Small Businesses The Long, Winding Road to Credit

Enrique Pino Hidalgo*


Antonio Nava/AVE

Micro-, small and medium-sized businesses provide most of Mexico's jobs.

In Mexico, only one-third of the work force has access to credit in the national financial system. This restriction is even greater for businesses. At the end of 2000, only 29 percent of Mexican businesses enjoyed some form of credit from any kind of banking institution. This is basically due to three factors: high interest rates, the banks' reluctance to grant loans and economic uncertainty. In any case, Mexican banks are not in sync with the economic and financial modernization the country requires.

Six years after the 1994-1995 financial and productive crisis, the Mexican banking system has only just begun to reactivate credit lines to productive sectors. It is, however, far from satisfying the demand, and, above all, the financial needs of hundreds of thousands of micro-, small, and medium-sized entrepreneurs, whose companies provide the majority of the country's jobs. Obviously, the difficulties and challenges these businesses face are not reduced to getting resources from formal and informal financial markets. In addition to scarce and expensive credit, they face problems in the commercialization of goods and services, the labyrinthine tax structure, accounting and management skills.

The federal government recently announced that it will take a three-pronged approach to reactivating credit to the country's productive sector:

a) A broad restructuring of the development banking system;
b) the reactivation of commercial credit; and
c) a program of "popular" banking and micro-financing.

* Economist, researcher and professor at the Autonomous Metropolitan University, Iztapalapa campus.

Given the commercial banking system's inability or disinterest in supporting micro-businesses, the role of development banks and social banking institutions becomes more important. By their very nature, these institutions are more oriented to linking up with the real economy since their objective is to promote and orient production by micro-, small and medium-sized companies, which numbered more than 3.5 million in 1996.

In Mexico, the "popular" banking system is made up of more than 600 institutions that take in resources from low- and medium-income households. As a sector, it is very heterogeneous and deals with different financing needs. For example, credit unions receive monies both from their members and government development banks that they channel as loans to productive projects. Savings and loan associations are local; they receive monies from their members and give loans only to members. Cooperatives, on the other hand, are usually part of a regional or state federation and receive savings from their participants and grant loans to both members and non-members with collateral.

Community savings associations are local organizations that receive monies from their members and grant them relatively small loans. And, finally, mutual aid or solidarity associations accept contributions from their members with the aim of covering specific emergency expenditures the members may confront, such as funeral costs, emergency health care or other extraordinary expenses; they usually operate on a community, neighborhood or factory level.

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These financial institutions cover more than 2.5 million people. Despite its relative geographic and demographic dispersion, the social banking system represents less than 1 percent of all the assets of the commercial banking system. In any case, the potential and social and economic importance of these kinds of intermediaries is clear (see table on popular savings and credit).

This article will present a panorama of the new credit options for micro- and small businesses, as well as a few initial observations about the "Social Banking and Micro-credits Program" announced by President Fox and the "Micro-credit Program" promoted by the Mexico City government. As we shall see, these policies suffer from considerable limitations, both due to the overall amount earmarked for loans and the size of the loans granted. However, I think both programs will have a positive effect in the reactivation of micro-business credit markets that until now have been practically non-existent.

Stratification And Characteristics of Mexican Businesses

Mexico has different kinds of micro-, small and medium-sized businesses. In some cases, micro-businesses are classified as part of the informal economy and include self-employed workers and non-paid family-member workers. In other cases, they are classified as family businesses, the informal sector or even as part of the criminal layers of society.[1] They range all the way from women who make tacos on portable grills and sell them on the sidewalks outside their front doors at night to craftsmen making wrought iron screens in workshops in Tlaquepaque, Jalisco, filling orders for stores in Manhattan. The International Labor Organization's (ILO) more or less standard definition is based on the number of jobs they provide and the amount of annual sales or income they take in: micro-businesses have up to 6 employees (except in manufacturing where they can have up to 16), while small non-manufacturing businesses have from 7 to 15 employees.[2] In the category of micro-businesses, the definition includes:

Family businesses, which are less developed and operate in traditional industries. Frequently, they are a survival strategy and aim their production at the local market. Generally, their owners lack basic skills and instruments for competing in the marketplace.[3]

Competitive micro-businesses, which are more developed. Their owners know more about the market and institutions that provide advisory and other financial and non-financial services. They have permanent, waged workers whose labors are supplemented by temporary employees when the market demands it.

POPULAR/COMMUNITY BANKING SYSTEM (2000)				
Type of institution	**Number**	**Members (1000s)**	**Savings regulated by law**	**Effectively regulated and supervised**
Credit unions	32	19	Yes	Yes
Savings and loan associations	11	675	Yes	Yes
Cooperatives	157	1,081	Yes	No
Mutual aid associations	210	190	No	No
Community savings associations	247	633	No	No
Total	657	2,598		

Source: National Savings Bank (Patronato del Ahorro Nacional).

Micro-businesses articulated in consortia, which are usually linked horizontally or vertically to larger companies and have reached significant levels of productivity, with their output aimed at export or national domestic markets.[4]

More generally speaking, the companies are characterized by the size of the wages they pay, production and sales levels, the value of fixed assets and, of course, the kind and amount of financing they require for setting up and getting started. These variables also act as indicators of entrepreneurial activity and certain behavior that corresponds to patterns associated with the size of the firms. From that point of view, conventional economic theory suggests that efficiency increases as companies move from being micro to medium-sized to large, but that is now a matter for debate.

In Mexico, micro- and small companies have the following characteristics:

a) They operate with small-scale production and employ labor-intensive production techniques.
b) They use technologies adapted to employees whose abilities and skills have been learned on the job or through informal educational systems outside formal schools.
c) They are frequently owned by a single family and financing comes from their own pockets.

In our country, companies classified as micro-, small and medium-sized make up more than 95 percent of the total 2,187,000 establishments and provide more than 50 percent of all jobs.[5] The majority —55 percent— of these firms are in wholesale and retail trade.

In 1994, large corporations employed 3.374 million workers; medium-sized companies 1.518 million workers; small firms, 1.697 million; and micro-businesses, 2.76 million.

SELF-EMPLOYMENT COEXISTING WITH INTERMEDIATE PRODUCTION

Micro-businesses are extremely varied and encompass survival strategies linked to self-employment as well as intermediate production units. They include different forms of commerce and services that can even generate greater income than the wages earned by some workers in formal sectors. For example, Doña Francisca, who sells newspapers from a pushcart on a corner of two major streets in southern Mexico City for 6 hours a day, may sell up to 150 papers a day. Making one peso per paper, she takes in at least twice the minimum wage, while a bookstore or stationary store employee usually only makes minimum wage for an 8-hour day. (Forty percent of Mexico's work force makes twice the minimum wage or less a day.)

In the Mexican economy, micro-businesses are a manifestation of the heterogeneity of entrepreneurship and a response to their owners' own need for employment. In reality, micro-businesses are a mechanism to substitute for the lack of jobs and/or a reaction to the low wages prevalent in the formal job market. Regardless of why they arise, the economic role and weight of these companies is significant both because of their sheer number and the number of jobs they provide —almost 3 million nationwide.

Usually, micro-business owners have part of the capital they need to invest; for that reason they require financing and other kinds of support like accounting and merchandizing advice. Owners may very well not possess the characteristics of the "classic businessman (or woman)" (being creative, innovative, etc.), but they represent a social situation and a financial demand that cannot be ignored. In that sense, one segment of micro-firms are subsistence producers who have set up shop because of the economic and social effects of the economic crises and recessive adjustment programs that sharpen unemployment: this might include the woman —laid off from her job or unable to get a job in the formal market— who sells tacos on her doorstep. Prolonged recessions nourish the expansion of micro-businesses, while sustained economic recovery and growth would probably reincorporate many of their owners into the formal job market.

In this sector, we also find waged workers and professionals who decide to set up a business based on self-employment; for example, computer designers and/or technicians or accountants who work out of their homes. These are also self-generated jobs, but with the tendency to a broader outlook in which their owners are closer to the "classical" entrepreneur, with their organizational capacity, business sense, etc. These are "medium-level businessmen." From the sociological point of view, these economic actors have been classified as "the entrepreneurial middle class."[6]

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In brief, in some cases, micro- and small businesses are subsistence strategies or temporary employment, while in other cases, they correspond to projects with more integral, long-range visions that require financial and technical support for their consolidation. These projects can become stable, successful productive units and, therefore, may be a viable alternative in an economy with high degrees of structural unemployment such as Mexico's.

Low Capital Investment And Restricted Access to Financial Markets

It is interesting to note that even in developed economies, micro- and small businesses also face obstacles to their entry into bank financing systems. For example, in Canada, development banks are considered absolutely indispensable institutions for supporting small businesses so that they can play an effective role in growth and social well-being. However, small businesses systematically face difficulties in getting loans since most of the commercial banks' money goes to large corporations.[7]

To foster the long growth cycle that led to the Asian Pacific economies' industrialization and modernization, their governments encouraged long-term programs that gave preferential credit to small companies. In South Korea, Taiwan, Hong Kong, Singapore, etc., state banks contributed decisively to industrialization by providing stable, long-term loans to small and medium-sized companies.[8] An illustrative example is the Financial Corporation for the Small Company in Japan. Founded in 1953, this corporation granted long-term loans to small and medium-sized companies to be used for acquiring installations and equipment.[9]

In the case of Mexico, micro- and small businesses generally have little capital and very limited or absolutely no access to financial markets. We should remember that since 1994, financial support for businesses has dropped 91 percent. Five years ago, in 1996, more than 136,000 companies were granted loans; by 2000, only 12,000 had been so favored.[10] This is crucial for understanding how these kinds of companies have developed novel mechanisms for financing and have built informal markets through intermediaries like community savings funds, local savings and loan associations and credit unions. The universe of micro-, small and medium-sized businesses is a natural sphere of action for financing by development institutions and the social banking system.

Government Loan Programs Are Insufficient

Recently, the new Vicente Fox administration defined its strategic objective of strengthening production and employment, both very hard hit by the 1994-1995 financial and productive crisis. The administration defined five overall lines of action:

1) Access to credit;
2) deregulation;
3) support for exports;
4) the creation and strengthening of productive chains; and
5) coordination among government bodies linked to economic growth and development.

The government's emphasis on how urgent it is to reconstruct the fabric of production to make it more efficient, competitive and capable of stimulating economic growth is noticeable in its diagnosis of the situation. To achieve this end, it gives important space to the performance of the country's micro-, small and medium-sized companies.

In that context, President Fox announced the "Social Bank and Microcredits" program, with its initial fund of 1.2 billion pesos, of which 800 million pesos come from the National Fund for the Support of Solidarity Companies (Fonaes), and the rest from the Ministries of Economy and Finance. It is hoped that the loans will go out to more than a million companies and will ensure the self-employment of 1.3 million Mexicans.

To that end, the federal government has established the prerequisite that the companies operating in the informal sector of the economy must make the decision to become part of the formal sector. This will give them a "boarding pass" for loans. In addition, they will be given access to vital input and other governmental support like discounts in utility rates, special tax brackets and access to lists of government suppliers.

The advantage of the program, however, is that it practically eliminates the collateral requirement, allowing access to formal financing to firms that would not otherwise have it. It also would free micro- and small businessmen from the loan sharks in the informal credit market, who loan money at 5 percent a day! (A typical example of this are the loans available at Mexico City's central market.)

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To implement the program, the federal government will be using the community savings associations and credit unions as its main conduit for granting loans, particularly to the *changarros* or "hole-in-the-wall" businesses that feed Mexico's extensive informal economy. The program has been given the Hollywood-esque slogan of "Own your own dream."

The country's chambers of commerce and industry do not share Mr. Fox's proverbial optimism about the whole project and have pointed to the high cost of the loans. In effect, micro-financing agencies —mainly community savings associations and credit unions— will be given the funds at an interest rate determined by federal treasury certificate (Cetes) earnings (which came to 15 percent at the beginning of April 2001) plus one point. The loans will be made to the companies themselves at from 2.5 to 6 percent a month,[11] which makes for more than 30 percent a year in interest, making the cost of these loans equivalent to that of commercial banks.

Mexico City's Federal District government is attempting to present its own alternative to President Fox's proposals: it has also announced a "Microcredit Program" of 100 million pesos for the year 2001. This program's stated objectives are to increase the number of jobs and turn micro-companies into small companies, contributing in the long term to the consolidation of the city's patrimony. Mexico City Mayor Andrés Manuel López Obrador's proposal is to earmark 70 million pesos for micro-credits and 30 million for small businesses.

Most of the loans will not exceed 2,500 pesos (about U.S.$250) and will go to the small family and subsistence businesses that proliferate in the informal economy. The repayment periods are extremely short: 16 weeks with a fixed weekly rate of 0.7 percent, or 33.6 percent annually. It is true, therefore, that the program has very high financing costs, putting it on the same level as the commercial banking system, but these tiny businesses have no access to those kinds of loans. Loan candidates will be all those people who were previously already organized, whose groups will act as co-signers.

An important chapter in the federal government's financial reform is the creation of a single legal framework for the intermediaries of the "popular" banking system. Currently, the lack of legislation has meant that the 600 intermediaries in this banking sector have no security deposits to guarantee the savings of thousands of Mexicans who put their money into these institutions.[12] The legislation approved in May by the Congress requires such deposits. Since many savings associations do not have the wherewithal to comply with this stipulation, the Finance Ministry will begin the sector's reorganization with a first step: a one-time Finance Ministry endowment to create the savings association insurance fund. In addition, the new legislation establishes a framework for the prudential regulation and supervision that will guarantee depositors' savings. This is particularly important given the recent failure of several of these associations due to fraud that left thousands of depositors with nothing.

Conclusions

The two new loan programs mentioned have the merit of recognizing the existence and the economic contribution of micro-, small and medium-sized companies. Nevertheless, their scope is very limited in two ways. First, the overall sum they will be offering the small business community is very limited: Fox's 1.2 billion-peso program represents less than 1 percent of the 140 billion-peso increase in revenues that the federal government hopes for with its controversial "distributive fiscal reform." Secondly, the costs of the loans are quite high.

However, we can anticipate that the micro-credits will have positive effects given the total absence of other resources available to micro- and small businesses. At the same time, the programs will stimulate Mexico's credit markets in general by showing that the projects financed are viable. Micro- and small businesses will be able to show that they are profitable and, as such, should be eligible for commercial credit.

Probably the most important factor in the whole plan will be the change in legislation on the social banking system which will facilitate its reorganization as an alternative for savings and loans for the enormous world of micro-businesses and for large sectors of low-income Mexican working people. VM

Notes

[1] J. J. Thomas, *Informal Economic Activity* (London: Ed. Harvester, 1992).

[2] According to Mexico's Trade and Industry Ministry, large companies employ more than 250 workers and have net annual sales of 2,010 times the daily minimum wage or more. A medium-sized company has from 16 to 249 employees and annual sales of less than 2,010 times the daily minimum wage. Micro-businesses employ up to 15 workers and annual sales for up to 110 times the minimum wage (SECOFI, *Compendio Estadístico de la Industria Nacional* [México City, 1997]). According to the National Micro-business Survey, micro-businesses are those who work in goods, trade, services, construction and transportation that employ up to six workers, except in manufacturing, where they can have up to 16 employees (INEGI and STPS, *Encuesta Nacional de Micronegocios* [Mexico City: INEGI and STPS, 1996]).

[3] ILO, *Integración del sector informal al proceso de modernización. La legislación laboral y su impacto en la microempresa* (Lima: ILO, August 1997).

[4] An interesting case is the subcontracting to networks of small and micro-businesses around Tijuana's maquiladora industry, capable of stimulating interindustrial cooperation and entrepreneurial learning. Ariel Moctezuma and Alejandro Mungaray, "Subcontratación entre maquiladoras y pequeñas empresas en México," *Comercio Exterior* vol. 42, no. 2 (Mexico City), February 1997.

[5] This estimation is arrived at on the basis of counting all the companies not considered "large," which is why the figure covers micro-, small and medium-sized businesses. See the interesting study sponsored by Coparmex, BDEA and FUNDES Mexico, *El fenómeno de la empresa media mexicana en estadísticas* (Mexico City: Ed. FUNDES México, 1998).

[6] Coparmex, BDEA and FUNDES Mexico, op. cit., p. 11.

[7] Donald Layne, "Políticas financieras nacionales para la promoción de la pequeña empresa" (paper read at the International Seminar on the Role of the Micro-, Small and Medium-sized Company in the Process of Globalization of the World Economy, Mexico City, March 1993).

[8] Kato Kimihiko, "Esquemas de financiamiento para la pequeña y mediana empresa en el Japón" (paper read at the International Seminar on the Role of the Micro-, Small and Medium-Sized Company in the Process of Globalization of the World Economy, Mexico City, 1993).

[9] Ibid.

[10] "Reactivaremos las uniones de crédito: Nafin," *El Universal* (Mexico City), 28 March 2001.

[11] "Tasas de interés quitan el sueño," *El Financiero* (Mexico City), 21 February 2001.

[12] "En una mar de incertidumbre nace programa de microcréditos," *El Financiero* (Mexico City), 21 February 2001.