provide additional or subsequent credit to those small enterprises which were successful in obtaining loans from the public institution. Moreover, the obstacle of insufficient creditworthiness of small industries can be relieved by public financing.

Another feature of public financing is that it contributes to carry out specific development policies for the small-scale sector. Common facility services, industrial estates, hire-purchase of equipment and other measures have been encouraged in several countries through public and semi-public financing.

How much budgetary funds should be contributed depends on the Government's policy with respect to the over-all development plan. The public financing target in a particular period might thus be predetermined. Pakistan's comprehensive industrial investment schedule provides a noteworthy example of dovetailing the development plan and the financing measures. The schedule provides an investment allocation for the private small industry sector separate from that for the large and medium industry sector. The industrial programme for small-scale industries is thus spelled out in the national plan. While development banks often complain of shortage of funds, the public financial institutions for small industries are sometimes not able to utilise fully the funds provided.

Exceptions are in the case of the State-Aid-to-Industries scheme of India and the Small Industries Corporations of East and West Pakistan. Long-term and medium-term financing of small-scale industry would best be implemented if targets were set out as part of the development plan, rather than on an ad hoc basis. Short-term financing on liberalized conditions is, however, a more difficult matter.

As to the interest rate, favourable conditions are offered by every public financing institution, as compared with commercial banks. There are even criticisms against excessive favouritism in some instances. In each country the favourable rate is decided by Government policy taking into account the market level of interest rates. The public financing interest rate is different from the commercial market rate in the sense that it does not necessarily fluctuate in the short period and does not follow changes in the central bank's rediscount rate. The governmental rate could in principle be less than the commercial rate, although the expense rate per loan is greater in the case of public financing than in that of commercial bank financing, particularly for loans to small-scale industries. The governmental rate for small industries could be reduced if credit risks were shared, for instance through a guarantee system.

In most countries public financing for small industries is carried out by independent specialized institutions. By nature, a public financial institution has to meet certain public service requirements, for instance the appointment of directors by the Government. However the institutions, except Government departments, should be organised and operated on a self-sustaining basis, like business concerns that pay dividends on profits to the shareholders. Sound banking should be an established principle of lending.

The fundamental problem regarding public financing for small industries is to combine two principles viz. sound banking and development policy needs.

It might be worth considering whether the public financing practices put too much emphasis on the former principle. This is not the case of the liberalised credit scheme of the State Bank of India, the largest commercial bank in the country, which is operated in line with the Government's small industry financing policy. This scheme is purpose-oriented and not security-oriented. A credit guarantee scheme might be a bridge to combine these two principles.

The small industry development policy should take into account the different requirements of different types of small industry. This sector covers a broad field of enterprises, with different degrees of capital intensity, from petty subsistence business to modern firms using sophisticated equipment. The criteria of financial aid under the policy should be different from those of commercial banking. However, in the development policy for modern industry - whether small or large - there should be no discriminatory financing criteria between public financing for small units and development bank financing for large industries. In both cases, financing should be based on a project-oriented analysis. Moreover, social overhead investment might be required both for large industry and small industry, for instance, workers' housing, employment exchanges, problems of smoke, sewage, drainage, etc.

A more effective and dynamic co-operation between public and semi-public financing agencies for small industries and advisory and consultant services for them is vital in a developing economy. The link should be maintained both at the pre-investment stage and at that of follow-up, after the loan has been obtained.

In a sense, credit institutions could be a source of innovation to promote the development of industrial entrepreneurs. The public financing institutions should not confine themselves to traditional banking concepts but should visualise their role in a broad perspective of development.

Schumpeter's ideas of the "innovating entrepreneur" and of "credit creation" deserve consideration by development financing institutions.

To solve the inadequacy of staff qualifications is another urgent issue everywhere in the region. All countries in the region have been making strenuous efforts in general manpower training. They should realise that, in the public financing field, special technical skills should be taught and proper motivations and attitudes built up in the personnel of the financial institutions.

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