POLICY PAPER ON

FINANCING SMEs IN BANGLADESH

LESSONS FROM THE GERMAN EXPERIENCE

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FRIEDRICH EBERT STIFTUNG Bangladesh

SME FOUNDATION

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1. Introduction

An industrial organizational system with large number of micro, small and medium enterprises (MSMEs) can create sound economic growth in developed and developing countries. Small and medium enterprises can upscale, and can promote forward linkages for medium and large enterprises. It can also contribute to equitable regional growth, income redistribution, distributive employment creation, poverty alleviation and innovations particularly in small enterprises (e.g., Helmsing 2003; Calvino et al. 2016; Reeg 2013). As such, there will be efficient use of resources - shifting resources from unproductive traditional sectors to more productive and modern sectors (Acs and Audretsch 1990; Read and Staines 2004). It, therefore, enhances productivity growth and leads to expansion of national and international trade (Cook and Nixon 2000; Khan 2014).

In most developing countries, micro and small enterprises constitute almost 95 percent of total enterprises. A recent data shows that, globally MSMEs constitute over 90 percent of all firms and business enterprises; employ more than 60 percent of total employment (World Bank, 2010). The contribution of MSMEs to GDP is lower in developing countries than that in developed countries.

An economy with a large number of small firms would be dynamic and rewarding entrepreneurship (Read and Staines 2004). Entrepreneurs try out innovative ideas through small firms. This innovation allows for the organic growth of enterprises from small to medium and possibly large enterprises. This is the role of innovation and entrepreneurs that Schumpeter (1934) argued in his theory of 'Creative Destruction. He argues that entrepreneurs play a critical role in real economic growth through innovation, new products, new employments, new markets and new industrial organization. When all these changes take place, Schumpeter's creative destruction takes place as well.

In Bangladesh, the SME sector has been given special emphasis in the five-year plans (more in Seventh Five-Year plan document), industrial policy 2016, SME financing credit policy of Bangladesh Bank, and SME policy 2019. The sector includes cottage, micro, small and medium enterprises (GoB 2018). The plan document and the SME and industrial development policies recognize SME development as a vehicle for employment creation, inequitable distribution and poverty alleviation, in addition to economic growth. The data suggests that the contribution of SMEs to GDP has increased but it has increased at a slow pace. Although SMEs include cottage and micro enterprises, institutional support for cottage and micro enterprises has been relatively limited. Even between the small and medium enterprises, supports for medium enterprises have also been dominating. The Bangladesh Bank statistics show that around 18 percent of industrial loans are for SMEs, and a very small percentage for micro enterprises (Scheduled Bank Statistics June 2020). Over the past years, the rate has been more or less similar.

In Bangladesh, small enterprises contribute a little over three percent and SMEs together around 25 percent to GDP (in case of manufacturing SMEs, the rate is around 17 percent) when micro and small enterprises constitute almost 99 percent of the enterprises[1], while among the Asian countries, the SMEs contribute about sixty percent to GDP in Indonesia; over 35 percent in Malaysia and over fifty percent in South Korea during the period of 2007-2012 (Yoshino and Taghizadeh-Hesary 2015). In the European countries, micro and small enterprises constitute almost 95 percent of the enterprises. Contribution of micro and small enterprises is higher in employment than those of medium and large enterprises. In the USA, it is also around 95 percent.

The question is, why pace of developing SMEs in Bangladesh is slow compared to other countries as noted above? There must be some market and policy failures. Limited access to finance appears to be a dominating and critical constraint in the SME development. This is evident from the survey of literature on SMEs in Bangladesh (e.g., Rahman et. al. 1978; Ahmed 2017; Ahmed 1999; Khalily et al. 1994). What ought to be done to address the issue of access to finance? One of the approaches can be to derive lessons from the best practices in different countries.

Germany is considered as the second most successful countries in SME development and its contribution to GDP. The policies are diverse. Most of the enterprises in Germany are SMEs. Development of SMEs is driven by different perspectives. Several interesting policies help developing SMEs in Germany. They are (i) both start-up SMEs are differentiated from mature SMEs; (ii) definitions and classification of SMEs are focused and objective oriented with micro enterprises defined as the enterprises with employees of less than 10; (iii) skilled manpower, a critical element in development of SMEs, is linked with high investment in human capital (vocational education and training); (iv) supportive banking system; (v) networking of SMEs that has implications for dissemination of information and learning from each other; and (vi) close relationship with government support agencies. *The critical goal in Germany is to develop Schumpeterian type of innovative, efficient, dynamic and sustainable SMEs.* Bangladesh may derive some lessons from the experiences of Germany in SME development.

The basic objective of this policy brief is to draw lessons from the experiences of Germany to address the constraints and/or policy or institutional failures for SMEs in Bangladesh.

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[1] Bangladesh Industrial Policy of 2010 outlines that enterprises with employees of less than 10 have been defined as cottage enterprises. Micro enterprises are the enterprises with number of employees between 10 and 25, while small enterprises constitute enterprises with employees between 25 and 99. Enterprises with employees between 100 and 250 are termed as medium enterprises. But this has been revised in Industrial Policy 2016. In the 2016 policy, Enterprises with employee of maximum 15 are defined as cottage industries; micro enterprises are with employees between 16-30. Enterprises with employees between 31 and 120 are termed as small enterprises. Enterprises with employees between 121 and 300 will be defined as medium enterprises, and enterprises with employees of above 300 will be termed as large enterprises.

2. ROLE OF SMEs IN BANGLADESH

Small and Medium Enterprises (SMEs) refer to the non-farm enterprises in Bangladesh. As noted earlier, it is defined in terms of number of employees and size of fixed assets (excluding land and building). These enterprises include manufacturing, trade and services. Bangladesh Bureau of Statistics (BBS) provides information on number of economic enterprises through census of economic enterprises and survey of manufacturing enterprises. The former one is more comprehensive. The latest available statistics suggest that there are some 7.82 million economic enterprises in Bangladesh (Table-1). Of these enterprises, cottage and micro enterprises constitute 88.8 percent with 87.52 percent as cottage and 1.33 percent as micro enterprises. The 2013 Economic Census also shows that the number increased from a total of 3.71 million in 2001-03. The majority (71.5 percent) of these units are located in the rural areas.

Table 1: Size distribution of economic enterprises in Bangladesh

Category	Number (million)	percent of total
Cottage	6.843	87.52
Micro	0.104	1.33
Small	0.859	10.99
Medium	0.007	0.09
Large	0.005	0.07
All	7.818	100

Source: BBS, Economic Enterprise Census 2013

Among different economic activities, the service sector is the dominant with wholesale and retail trade and repair of motor vehicles and motorcycles accounting for nearly 46 percent of all establishments followed by transportation and storage (16.7 percent) and other service activities (13.2 percent) while manufacturing has a share of 11.1 percent. It is seen that the majority (more than 51 percent) of the establishments operate businesses without any registration (Bakth and Basher 2015).

A comparative analysis of the statistics covering the period 1986-2013 provides several interesting findings (Bakth and Basher 2015):

- Since 1986, total number of economic enterprises has increased by almost four times by the end of 2013 with an annual compounded growth rate of 3.4 percent between 1986 and 2003 and 7.2 percent between 2003 and 2013 This growth rate was much higher than the population growth rate of Bangladesh.

- Number of manufacturing enterprises has increased by 1.70 times since 1986, with a declining share in the total – reducing from 24.5 percent to 10.9 percent in 2013

- Number of enterprises (almost 90 percent) are engaged in trade and service sectors;

- An increasing trend in the location of enterprises in rural areas suggests a dynamic behavior of rural economy.

The area of concern is the declining share of manufacturing enterprises. However, increasing share of cottage and micro enterprises and rural enterprises perhaps suggests that the SMEs in Bangladesh are more towards livelihood, employment creation and poverty alleviation.

The BBS Economic Census 2013 reveals that, out of the total employment of 24.5 million, medium and large enterprises together have a share of only 17 percent. Cottage and micro enterprises together have a share of 56 percent of the total employment. With inclusion of small enterprises, the share is around 87 percent.

Similarly, Manufacturing SMEs have contributed to GDP with a total share of 18 percent in recent years. By definition, contribution of large and medium enterprises in total employment will be relatively high. Bakth and Basher (2015) showed that since 1986, the share of cottage enterprises in total employment has decreased from 73.8 percent in 1986 to 53 percent in 2013. They further showed that more than 84 percent of rural non-farm employment was generated through cottage (over 80 percent) and micro enterprises (around 4 percent) in 2013. The contribution of various categories of SMEs together is between 80 and 85 percent of industrial employment and around 25 percent of total civilian employment. This brings to another area of concern that SMEs (small and medium enterprises) excluding micro and cottage enterprises are more urban focused. Therefore, it contributes to inequitable regional and income distribution against rural areas.

An important positive change that has taken place in small and medium enterprises is the diversified sub-sectors within SME sector. It can be evident from the information derived from different sources (e.g., Ahmed, 2001; Mintoo 2004) that along with traditional sub-sectors, the non-traditional SMEs that have flourished include shipbuilding, IT, apparels, pharmaceuticals, light engineering. Such changes are noted in small enterprises.

The question is, why cannot SMEs develop, particularly manufacturing enterprises? What institutions are in place to support SMEs in Bangladesh? What are the policies driving development of SMEs?

3. Access to Finance as a Support Service for SME Development in Bangladesh

Considering importance of SMEs in Bangladesh economy, the Government of Bangladesh has established new or directed established institutions for providing different support services to the small and medium enterprises. Extending different services through different institutions is an outcome of series of initiatives taken by the GoB for SME development. It established SME Cell (a permanent unit) under Ministry of Industries in 2003 and constituted a national SME taskforce (temporary body comprising experts and professionals assigned with specific objectives) in the same year. The GoB also formulated SME Policy Strategies in 2005, implemented Small and Medium Enterprise Development Program (SMEDP) in 2006 and then finally established SME Foundation, as an apex organization for promoting SMEs, in 2007. The support services may be classified into: (i) Financial support through banks, MFIs and SME Foundation; (ii) Technical assistance support; (iii) Governance and regulatory support; and (iv) Fiscal policy support. We focus here on access of SMEs to finance.

3.1 Bank-led financing of SMEs

Access to finance is inevitable for the development of the SME sector in Bangladesh. Prior to 2010, banks used to finance enterprises through their own credit programs and also in accordance with the directives. Although development of the SME sector was recognized industrial policy, there was directed credit policies for SME-financing. In 2010 Bangladesh Bank (Central Bank of Bangladesh) for the first-time formulated SME targeted credit policy to promote and develop SMEs consistent with the SME development policy of the government. In addition to setting targeted loan disbursement amount for SMEs, the policy recognizes development of SMEs through area-based and cluster-based approach to SME development. The area-based development approach requires that SME credit should be disbursed through all bank branches to finance all types of SMEs. The cluster development approach requires banks to finance cluster-based SMEs so that multiplier effects are large.

The policy underscores the need for promoting women enterprises through making provision of collateral-free loans under personal guarantees. It requires all banks to have dedicated desk for the women entrepreneurs. It is often observed that banks are reluctant to finance SMEs on the ground of no collateral or high risk of default. Bangladesh Bank provides for refinancing schemes for minimizing of risks and cost of fund for financing the SMEs. The policy requires that three important segments of the policy and programs are priority lending to women entrepreneurs, small enterprise development, and refinancing of SMEs. Apart from regular financing by banks and non-bank financial institutions (NBFI), the central bank has refinance schemes for medium to long-term finances to SMEs through banks and NBFIs against their disbursed SME credit. Presently, Bangladesh Bank with the help of government and different development partners is operating five refinance schemes in the SME sectors – Agro Product-Processing Industries in Rural Areas, Bangladesh Bank Fund, Bangladesh Bank Women Entrepreneurs Fund, New Entrepreneurs Fund and Islamic Shariah Based Fund (GoB, 2020).

Generally, banks are more inclined to lend to medium and large enterprises for low transaction cost and expectedly low rate of default. As a result, small enterprises are often screened out. In order to ensure promotion of small enterprises, Bangladesh Bank requires that at least 40 percent of the SME loans disbursed should be given to small enterprises. This policy is also most likely to ensure regional enterprise development, reduce income inequality and redistribution of resources.

The policy[2] continues with an increase in targeted credit amount of SME credit. SME credit disbursement target has been revised to

[2] Banks finance SMEs in Bangladesh. The Bangladesh financial system comprises of six public-sector banks, three specialized banks, 43 private commercial banks including ten Islamic commercial banks, nine foreign commercial banks, fine non-scheduled state-owned banks and thirty-four non-banking financial institutions. It also includes microfinance institutions (MFIs) under Microcredit Regulatory Authority. Banks generally finance SMEs and MFIs finance micro and small enterprises. Two agencies like SME Foundation and Bangladesh Small and Cottage Industries Corporation provide financial and technical supports to the SMEs with support from banks.

20 percent of annual total loan disbursement in 2017, which will be increased to 25 percent by 2021 with minimum of one percent increase in each year. Furthermore, the Central Bank has instructed banks and non-bank financial institutions (NBFIs) to disburse at least 40 percent for manufacturing, 25 percent for service and a maximum 35 percent to service sector of their total SME loan disbursement by 2021. The target is set by the Central Bank to ensure that SMEs are financed, as opposed to the preference of banks to finance working capital and terms loans for large enterprises. Such target is set for diversifying enterprise development and creating employment opportunities across regions.

Total amount of SME loans disbursed has increased by almost three times over the period 2010-2019 (Table-2). But more than fifty percent of the total SME credit disbursed was for trading, and around 25 percent for manufacturing enterprises. Women enterprise loans have steadily increased.

Table-2: SME Financing by Banks and NBFIs

(Taka in Billion)

Year (Dec End)	Trading	Manufacturing	Services	Total SME credit	Women Enterprise
2010	350.41	151.48	33.55	535.44	18.05
2011	343.83	158.06	35.10	537.19	20.48
2012	442.25	218.97	36.31	697.53	22.44
2013	567.04	240.16	46.03	853.23	33.56
2014	627.67	302.46	78.97	1009.10	39.39
2015	735.52	304.62	118.57	1158.71	42.27
2016	905.47	351.69	162.19	1419.35	53.46
2017	969.45	423.14	225.10	1617.68	47.73
2018	669.36	557.39	368.34	1595.10	55.17
2019	725.22	587.15	367.24	1679.71	61.08

Source: GoB, Bangladesh Economic Review 2020.

In addition to banks and non-bank financial institutions, SME Foundation has been offering limited financial support to selected number of micro and small enterprises, given limited financial capability of the Foundation. In addition, it links some enterprises to different banks for financial support. SME Foundation, established in 2007, has also been providing technical assistance. Technical assistance services include providing training to the entrepreneurs, linkage with the market, providing financial services in a limited way but mostly linking the SMEs with banks. Although the name of the institutions is SME Foundation, it is more focused on cluster development of micro and small enterprises. Cluster development has become popular because of the important role that the Foundation has been playing.

MFIs have also been providing loans to poor and non-poor members. In recent years, they have been providing micro enterprise loans to traders mostly. In 2016-17, these MFIs have provided over Tk.300 billion to micro enterprises. They seem to be more effective in rural areas where density of MFI-branches is almost three times more than those of banks.

3.2 Limited Access to Finance as a Major Constraint in SME Development in Bangladesh

Globally micro and SMEs are subject to some constraints. The constraints are quite common, although magnitude may be different. Several authors have addressed the constraints that the SMEs are confronted to. Therefore, they are subject to challenges of different degree. Indeed, the nature of problems will be different in different economies. In developed economies, SMEs face challenges from intense competition and technological change as in the European countries. In developing economies, most micro enterprises are not registered. They are constrained by lack of or limited information about market and technology, lack of finance, shortage of skilled manpower and weak industry associations.

Yoshino and Taghizadeh-Hesary (2016) argue that many SMEs are not able to utilize their capacity and cannot operate with efficiency due to:

- Lack of access to finance, skilled labor, market information and technology,
- Lack of scale and scope advantages,
- No effective networks for access to information, new knowledge about technology, domestic and international markets,
- Inability to compete with large firms because of their advantages in innovation and R&D expenditures in developed economies, in particular,
- Lack of entrepreneurial zeal, capacity, and know-how.

SMEs commonly face constraints that include low productivity, less value-added products, small investment, limited market area, business networks extremely limited, lack of access to sources of capital and raw material, and unprofessional management (Koe, Wei-Loon, R. Omar, and J. Rizal Sa'ari 2014; Munizu, Sumardi and Armayah 2016).

In Bangladesh, quite a number of publications and research studies have been conducted since 1970s. Most of the publications[3] focused on constraints to and challenges for development of SMEs in Bangladesh. Quite a diversified set of constraints have been identified. Like in other countries, limited access to finance emerges as one of the dominating constraints.

Finance is a powerful intervention for economic growth especially in a resource-constrained developing country like Bangladesh. Access to finance especially to the

[3] See Ahmed (1999; 2001; 2004; 2009; 2013; 2014; 2017), Ahmed, N. et al. (2011), Ahmed, S (2012), Bakth and Ahmed (2010), Bakth and Basher (2015), Begum R (1993), Chowdhury, et al. (2013a, 2013b), Daniels (2003), GoB (2006), Hasan and Jamil (2014), Islam (2014), Islam et al. (2009), Kamal Uddin (2014), Khandker (2014), Khandker, et al. (2013), Khalily, et al. (1994), Khalily (2006), Khan 2014; Khan, et al. (2002), Miah (2006) Mintoo (2004), Qamruzzaman (2015), Rabbani, et al. (2005), Rahman et. al. (1978), Rahman et. al. (2012), Razzaque (2003), Sarder (2000), SEDF (2006), Zaman and Islam (2011), SME Foundation(2013a-2014), among others.

poor is essential for promoting inclusive economic growth and eradicating poverty in the country. Recent studies have pointed to the importance of the rural nonfarm sector (RNF) in developing economies.

Since the independence of Bangladesh institutional structure and traditional collateral based lending has changed significantly. Despite increasing in the number of banks and financial institutions and targeted policies, SMEs do have constraints of limited access to finance. It was highlighted by enterprises also in the cluster zones. Several factors contribute to limited access to finance: lengthy and complex loan sanctioning procedure, requirement of too many documents, collateral requirements. Interest rate was considered as high, although this is not a problem now-a-days. The recent statistics show that although SMEs do have access to long term loans for investment in fixed assets but most of them, particularly small enterprises, have little access to working capital loans. As these enterprises have little access to capital market, SMEs (particularly small enterprises) are more dependent on bank financing for both term and working capital loans.

In a recent study Ali and Islam (2018), based on their survey result, showed that 80 percent of the SMEs did not have access to institutional credit although 85 percent of the respondents expressed their desire to borrow from institutional sources. This finding is validated by the authors from another finding that vast 90 percent of the SMEs have been suffering from lack of sufficient finance. As evident in other studies, the authors identified collateral requirement as a barrier to get loan. Based on the Economic Census Data, the authors call the SMEs as the missing middle in credit market. The authors argue that cottage and micro enterprises have access to micro credit, and the large enterprises have access to institutional bank and non-bank financial institutions (Ali and Islam 2018). The missing middle is further exemplified by the fact that 70 percent of the SME credit demand remains unmet.

In another study, the World Bank (2019) reported that access to finance for SMEs is limited compared to the South Asian countries. Based on few literature (such as IFC 2017, Daniel 2003, Haider and Akthar), the report the financial constraint is well documented. It also argued that lack or poor quality of collateral is detrimental to access to finance in formal credit market, among other things. The most important evidence that the report provides is, financing gap for micro and SMEs has increased over time, from BDT 130.4 billion in 2011 (IFC 2013) and BDT 193.1 (World Bank 2019). However, the financing gap increases, as reported in the World Bank, to BDT 237 billion enterprise headcount is adjusted.

3.3 Credit Guarantee Scheme in Bangladesh is yet to make a headway

In recent years, different attempts were made to introduce credit guarantee scheme in Bangladesh. Following the catastrophic impacts of Corona on cottage, micro and SMEs, Bangladesh Bank in early August of this year announced Credit Guarantee Scheme (CGS) for expanding credit facilities to micro and SMEs. The CGS is a partial guarantee scheme. Under the scheme, at first, banks and non-bank financial institutions will have to sign an agreement with the Bangladesh Bank.

The agreement will span over five-years. The participating institutions will be required to pay one percent of loan amount as CG fee in first year. This fee can be reduced in the subsequent years should the non-performing loan rate remains at five or less. The CGS is termed as the partial CGS because Bangladesh Bank will pay 80 percent of the bad credit guaranteed amount and the bank will bear the remaining 20 percent. However, in order to participate in the CGS, banks will be required to have 3-year experience in SME financing. The banks will have to maintain non-performing loan rate of 10 or less percent in order to continue participation in the subsequent years.

4. Challenges

Based on the review of the policies and the problems, quite a number of critical challenges can be identified:

First, SMEs are missing middle in the formal credit market, although substantial policy changes and institutional arrangements have been made over the past years[4]. Despite the increasing trend, most of the SMEs find it difficult to access formal credit market.

Second, there is a huge financial gap in financing micro and SMEs. The gap has been increasing over time. Over the period of 2011-2019, it has increased by over 40 percent.

Increasing financial gap demonstrates inadequate access of micro and SMEs to formal finance.

Third, credit guarantee scheme is not yet institutionalized in Bangladesh; it is more of a scheme. Consequently, its utility and practice is very limited. The CGS that has been proposed very recently is yet to take off. Bangladesh Bank tried at different times to launch CG but failed.

Fourth, collateral and poor quality of collateral remains as a barrier in accessing bank credit. It is a serious problem for start-up enterprises.

Fifth, banks are reluctant to lend to micro and SMEs. Such reluctance is consistently observed, and in fact such behavior is quite rationale given the fact that such reluctance is due to preference for lending loans to large enterprises.

Sixth, due to limited role of training institutions and weak apprenticeship programs, dearth of skilled manpower exists. Continuous apprenticeship and on-the-job training programs are one of the pre-requisites for creating skilled workers in SMEs. High

[4] The SME policy 2019 identifies following goals for SME development: (i) Improving business environment and institutional framework; (ii) Increasing scope of the SME sector to receive institutional funding facility; (iii) Support to increase competitiveness capability and access to SME products market; (iv) Support short-term, low cost SME business support services to the start-ups; (v) Develop and expand SME Cluster-based Business Network; (vi) Increase use of ICT and other technologies; (vii) Expansion of skill developing education and training programs for entrepreneurs; (viii) Expanding women entrepreneurship development programs and providing specialized services; (ix) Establishing SME as a backward and forward linkage enterprises to the large industries and ensure protection of SME products; (x) Establish environment-friendly SME industries and develop better capacity for waste management; (xi) institutionalize SME statistics and conduct research and development activities. It has formulated multiple implementation strategies for promoting through agencies like wholesale agencies and non-bank development agencies, and financing SMEs with major financing role of banks.

mobility of new trained workers makes it costly for the enterprises.

5. SMEs in Germany: Role and Financing

5.1 Role of SMEs in Germany

Germany is a role model for SMEs globally. The German SMEs are known as Mittelstand firms or companies. Most of these companies are family-owned and based in small towns yet they hold market shares of up to 90 percent in worldwide markets niches. The 2019 SBA fact sheet reveal that the SMEs generate 54.4 percent of overall value added and 63.7 percent of overall employment in the German non-financial business economy. Around 99.5 percent of the German enterprises are SMEs including 82.0 percent micro enterprises and 15.1 percent small enterprises. The SME value added of the SMEs in 2017-18 grew by 4.4. percent, and the micro-firms contributed most to this growth. Small business development in Germany has taken place based on several principles as noted the Small Business Act (SBA). The principles include (i) think small first, (ii) promotion of entrepreneurship, (iii) second chance for the honest bankrupt enterprises, (iv) responsive administration to the needs of the SMEs, (v) facilitating SMEs through state aid and public procurement, (vi) access of SMEs to finance, and (vii) policy support for SMEs in the single market. These principles are equally applicable for the EU countries including Germany.

The Mittelstand firms have some unique features (De-Massiss et. al. 2019). First, the Mittelstand firms promote localized economic development while enabling firms to excel internationally within well-defined niche markets, complemented by investment on research and development. Such companies are not only leaders, and they often have share of more than 50 per cent in the market. Second, most of the Mittelstand companies are family-owned and prefer to rely on their own financial power, which brings with it a high degree of independence, autonomy, and security. Third, a strategy focusing on the quality, innovation, and technology of the product as sources of competitiveness, rather than relying mainly on price competition, is another characteristic of the Mittelstand firms. Fourth, the SMEs in Germany have highly skilled, motivated, committed and capable human resources who feel a sense of community at their company and also feel that the values of the company coincided with their own values. An extensive boost in training, skills, human capital, and capabilities invested in young people through the German apprentice system contributes to such value creation. Fifth, the flat organizational structure of SMEs allows decentralization and independent decision-making. Most of the SMEs are family owned. Employees have direct access to management and are involved in decision- making. Sixth, the long time-horizon used for planning and decision-making is another feature of German SMEs. Most SMEs are working to secure the company's long-term existence and place great value on lasting relationships with customers, suppliers and other businesses. Seventh, flexibility is not just a core strategy for the company but grounded in its cost structure. Over the last several years, when demand for the company's products was high, the company registered about forty-five thousand hours of overtime work. While this may cost more in the very short run, SMEs enjoys the longer-run costs savings. Eighth, generally, the Mittelstand firms follow conservative growth-path due to their unwillingness to access external finance. But at the same time, they are not also willing to restrict their operations to limited local markets. The desire to be competitive in global markets makes these firms to be more focused. Nineth, the German Mittelstand firms have higher external orientation reflecting in higher participation in exports.

5.2 The German SME Policy:

The German SME policy is formulated with multiple objectives and goals along with specification of strategies. The policy focuses on ten areas. They are as follows:

First, promoting entrepreneurship is the primary focus of the policy. SMEs are recognized as an engine of growth in Germany. More than 300,000 new enterprises start-up every year in Germany creating additional economic drive and new jobs.

Second, strengthening the financing of start-ups and growth SMEs. Access to finance is recognized as a requirement for SMEs to be innovative and competitive. As enterprises are credit-financed, the federal government always review impact of financial regulation on SME financing. Government has introduced several financial support programs for start-ups, growth-oriented and high-tech enterprises. These programs provide for credit and venture capital.

Third, securing skilled labor and bringing refugees into vocational training and work. As SMEs may face tougher international competition, and competition from large companies, the SME policy stresses upon development and recruitment of skilled workers. Federal government has joined with different stakeholders including employment agency, enterprises, unions and lenders to strengthen the skilled development training and apprenticeship program for the workers.

Fourth, pressing ahead with efforts for better regulation and less red-tape. In order to enable SMEs to concentrate on their core business, federal government reviews the system and removes red-tape in bureaucracy to make start-ups simple and less costly.

Fifth, harnessing and shaping digitization. The policy supports digitization within the skilled craft sector by centers of excellence for SMEs that offer expertise services, network for sharing experiences and best practices. The government extends support to the SMEs that introduce modern information and communication technologies.

Sixth, boosting innovation. Ability to innovate drives competitiveness of any enterprise. Federal government supports such ability through creating a pro-innovation environment and market-driven funding programs. Furthermore, it provides grants for market-driven research and development programs in technology and formation of innovation networks.

Seventh, using the opportunities afforded by globalization. The German Mittelstand has strong presence in international market. Some 44 percent of the companies export their goods. Small companies are even benefitted from such exports. A toolbox called 'Mittelstand going global' helps SMEs to go international. The program caters to the forward-looking companies and provides information about foreign markets to facilitate international trade.

Eighth, Small and medium-sized enterprises (SMEs) are Europe's driving force for growth and jobs.

Ninth, strengthening SMEs in less-favored areas. The policy focuses on targeted regional policy to improve business environment in less-favored areas so that SMEs can be spread across the Germany.

Tenth, supporting the development of new fields of business driving from the energy transition. The energy transition offers major opportunities to small SMEs to expand into new markets. The government provides advisory services and financing opportunities to enable SMEs into these new markets.

5.3 The German Banking System

The German Financial System is historically known as bank-based system. There are three major types of banks: publicly-owned savings banks, cooperative banks, and private banks (Kaya 2014). These banks can perform commercial and investment banking. In addition to these banks, there are also specialized banks (Detzer et. al. 2013). Both publicly-owned savings and cooperative banks are non-profit oriented banks. They would operate on a minimum profit basis.

Private banks comprise big banks, regional banks and branches of foreign banks that operate for profit. The big banks such as the Deutsch bank and the Commerzbank traditionally have acted as house banks to the Germany's big industrial undertakings. The second group of private banks includes smaller joint-stock banks most of which operate on a regional basis. In 2018, the private commercial banks accounted for 40 percent of total assets in the banking system (EU 2019). The German banking system is local economy-based system concentrating on regional development, commercial, and household issues.

The savings bank sector consists of primarily the primary savings banks or Sparkassen. These banks are owned by local city and county government. Profit maximization is not their primary objective. The basic objective is to serve the public interest in their local community. The close relationship between the Sparkassen or primary savings banks and the SME sector has greatly contributed to access of SMEs to credit. The second level of the savings banks comprises of the banks jointly owned by the regional association of the Sparkassen or primary savings banks and the regional state governments. These banks may be termed as regional banks. There are some 385 savings banks in the country representing 26 percent of total assets in banking system (EU 2019).

Cooperative banking sector comprises the primary cooperative banks and regional institutions. Regional institutions act as the central banks for the primary cooperative credit banks. Because of the localized nature of primary cooperative banks, these banks compete with commercial and investment banks at the local level. Currently there are some 875 cooperative banks. It accounts for 50 percent of the institutions and 18 percent of total bank assets (EU 2019).

Finally, in addition to the private, savings and cooperative banks, there are three specialized groups of banks that provide specialized functions. One group consists of mortgage banks; another group is made up of building and loan association. The last group of specialized banks provide funding to promote investments in specific sectors. The largest is the public-owned KfW. It also includes IKB (German Industrial Bank). These banks have been instrumental in providing finance for SMEs.

It can be argued, in brief, that banks in terms of ownership can be grouped into three – commercial banks (owned by private investors), public banks (owned by municipalities) and cooperative banks. Most of the small and savings banks are publicly-owned. Both public banks and cooperative banks may also be termed as regional banks. These banks are prime providers of credit for SMEs and households. Private banks operate at the national level (some even operate at the international level) focusing on financing mostly corporate and institutional clients. Deposits are protected in private banks by deposit insurance and deposits in public and cooperative banks are protected by institutional guarantee.

Therefore, the banking system in Germany has a mandate to serve local economy providing supports and services to local firms and private households. Both public savings banks and cooperative banks are only allowed to credit in their region and they assume joint-liability for sharing losses with the firms. Also, the banks give long-term credits and reschedule credits in times of problems.

The German banking system is based on relationship lending approach (Herr and NEttekoven 2017). The financial institutions have close relation with the firms for a long time. They participate in the decision-making process of local firms' management. Through this practice, banks work as house bank of the firms. Besides the financial affairs, there exists a good social relationship between the two groups of stakeholders. This relationship is highly valued as social capital, which can be leveraged, in financial environment. Social capital is built on trust and this trust helps local banking system to overcome asymmetric problem. This overall process facilitates the German Banking System allowing local firms easy and more access to finance from banks with low interest rate. Therefore, almost all firms including small firms and firms with R&D are financed, such as short term, long term, and even finance for temporary difficulties, by public banks comfortably (Spence et al., 2003).

The banking system in Germany has created a culture of good network with all stakeholders based on local economy. A heavy involvement of public-banks in company's decision-making helped to create such network. Such position of banks in company's management facilities extending their advisory role to and guiding the firms in the line of planned direction (Krahnen et al., 2014).

5.4 Financing SMEs in Germany

There are some institutional mechanism and financial policy interventions for promoting and financing SMEs in Germany.

(i) *Pro-SME institutional mechanism:* one of the important characteristics of the German financial system is the fact that quite a large number of regional publicly-owned savings and cooperative banks operate in local economy. As a result, there is a close relationship between SMEs and the regional savings and cooperative banks. Because of such relationship, banks have access to more firm-level information and are able to monitor credit-repayment behavior. It has also strengthened relationship banking between borrowers and lenders. As such, this facilitates region-based SMEs to borrow from the institutions.

(ii) *Strong role of specialized public sector bank, KfW, to support SMEs:* KfW is the leading institution to provide long term investment and working capital loans to SMEs in Germany. They do not directly lend to the SMEs; they channel funds for promotion of SMEs through commercial and public sector regional savings and cooperative banks. It offers a number of programs for (a) self-employed individuals, (b) start-up or new enterprises, and (c) old and dynamic SMEs. KfW typically provides loans at a fixed and subsidized rate.

(iii) *Government initiatives to provide subsidized credit to SMEs:* Governments at the federal and state levels have undertaken different credit/equity support programs for start-up and growth enterprises (OECD 2020). These programs are implemented through different leading pubic sector banks like KfW. The programs include (a) credit-based financing for start-ups and new enterprises with long maturity period; (b) ERP innovation financing to promote digital transformation of SMEs; (c) high-tech start-up fund for relatively new highly innovative and technology-oriented enterprises; (d) micro-mezzanine fund to provide equity support for small companies and business-starters; (e) KfW Capital (German promotional bank capital) for venture capital; and (f) venture tech growth financing for innovative fast-growing tech companies. All these programs have addressed different groups of enterprises – from small companies to high tech innovative companies. We may term it as highly targeted programs for different types of companies with the objectives of creating start-up companies and promoting innovative high-tech companies.

(iv) *Institutionalized credit guarantee banks:* Lack of collateral is a constraint for many companies including start-up and growth enterprises, to get loan. Some companies get loans, and others do not; some are credit-rationed out. Credit guarantee scheme is quite a popular strategy in different countries that undertakes some of the credit risk in order to banks to finance sound and profitable projects. Since the beginning of 1950, Germany has institutionalized credit guarantee schemes, often termed as credit guarantee banks. As noted by Valentin (2014), German guarantee banks are specialized banks with limited liability. They all have general assembly and an executive board. Every one of the federal states in Germany has an autonomous guarantee bank. These banks concentrate their business on (a) start-up SMEs; (b) growth SMEs; (c) innovative and high-tech SMEs; (d) SMEs in new industrial sectors, and (e) survival SMEs with a risk-sharing partner. It covers almost all the viable sectors including manufacturing enterprises. Different risk-undertaking contractual arrangements are made. Generally, a guarantee covers up to 80 percent of the overall loan amount. However, with counter-guarantee of federal and state, the default risk liability of a guarantee bank amounts to 35 percent. As such, of the overall liability risk, banks assume 20 percent of default liability, guarantee bank assume 28 percent and the federal government and federal state assume a total of 52 percent of total liability risk. Such institutional arrangement and participation of the government in liability risk facilitate SMEs, particularly small enterprises, to access credit from commercial and public-sector banks.

6. Lessons from The German Experiences

Bangladesh has progressed quite a lot in terms of institution and policy over the past four decades. The changes that have taken place are quite substantial. As noted earlier, different types of financial institutions have emerged; there are public-owned commercial banks, private commercial banks, specialized banks and non-bank financial institutions. However, their effectiveness in SME development is quite limited. Large enterprises have access to credit as they are sponsors of private banks. Different government-guided credit policies for agriculture and industrial development are in practice, as formulated by Bangladesh Bank. Despite government efforts and directed credit policies as well as institutional mechanism, SME financing has a limited success. As evident in different studies, SMEs are the missing middle in Bangladesh credit market. The critical determinant of limited access of SMEs, particularly small enterprises, is collateral. Lack of collateral restricts supply of credit SMEs. What lessons can be derived from the German experiences to solve the problem of SME financing?

First, institutional structure particularly regional banks have contributed to developing relationship banking at the regional level. Such relationship banking is a key to financing of SMEs in Germany. Bangladesh needs to evaluate the institutional structure and search for developing closure banking relationship banking at the regional level. Existing institutional structure in Bangladesh is not pro-SMEs, particularly for small enterprises. Regional banks or increase in branch density will be a supply side intervention to develop closure relationship between SMEs and banks.

Second, there is a direct role of public sector bank, particularly KfW, in expanding credit facilities to the SMEs through regional public sector savings and cooperative banks in Germany. This implies, public sector institutions are key to access of SMEs to finance. With government support, public sector banks have been providing subsidized credit to the SMEs. The public sector banks in Germany are not profit-driven. In Bangladesh, given the fact that SMEs, particularly small enterprises, are screened out in private banks, public sector banks, as in Germany, can be specifically assigned with the responsibility of financing SMEs mostly across the country.

Third, as in many other countries, lack of collateral restricts supply of credit to SMEs, particularly small enterprises, although it is true that collateral does not reduce probability of default. Collateral protects loan amount. Therefore, there is a need for alternate mechanism. In Germany, credit guarantee banks (CGB) have been developed to provide guarantee against credit risk. It is a public-private partnership. Government also provide guarantee. With the participation of different stakeholders, in Germany the share of CGB is around 28 percent. In Bangladesh credit guarantee scheme (CGS) has been tested but not much with success. The Bangladesh SME Policy 2019 recognizes CGS as a policy intervention. In 2020, Bangladesh Bank has developed a CGS for supporting SMEs in Corona crisis. Bangladesh Bank in consultation with Government of Bangladesh needs to institutionalize collateral guarantee, and it should be developed in every division so that SMEs can focus on business development. This is the lesson that Bangladesh can derive from the German experiences.

Fourth, SME policies in Germany are based on ten areas, as noted earlier. The critical feature is that the policy addresses start-ups and matured enterprises as well high-tech enterprises separately. Financial programs have been also separately formulated accordingly in Germany. In Bangladesh, the SME financing programs should be separate for the diverse types of SMEs. Bangladesh Bank, in consultation with government of Bangladesh, can design targeted credit programs for different segments of SMEs.

Fifth, one of the key drivers of success of SMEs is skilled workers. Strong apprenticeship program is the key driver. Business risk can be significantly reduced through quality skilled workers. Credit risk will be lower when business risk is lower. In Bangladesh, focus on developing skilled workers will be in the best interest of SMEs and lenders.

Sixth, SMEs need to properly defined to make development of micro, small and medium enterprises (MSMEs) more focused. It should be consistent with international practices. A simpler approach needs to be taken to define MSMEs.

7. Conclusion

SMEs do play a strong role in the developed economy. A strong and competitive SME sector is important for employment creation, value addition, economic resilience, innovation and competitiveness at the national and international level. But SMEs are heterogeneous in nature and types. That is why, in Germany has formulated different sets of policies, particularly financial policies, for different segments of enterprises – start-ups and matured enterprises; innovative and non-innovative enterprises. Innovation drives the German SMEs more competitiveness. Bangladesh Bank may formulate policies for high-tech, innovative and competitive enterprises, non-innovative normal SMEs and local market driven SMEs. There are always international good practices; Bangladesh should derive lessons from those best practices. The success of German SMEs in national and international markets makes it global best practice for deriving lessons for. Bangladesh can derive some lessons from the German experiences that might be useful in developing a competitive, innovative and vibrant SME sector in Bangladesh. Institutional and policy reforms might be required to make the sector competitive. The recently formulated Bangladesh SME Policy 2019 is a step forward.There are still rooms for lessons for Bangladesh from the best practices like Germany.

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