

Role of Banks in Creating SME Linkages with the Formal Sector

Introduction

One of the Key economic questions of our time is the question of how the estimated US\$7,4 billion that is supposedly circulating in the informal sector can be harnessed for economic development. Other key questions evolve around how the informal sector contribution to the overall economy can be better measured and accounted for.

In this vein, the promotion of business linkages between formal and informal sectors becomes a key challenge that must be addressed in many economies.

Typically, a holistic, multi-sectoral and multi-stakeholder partnership approach involving Government, development partners and the private sector is required.

Such partnerships are usually aimed at promoting the growth and survival of Micro, Small and Medium Enterprise businesses (MSMEs) through capacity and capability enhancement on one hand, while improving the policy environment for larger formal businesses to flourish on the other.

Experience has shown that countries that facilitate the development of sustainable Formal – informal Sectors linkages can upgrade their local productive capacities and enhance their industrial performance by integrating their MSMEs into local and global supply chains of large firms.

Importance of Banks in the economy

In discussing the role of banks in influencing linkages between the SME sector and the formal sectors of the economy, one cannot divorce the key role that banks play in the broader economy. This role encompasses inter alia:

- Financial Intermediation- Mobilizing and pooling financial resources from savers to borrowers.
- Facilitating Trade- By managing and executing payments for transactions through national and international payment systems and platforms including mobile based systems;
- Advising Businesses on various issues pertaining to the specific business segment, business sector, the local and international economy.
- Mobilization of resources both internally and externally for lending to those sectors in need of these resources;
- Pooling, spreading and transferring of certain risk;
- Ensuring the optimal and efficient use of scarce financial resources.

The importance of the Informal Sector

Comprising over 65% of Zimbabwe's private sector, and accounting for approximately 70% of employment the MSMEs sector can rightly be considered to be critical in accelerating economic growth through the expansion of productive jobs, tax and export revenues, as well as through the reduction of the country's import bill by substituting imports.

However, most of Zimbabwe's MSMEs are generally not only unable to meet business standards required to deal with formal businesses on such crucial competitive issues as price, quality and volumes, but are also found wanting in basic governance and organizational standards.

In spite of such limitations however, the larger formal businesses particularly Banks are found to be ready to upgrade business relationships with MSMEs into long-term relationships, provided the MSMEs commit themselves to remedy identified shortcomings.

Such linkages with formal business can be facilitated in a number of ways.

The Power of Self Organisation

The formal sector, particularly banks, would like to see MSMEs organized in accordance with their specific subsector or product category. Strong member driven associations of MSMEs improve accountability and order within the membership. They also foster an air of seriousness and enable research in the sector to be done more accurately, improving the ability of financial service providers to accurately design solutions. Member driven entities comprising the multitude of SMEs would also be better placed to mobilize members for common causes including the pooling and raising of own financial resources to augment formal sources of finance.

In short, if the MSME sector self organizes into strategic value clusters, it also becomes possible for formal businesses to quickly and easily identify potential areas of linkages.

In all interactions with the informal sector , it is therefore key for banks to emphasise this key aspect.

Possible Interventions by the Banking Sector

One of the ways in which banking sector can become a vehicle for fast tracking the creation of dynamic linkages between the formal and informal sectors is through the structuring of innovative financing tools such as SME Bonds that have been launched by one bank in Zimbabwe already.

These bonds enable deserving SMEs who have a formal structure with a dedicated membership to raise money from the formal sector, ie pension funds and insurance companies something that the SMEs would not be able to do themselves.

So banks, in creatively carrying out their intermediation role can play a big part in “connecting” the formal financial markets to the informal sector players in a mutually beneficial fashion. The institutional investors in the Bonds also have an opportunity to evaluate the SMEs who are benefitting and such knowledge sharing helps the overall financial sector in understanding the SMEs better, enabling future innovations.

The multi-sectoral, multi-stakeholder approach is also demonstrated in this instance as Government has accorded these SME Bonds both prescribed asset status and liquid asset status to enhance their investment appeal.

However, it is important to note that for banks and investors to participate in the SME sector, there is need for SMEs to have a robust, disciplined and focused membership driven organization.

Value Chain Finance

The banking sector can also facilitate linkages between formal and informal sector businesses by designing

appropriate value chain financing mechanism for the various subsectors of the economy.

Value chain finance is particularly important to MSMEs and includes but is not limited to Order Financing and Invoice Discounting products traditionally offered by banks.

The domestic value chain finance model can be formulated to nurture local MSMEs to meet international business standards and encourage large local and foreign businesses to source locally from the local MSMEs instead of sourcing from foreign firms.

Locally the value chain finance has been prominent in the priority sector of agriculture, where banks and large players in the formal sector have teamed up to provide funding for the production of cotton, tobacco and sorghum.

Large firms in the telecoms and beverage distribution sector also have a significant presence in the informal sector as most of their sales are conducted by informal traders.

There is need to carry out researches in the other sectors such as real estate development, manufacturing and distribution.

The Economic Benefits of Strong Formal Sector Linkages with the Informal Sector

Overall, strengthening the linkages between informal sector and the formal will result in tremendous improvement in operations of MSMEs which can be observed in various areas such as;

1. Improved competitiveness of MSMEs through facilitating technological, knowledge and management skills transfer and capital injection.
2. Behavioral transformation as entrepreneurs displays much higher commitment to the fulfillment of contracts.
3. Improvement in revenue turnover and employment numbers.
4. Increased domestic sourcing by transnational corporations and large local companies leading to import substitution.
5. The creation of higher quality jobs and or the preservation of these.
6. The increased ability of commercial banks and other financial sector players to provide credit and other financial products to MSMEs due to improved attractiveness.
7. Strong, deeply rooted local supply chains emanating from the MSME sector to the formal corporates.
8. A more dynamic private sector.
9. An increased capacity to attract Foreign Direct Investment as the informal sector becomes more organized and accountable.
10. Increased contribution of the informal sector to direct and indirect taxes will enhance overall economic performance.
11. The economy will become easier to measure and there will be better policy responses to policy as the size and extent of the informal sector players can be more easily ascertained or more accurately estimated.

The Role of Technology.

In playing their role as integrators of the formal and informal sectors, technology obviously plays a very critical role.

With the advent of mobile and internet based delivery systems, banks should: -

1. Create mutually beneficial payment platforms and systems that enable them to mobilize from and to lend money to informal sectors whilst meeting all regulatory requirements which are presently a challenge specifically for the informal sector. Banks are motivating for a leveling of the playing field with various regulators in order to unlock some of the key bottlenecks to financial inclusion.
2. Provide better access to funding which will enable the informal sector players to transform into formal sector players. Funding could be in the form of micro-credit.
3. Improving access to information. Informal sector activities are not visible in official statistics. Banks can play a crucial role in aggregating and providing research on the informal sector within the limits of confidentiality disclosure constraints faced by banks.

Conclusion

It is therefore important to note that banks can and do play an important role in the creation of linkages between the informal sector players and the formal sector. This interaction is mutually beneficial to both parties and has broader developmental benefits also drawn from the linkages.

The Banking sector therefore is continuing to research ways and means of enhancing financial inclusiveness as a business agenda aimed at bringing as many as possible of the currently unbanked participants in the formal sector into the ambit of formal banking as a first step in identifying and creating strong linkages between the formal sector and the informal sector. As such, under the multi-stakeholder approach alluded to in the foregoing discussion, Government has the key role of removing, particularly those barriers that are hindering the integration of the informal sector in the mainstream economy.

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