Opening Remarks by Governor Jazbec for the SME Conference
23 September 2015

Spoštovane, spoštovani,

v veselje mi je, da vas lahko pozdravim na današnji konferenci, ki jo skupaj organiziramo Banka Slovenije in Evropska komisija. Naša konferenca bo potekala večinoma v angleškem jeziku, zato bom tudi jaz svoj uvodni nagovor nadaljeval v angleščini.

It is a great pleasure to welcome you all to the high-level conference on SMEs organized jointly by the Bank of Slovenia and European Commission. It is indeed a great honour to have a very distinguished gathering of senior officials of international institutions, bankers, policy makers, academics, and diplomats attending the conference on an issue that is very critical for Slovenia.

You may ask why the Bank of Slovenia is taking the lead in organizing a conference on SMEs. This can be answered from two perspectives.

The first perspective is the overwhelming importance of SMEs in the Slovene economy. The facts and figures are very revealing.

- SMEs account for 99% of total number of firms, 67% of employment, 57% of value added and 38% of exports.
- If one takes a disaggregated look at the SME sector, it is really the micro firms that dominate the number of firms (the definition for micro firms being less than 10 employees, turnover less than € 2 million, assets less than € 2 million); they account for 90% of total number of firms, 30% of total employment, 20% of value added and 9% of exports.
- Smaller firms account for a disproportionate share of job creation relative to their share in total employment.

The second perspective is, as the financial crisis has made it amply clear, the strong two-way interlinkages between financial sector and real sector developments. This makes it vital that the central bank understands and monitors developments in the real sector and the interlinkages with the financial sector. But, this is not the responsibility of the central bank alone. Banks, government agencies, and everyone involved in policy formulation and implementation also need to be aware of this analysis so that they can create a supporting environment for the SME sector. The Bank of Slovenia is facilitating this process also by organizing this conference.

The findings of recent research by Bank of Slovenia (already available on the website of the Bank) indicate that small and young firms were more sensitive to the cyclical downturn than large and old firms. Small firms and young firms experienced a larger drop in net employment growth than large firms and older firms during 2009-2013. The negative impact of the recession was felt most severely by firms in the 25-49 employees range, the group that had grown most rapidly during the pre-crisis boom period. The findings of another research project of the Bank of Slovenia that will be presented at the conference today indicate that small and medium-sized firms are more prone to deleveraging since the onset of the financial crisis.

How do we explain this outcome?

The relatively greater tightening of bank credit to small and medium-sized firms was only part of the reason for this outcome. This outcome also reflects variations in market orientation and the impact of inter-firm linkages. As I have already noted earlier, the SME sector is less export oriented and more dependent on domestic demand. Thus, SMEs were impacted more than large firms by the contraction in domestic demand during the recession. Another reason that is often under-appreciated is the impact of inter-firm interlinkages.

SMEs that were subcontractors for or suppliers to large firms experienced liquidity squeeze on account of payment delays by large enterprises that were also hit by the crisis.

The Bank of Slovenia has initiated a project to analyze inter-firm linkages. Another paper to be presented later today by the Bank of Slovenia staff addresses the question of economic structural changes and key sectors using input-output tables before the crisis and during the crisis. In the next stages of the project, our aim is to expand the analysis to SMEs and to connect real and financial aspects of the crisis.

A key goal for all policy makers is to create a supporting environment for SMEs—for new entrants as well as for continuing firms. Improving access to finance is key. Financing programmes offered by the Slovene Enterprise Fund and Slovene Export and Development (SID) Bank have helped to support access to finance of SMEs. But, we also need to focus on the more vulnerable categories of small businesses that are currently underserved by the market. It would be important for the two Slovene financial institutions, in coordination with their partner banks responsible for final credit delivery, to develop new financial instruments for start-ups and young fast-growing enterprises.

New business start-ups already play a significant role in Slovenia. New entrants account for a little over 2% of total private sector employment in any given year, but their share in annual gross job creation is around 25%. Thus, it would be important to increase the awareness of potential and existing entrepreneurs on access to finance, put in place a one-stop shop structure to help SMEs overcome the administrative barriers for obtaining financial support, and provide support for getting foothold in export markets.

The banking sector alone cannot be expected to meet all the financing needs of SMEs. Lending to SMEs is inherently risky. The failure rate among SMEs is very high. Research by Bank of Slovenia staff indicates that three years of operation is a critical turning point in the probability of firm exit in Slovenia. Thus, evaluating the idiosyncratic risks from SME lending is not easy. In addition, information for carrying out adequate screening of loan applications is often imperfect and incomplete, and the process can be costly and resource intensive. Elsewhere, venture capital investments fill the gap that banks cannot cover. The venture capital market in Slovenia is thin. Thus, we need to explore methods for attracting higher volume of venture capital investment from foreign sources. For this to happen, one requirement is the development and implementation of a communication strategy to promote and market Slovenia as an attractive FDI destination.

Still, it is valid question to ask what is holding back bank lending to SMEs and how bank credit growth to this sector can be reinvigorated.

As I have remarked on numerous occasions, repairing the balance sheets of both the banking sector and the corporate sector is essential for unlocking credit growth. Repairing the balance sheet of the banking sector in Slovenia involves two main elements: restoring capital adequacy and addressing the problem of a large volume of nonperforming loans. Based on the findings of a comprehensive asset quality review and stress tests in December 2013, the government has already recapitalized five major banks and transferred a significant amount of non-performing loans of several large state-owned banks to the Bank Asset Management Company. However, the volume of non-performing loans still remains high. Over 70% of the total nonperforming loans are claims against SMEs. As long as asset quality is poor and expected default rates are high, banks will tend to restrict overall credit supply and apply a large risk premium to lending rates. Liquidity may not be a binding constraint in such a situation. Indeed, there is considerable liquidity currently in the Slovenian banking system.

What we need going forward is more efficient debt restructuring and insolvency regimes for firms. The Bank of Slovenia is now working on two parallel tracks to resolve the non-performing loan problem. Guidelines are being drawn up, in collaboration with the Bank Association of Slovenia, for the restructuring of non-performing claims of SMEs. In addition, the Bank of Slovenia and the Ministry of Finance are in the process of drawing up procedures, with the assistance of a consultancy firm, for the establishing of special-purpose vehicle (SPV) for non-performing claims. Many of you will recall that the Bank of Slovenia had organized, jointly with the European Investment Bank, a seminar earlier this year that also addressed this issue.

A note of caution is in order regarding boosting credit growth. Banks must be careful not to boost credit growth by reducing credit standards. They must also not feel the pressure to do so. We must not repeat the mistakes of the pre-crisis period. Matters may become worse if additional credit availability enables enterprises to postpone balance sheet adjustment. It is important that good borrowers rather than bad ones are the main beneficiaries of credit growth. The process of creative destruction must be allowed to operate. The viability of firms that have been impacted by permanent negative sectoral and idiosyncratic shocks and are unable to adjust is questionable. Therefore, we must not fall into the mindset that all troubled enterprises deserve to be saved. Instead, one should ask what are the factors behind the successful entry and expansion of many SMEs during the crisis period, and focus on creating a stimulating environment that nurtures and encourages this autonomous process.

I would like to conclude by emphasizing that creation of an environment where credit flows to productive activities in the SME sector requires a coherent and comprehensive approach. This is not a task that a central bank can carry out alone. Banks and policy makers in the government have a critical role to play as well.

I am looking forward to a productive discussion.