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# EL SALVADOR:

# SMALL AND MICROENTERPRISE STRATEGY PAPER

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## Executive Summary

The combined effects of the general economic crisis throughout Central America, prolonged civil strife and, more recently, a major earthquake have devastated the Salvadoran economy. In an effort to rebuild the nation, stimulate greater economic growth and generate employment, the USAID Mission to El Salvador has sought, inter alia, to strengthen the role of the private sector. As part of this overall strategy, the Mission has specifically focussed on the key economic (and social) contributions small and micro businesses can make to recovery, seeking to enhance their viability and move them into the formal economy. This Strategy Document represents an initial step in the process of designing programmatic efforts to achieve the Mission's goal of providing effective support to small and microenterprises throughout the country.

The rationale for focussing on the SME sector as an integral component of the Mission's overall development strategy is twofold. First, a strengthened SME sector would be able both to create new and save existing jobs, and generate income opportunities. Second, encouraging greater numbers of SMEs to enter the formal sector would help expand badly needed public revenues to underwrite essential social services.

The goal of the Mission should be to support efforts to strengthen the SME sector, with specific emphasis on microenterprises.

The objectives of Mission efforts should be to: 1) support new initiatives designed to reach those SMEs at the pre-micro level which have been excluded from existing programs; 2) expand upon and complement current SME initiatives in order to assist the vast number of SMEs at the micro level who are presently not reached by these programs; 3) expand support for on-going credit, technical assistance and training programs which have effectively served SMEs to date; and 4) seek to promote public sector policies supportive of mainstreaming SMEs into the formal sector.

The anticipated outcomes of the goal and objectives are several. First, microenterprises, especially those at the lowest levels, will increase their chances to become viable businesses, contributing to employment and general economic activity. Second, social stability will be strengthened in communities with sustainable SMEs through the income opportunities they represent. Third, the role of women as entrepreneurs will be enhanced, as well as their ability to remain the mainstay of family integrity. Fourth, an increasing number of SMEs will enter the formal sector, effectively adding to public revenues through taxation.

The objective of this Small and Microenterprise Strategy Document is to assist USAID/ES craft a strategic framework for development of the design of a small and microenterprise (SME) program for El Salvador.

The purpose of the document is to provide the Mission with a strategy option for strengthening the performance of small and microenterprises.

In 1987, it was estimated that there were approximately 81,000 SMEs in El Salvador, of which 77,000 (95%) were microenterprises. In order to design an effective SME strategy, the distinguishing characteristics of these SMEs must be recognized and appropriate focus placed on the distinct needs of each "type" of SME. The following typology identifies the main features of the different types of SMEs in El Salvador.

<u>Pre-Micro</u> A rudimentary one person or small family business which is frequently operated part time. The entrepreneur may receive income from other sources, including a salary as an employee of another business. The enterprise is in a formative stage, has not yet stabilized, and possesses assets of less than 2,000 colones.

<u>Micro</u> Businesses which have less than six employees and assets not exceeding 20,000 colones. The business is stable. The entrepreneur derives his/her sole or principal incomes from the enterprise. Family members can and frequently are "employees." While the level of sophistication is greater than the pre-micro type, the micro entrepreneur will likely require basic assistance in accounting, production and marketing.

<u>Transitional Micro</u> Enterprises which are in the transitional stage of becoming a small business. Their assets are between 10,000 and 50,000 colones, they have a minimum of six full-time employees, and there exists a greater division of labor, particularly between "management" and labor.

<u>Small Business</u> Typically, but not necessarily, formally registered one-owner companies. Compared to micro enterprises, they are well-organized with clearly defined divisions of labor and specialization of tasks. They have more than six but less than thirty employees, with assets up to 150,000 colones.

A diverse array of SME initiatives has been undertaken in recent years by USAID, GOES and other organizations to provide credit, training, and technical assistance to SMEs throughout El Salvador. In the development of this document several of these initiatives were reviewed and important conclusions were drawn. First, credit remains the most universal need of the SME sector. Second, credit programs which have best served the needs of the borrowers, and which have enjoyed the lowest default and delinquency rates, have relied heavily on on-going extension and follow-up activities. Third, programs which have had the greatest impact in terms of number of beneficiaries reached have implemented vigorous outreach and promotional components. Finally, there continues to remain a group of SMEs at the lowest pre-micro levels which is not served by current SME interventions.

There exist several constraints to greater SME development, which can be categorized broadly as policy and institutional. Policy constraints impacting SMEs include interest rate caps imposed by the Monetary Board which serve as a disincentive to SME lending, cumbersome business registration requirements, and various regulations and tax laws. Institutional constraints include persistent problems of availability, accessibility, and terms of credit, as well as the mismanagement of some major credit institutions providing service SME borrowers.

Current SME program interventions focus, with varying degrees of success, on credit, outreach and extension, technical assistance and training, integrated community development, combinations of these services, and policy and institutional reform.

USAID/El Salvador's SME strategy and future program interventions should be guided by a set of strategic principles. First, interventions must be beneficiary oriented. Second, interventions should be flexible to permit effective attainment of project goals. Third, efforts must maintain a clear focus and not become splintered into several unrelated SME activities. Fourth, "sustainability" rather than "graduation" should be used as the measure of success. Fifth, initiatives should target the distinct needs of the beneficiaries. Finally, SME initiatives should be inclusive, in order to reach the maximum number of beneficiaries.

The strategy encompasses both policy and programmatic interventions. On the policy side, the strategy proposes that efforts to address the major policy and institutional constraints to SME development be initiated as part of a comprehensive SME program. Many policy reform initiatives in support of SME development can and should be undertaken immediately under the auspices of the Mission's on-going policy dialogue with the GOES and various private sector development projects. Concurrently, longer-term support should be provided to an institution able to work closely with the new government and to serve as a permanent policy interlocutor for the SME sector.

At the enterprise level, the strategy recommends continued and expanded support of the majority of current USAID/ES funded efforts, complemented by the introduction of a large credit program. In other words, the strategy envisions creation of a programmatic vehicle to provide critically needed credit, along with a concommitant ability to coordinate with existing SME projects, especially those furnishing technical assistance and training.

After carefully considering various options, it was determined that in order to meet the objectives of the SME strategy in a timely, complete and effective fashion, the only possible alternative is to use PROPEMI as the vehicle to implement the strategy. As an integral part of the effort, PROPEMI will also establish linkages with existing Mission-funded projects furnishing limited credit and technical assistance to microentrepreneurs.

A credit institution, known as PROPEMI II, will be established in FUSADES/PROPEMI to make available credit to SMEs, especially those microentrepreneurs not served by other programs. In addition, PROPEMI II will incorporate necessary ancillary services to support its credit functions, specifically outreach and extension, follow-up and referral. Other PVO credit programs, i.e., the village banks, will continue to provide credit to their constituents, although village banks as such will be eligible to seek loans from PROPEMI II.

PROPEMI II will meet a widespread need for SME access to credit, particularly for microenterprises (i.e., as distinct from pre-micro, transitional and small businesses), which tend not to be specifically targeted by current projects. At the same time, it would strengthen and expand availability of and access to credit across the entire spectrum of SME types. In addition, PROPEMI II will coordinate with existing technical assistance and training services offered by USAID/ES funded PVOs.

The ultimate goal of the program should be to extend credit opportunities as widely as possible. Ideally, PROPEMI II branches should extend throughout the country, making available loans to SMEs in the urban and rural areas outside San Salvador. This would help both to develop these other areas and stem migration to the capital. To begin with, however, the program needs to start modestly, expanding its operations elsewhere as its capacity and resources permit.

Finally, it is important to state three caveats by way of maintaining expectations at a realistic level, as well as providing additional guidance in application of the SME strategy to the design of the project. Perhaps the major caveat is the need to guard against creation of dependency attitudes among project beneficiaries. Second, while the objective is not to create SME dependency on subsidized interest rates and soft loans, it has to be recognized that only a permanently established private credit institution, such as PROPEMI II, will be able effectively to serve the credit needs of SMEs, especially pre-micro and micro entrepreneurs. Ideally, of course, this will become a self-sustaining organization. Third, the strategy specifically does not contemplate use of a public or quasi-public institution as the mechanism through which to channel credit services to SMEs. Even if a new governmental institution were established to implement the project, the problem of public perception would remain. That is, as a public entity, such an institution would be considered not a serious credit organization, but another governmental resource for loans which would not have to be repaid. Given past experience, this is a safe assumption. Moreover, it would be extremely difficult for a public institution to recover costs, as its political character would make it vulnerable to subsidization and mismanagement.

## I. Introduction

The combined effects of the general economic crisis throughout Central America, prolonged civil strife and, more recently, a major earthquake have devastated the Salvadoran economy. In an effort to rebuild the nation, stimulate greater economic growth and generate employment, the USAID Mission to El Salvador has sought, inter alia, to strengthen the role of the private sector. As part of this overall strategy, the Mission has specifically focussed on the key economic (and social) contributions small and micro businesses can make to recovery, seeking to enhance their viability and move them into the formal economy. This Strategy Document represents an initial step in the process of designing programmatic efforts to achieve the Mission's goal of providing effective support to small and microenterprises throughout the country.

The 1990-1994 CDSS pointed out clearly the need for "increased private sector activity (as) essential to reverse the economic slide which began in 1980." The Mission developed a series of objectives to meet the overall goal of increasing economic growth through strengthening the private sector, including: (a) promotion of non-traditional exports; (b) institutional development in both the private and public sectors; (c) encouragement of greater private-public sector working relationships; and (d) expansion of small and microenterprise participation in the economy.

The rationale for focussing on the SME sector as an integral component of the Mission's overall development strategy is twofold. First, a strengthened SME sector would be able both to create new and save existing jobs, and generate income opportunities. Second, encouraging greater numbers of SMEs to enter the formal sector would help expand badly needed public revenues to underwrite essential social services. Even if formal sector medium and large scale enterprises grow, there is little evidence to suggest they would be able to meet aggregate demand for jobs. Finally, if and when the war winds down, a significant number of military personnel (20 to 30 thousand) will require employment as they return to the civilian sector.

The near term goal of the Mission therefore should be to support efforts to strengthen the SME sector, with specific emphasis on microenterprises, as consistent with PD-17 guidelines to design programs to: "(a) seek out the very smallest enterprises and, among them, those with the greatest potential for expansion; (b) help firms access formal systems of financing and technical assistance; and (c) make at least fifty percent of their resources (credit, technical, and training) available to women-owned and -operated enterprises."

The near term objectives of Mission efforts should be to 1) support new initiatives designed to reach those SMEs at the pre-micro level who have been excluded from existing programs; 2) expand upon and complement current SME initiatives in order to assist the vast number of SMEs at the micro level who are presently not reached by these programs; 3) expand support for on-going credit, technical assistance and training programs which have effectively served SMEs to date; and 4) seek to promote public sector policies supportive of mainstreaming SMEs into the formal sector.

The anticipated outcomes of the goal and objectives are several. First, microenterprises, especially those at the lowest levels, will increase their chances to become viable businesses, contributing to employment and general economic activity. Second, social stability will be strengthened in communities with sustainable SMEs through the income opportunities they represent. Third, the role of women as entrepreneurs will be enhanced, as well as their ability to remain the mainstay to family integrity. Fourth, an increasing number of SMEs will enter the formal sector, effectively adding to public revenues through taxation.

### A. Goal and Purpose of Strategy Document

The objective of this Small and Microenterprise Strategy Document is to assist USAID/ES craft a strategic framework for development of the design of a small and microenterprise (SME) program for El Salvador.

The purpose of the document will be to provide the Mission with a strategy option for strengthening the performance of small and microenterprises. A more vigorous SME sector will contribute to greater national economic growth and generation of employment opportunities for marginal segments of Salvadoran society. Hence, it is critical to formulate approaches to SME development which meet the needs of small and micro entrepreneurs in the most effective and efficient way possible. Given the magnitude, impact and economic potential of the SME sector, it is especially important that any strategy take into account the need to capitalize on and complement existing initiatives, respond precisely and efficiently to the needs of small and micro entrepreneurs, and create programs which include rather than restrict participation.

The strategy will recognize explicitly the role and needs of women in development. They are a major force in both the economy and society, and support for them as entrepreneurs, as well as the key stabilizing factor in families, is essential.

The emphasis in the strategy document will be on micro enterprise. During the course of the field work, it was discovered that small businesses are more able than their micro counterparts to gain access to conventional sources of assistance, particularly credit. This is by no means to diminish their substantial needs. But it is clear that microenterprises, which constitute by far the largest part of the SME sector in terms of employment and sheer numbers of economic units, are in greatest need.



In the development of this document several USAID/ES supported SME initiatives were reviewed, as well as SME initiatives underwritten by other donor agencies. It is important to remember that the purpose of this exercise was not to conduct an evaluation of past and present SME projects. Instead, the purpose of the review was to gather impressions and secondary data to provide an empirical base from which to construct a realistic SME strategy.

### B. Relationship to Mission Strategy

A major thrust of the Mission strategy is to strengthen and expand the private sector as a central means to achieving economic recovery in El Salvador. Essential to this approach is the conviction that a larger private sector, specifically including small and microentrepreneurs, would "become an effective vehicle for distributing the benefits of growth in a more equitable fashion." At the same time, a more robust private sector would create increasing job opportunities and generate important gross tax receipts to permit financing of essential social services.

The Mission has been faithful to the goals set forth in the CDSS, and has underwritten several successful programs geared toward making available credit and training to new and established SMEs. But there is a need to expand support to SMEs in order to increase the universe of SME program participants, particularly those at the lower reaches of the economy. By the same token, it is critical to examine existing programmatic approaches as an initial step in devising new strategies and programs for increasing effective SME development.

Finally, it is necessary to highlight the fact that the Mission's strategy reflects a strong commitment to AID Policy Determination-17, which calls for microenterprise assistance as an "important element" of the broad-based effort to expand economic growth in LDCs.

## II. Nature and Scope of Problem

### A. Macro Review

Since 1979, El Salvador has been battered by severe external and internal shocks which have produced sharp social and economic decline. This has been caused by the downturn in the world commodity market, political violence and instability, and a devastating earthquake which destroyed vital infrastructure.

Economic deterioration was most severe during the period 1979-1982, when El Salvador endured the worst of the crisis. Gross domestic product (GDP) fell by 21%; exports declined by 38%, resulting in a trade balance deficit of 250.7 million colones; private investment plunged 57%; massive capital outflows occurred;

and combined underemployment and open unemployment were estimated as high as 50% of the eligible labor force.

Simultaneously, political violence and instability caused by the civil war effectively crippled many rural economies and severely disrupted urban economic activity. The war has also resulted in massive dislocations of rural poor populations to urban marginal communities, where social services and employment opportunities are virtually unavailable.

The 1986 earthquake further aggravated the economic situation, destroyed crucial economic infrastructure and resulted in damages estimated at over $1 billion.

Although economic and social conditions have undeniably deteriorated since 1979, several factors have combined to mitigate the full effect of this decline. First, a significant shift of economic activity into the informal sector has occurred, resulting in a growing informal economy whose contributions to national growth are not likely reflected in the national accounts. Second, massive emigration of working-age Salvadorans to the U.S. and elsewhere has served to slow labor force growth, especially in urban areas which have experienced an influx of displaced persons from rural areas. This has occurred at a time when neither rural nor urban formal economies have been able to keep pace with employment needs. Third, what might have been a more critical deterioration of foreign currency reserves has been attenuated by massive inflows of remittances from Salvadorans in the U.S., and long-term capital flows, including grants from international donor agencies.

Despite these factors, however, only modest improvements in per capita GDP have been registered since 1982 (0.8%-2.2% per annum). In fact, civil strife continues to disrupt the economy, export earnings show little sign of recovery, underemployment and open unemployment remain chronic and inflation continues to unabated.

## B. <u>SME Review</u>

Due to the steady shift of productive activity into the informal sector, and continued movement of displaced rural populations into urban marginal communities, it is likely that the number of SMEs has increased dramatically since 1979. Because an estimated 65% of SMEs in El Salvador exist outside the formal sector, accurate data on SMEs (microenterprises in particular) are difficult, if not impossible, to obtain. Official estimates tend to understate the size and contribution of the sector, and independent estimates are at best earnest approximations.

Despite these limitations in the data, an extensive assessment of the SME sector was conducted by Robert A. Nathan

Associates in 1987. The data from the study have been used as a main secondary source in developing this strategy.

According to the assessment, there were approximately 81,000 SMEs in El Salvador in 1987, of which 77,000 (95%) were microenterprises. Based upon even this conservative estimate, SMEs comprise 99% of non-agricultural private sector enterprises, employ over 10% of the economically active labor force, and produce approximately 6% of the GNP.

The majority of SMEs are located in urban centers and marginal communities centered around San Salvador. Around 75% of SMEs operate out of fixed structures, with the remaining 25% functioning as street enterprises. SMEs are involved in virtually every type of economic activity, although they are concentrated most heavily in commerce, followed by service and industry. Virtually all goods and services produced by the sector are sold in the domestic market.

Data from a FUSADES survey of San Salvador in 1985 indicate approximately 65% of SMEs were owned and/or managed by women. However, female participation in overall SME activity, both as owners and employees, particularly in commercial microenterprise activities, was estimated at closer to 80%.

Typically, most entrepreneurs have low levels of education and training (only 44% completed grammar school), although they have an average of 10 years prior work experience. The average age of SME proprietors is 44 years.

## III. Types of SMEs

The small and microenterprise sector is comprised of many different types of businesses which can be defined according to several competing criteria. In order for an SME strategy to be effective, it is essential to recognize the distinguishing characteristics of each "type" of enterprise. The purpose of the typology is to serve as a guide in order to insure appropriate focus on the distinct needs of each type of SME. In the project design phase, it may be advisable to refine further the typology (although great care needs to be taken not to develop an elaborate taxonomy), always adhering to the principle of maximum inclusion. It is vital that the application of any typology not serve as a mechanism for excluding SMEs from qualifying for and receiving assistance. PD-17 warns clearly against this kind of result. Similarly in keeping with the Policy Determination is the guidance to the Mission to "seek out the very smallest enterprises."

As also acknowledged in PD-17, each Mission should develop "a locally appropriate definition of microenterprise." The following typology identifies the main features of the different types of SMEs in El Salvador, based on levels of business experience, sophistication of operations, asset size and number of employees.

A. Pre-Micro

The pre-micro enterprise is a rudimentary one person or small family business which is frequently operated part time. The entrepreneur may receive income from other sources, including a salary as an employee of another business. The enterprise, as such, is in a formative stage, has not yet stabilized, and possesses assets of less than 2,000 colones. Women involved in FINCA assisted village banks are typical of this type, as are ambulatory vendors.

B. Micro

The micro type fits the more conventional definition of a microenterprise, and is constituted by businesses which have less than six employees and assets not exceeding 20,000 colones. The business is stable. The entrepreneur derives his/her sole or principal incomes from the enterprise. Family members can and frequently are "employees." While the level of sophistication is greater than the pre-micro type, the micro entrepreneur will likely require basic assistance in accounting, production and marketing.

C. Transitional Micro

The transitional micro type is characterized by those enterprises which are virtually in the first stage of becoming a small business. Their assets are between 10,000 and 50,000 colones, they have a minimum of six full-time employees, and there exists a greater division of labor, particularly between "management" and labor.

D. Small Business

Small businesses are typically, but not necessarily, formally registered one-owner companies. Compared to micro enterprises, they are well-organized with clearly defined divisions of labor and specialization of tasks. They have more than six but less than thirty employees, with assets up to 150,000 colones.

IV. Review of Current and Recent SME Efforts

A diverse array of SME initiatives has been undertaken throughout El Salvador in recent years, sponsored by a host of public and private organizations with distinct approaches and ideologies. It is instructive to review some of the major efforts in order to construct a programmatic context in which the development of the present Mission SME strategy can best be understood.

Any assessment of SME initiatives must be based upon an understanding of the fundamental heterogeneity of the sector. SMEs represent at least four different enterprise "types" or levels are located in rural, urban and marginal communities, and engage in a spectrum of economic activities ranging from ambulatory street commerce to relatively sophisticated small commercial, productive, and industrial operations. Due to these distinguishing characteristics, SMEs have disparate needs, and program interventions must be designed to account for these differences. No one intervention mode can necessarily serve the needs of all SMEs.

## A. Small Enterprise Development Project (519-0322)

The Small Enterprise Development Project was initiated in 1985 as one of A.I.D.'s first efforts in SME development. The project had a LOP funding of $1.0 million. Through a cooperative agreement with IESC, the project funded 20 sub-projects designed to test and evaluate the capability of Salvadoran private enterprises, business associations, PVOs and commercial banks to promote the development of SMEs in El Salvador. Efforts focused on developing the institutional capability of these organizations to provide credit, training, and technical assistance to SMEs.

A total of 22 organizations participated in the project. In the area of credit, sub-projects successfully established Small Business Units in five commercial banks to expand lending to SMEs, and to help the banks meet SME lending requirements imposed by the Monetary Board. Although these sub-projects were able marginally to increase the number of loans extended to SMEs, commercial banks continue to dislike lending to SMEs. The banks are unable to recover the cost of lending due to interest rate restrictions imposed by the Monetary Board, and they consider SME borrowers to be poor credit risks. Sub-projects which extended credit through PVOs and a business association resulted in high default rates, due largely to inexperience on the part of these organizations in lending and credit. It was discovered that business associations face a fundamental conflict in providing credit to members: they are politically unable to deny credit to a member, regardless of his/her ability to repay.

In the area of technical assistance and training, the project funded 15 sub-projects with 3 private enterprises, 4 business associations, 6 PVOs and 3 universities. The most successful sub-projects were those implemented by PVOs able to capitalize on existing community development networks. PVOs seemed to have a much better understanding of SME needs than their private sector counterparts, and were much better able to design specific interventions to meet these needs.

Those organizations with the least success in providing training and technical assistance were business associations and the universities. Business associations typically provide members with assistance in preparation of credit applications, export promotion, and legal counsel. These are not primary needs of SMEs. Furthermore, the associations experienced difficulties in designing training and technical assistance programs for SMEs due to their unfamiliarity of the sector. The universities proved to be completely ill-suited to provide training and technical assistance to SMEs. Not only were their programs inappropriate for SMEs who possess very low levels of education, but program locations required lengthy and costly commutes for participants.

Two sub-projects implemented by private artisan export firms were highly successful in artisan production training. Through these sub-projects, A.I.D. funds established centers within each firm to undertake training and promotional activities. It is undeniable that linkages between SMEs and larger firms need to be encouraged. However, it is difficult to understand on what authority public funds can be used to support, however well-intentioned, privately owned businesses. Clearly, other alternatives exist which would better serve the needs of the intended beneficiaries.

B. Small and Microenterprise Program (519-0304)

The Small and Microenterprise Program project provided $3.0 million to FUSADES in order to establish a Small and Microenterprise Promotion Program (PROPEMI). PROPEMI provides training and credit to established transitional micro and small enterprises located in the poorer communities in and around San Salvador. PROPEMI's success has been built upon a vigorous extension and outreach component, through which extension agents actively recruit SMEs to participate in the PROPEMI business training course, and provide on-going outreach to these SMEs during and following graduation. To date, 2,225 persons have completed the course, roughly 30% of whom are women.

Upon completion of training, PROPEMI graduates are eligible to apply for credits up to C50,000.00. Graduates may receive up to three credits, after which they are encouraged to obtain credit through the formal banking sector. Interviews with PROPEMI borrowers indicate, however, that they will most likely continue to face the same difficulties in obtaining credit through commercial banks as they did prior to their association with PROPEMI. As PROPEMI continues its lending program, extension agents should more actively encourage borrowers to open commercial bank savings accounts in order to facilitate eventual movement into the commercial banking system. Nevertheless, PROPEMI's lending record to date is impressive: 1,050 credits have been extended, with an average loan size of $2,000 and an average combined default and delinquency rate of 7%. PROPEMI has also made substantial progress in lending to women. Between 1986 and 1988, the total number of loans extended to women rose from 23% to 33%; the total colon amount of loans extended to women rose from 30% to 35%.

PROPEMI is a dynamic and well-respected organization with sound operating systems and organizational structures. It has been highly successful in reaching established transitional micro and small enterprises through its training and credit program. Efforts to expand the existing PROPEMI program both within and outside of San Salvador should be supported by USAID/ES. In addition to these efforts, however, the Mission also needs to support training programs that reach those SMEs at the lower end of the spectrum not served by PROPEMI.

## C. Local Currency-Funded Efforts

USAID/ES also provides assistance to rural microenterprises through the ESF/Local Currency Program. Since 1983, approximately 40 million colones in local currency funds and reflows have been allocated to two BCR-administered SME credit lines. The Special Fund for National Reconstruction (FERN) finances business activities of small producers who have been directly affected by civil conflict. The Special Program for Rural Microenterprise (PEMER) underwrites business activities of small rural enterprises in need of working capital and capital investment. These lines of credit have been fairly successful in extending credit to rural enterprises (62% disbursement rate). However, credits have generally been provided to small enterprises and have not been accessible to microenterprises.

In April 1989, USAID/ES and the GOES agreed to consolidate all existing credit lines financed through the ESF/Local Currency Program into three credit lines. All local currency funds provided in support of SME credit will now be channeled through a "Pequena Empresas" line of credit. 40 million colones was allocated to this account for FY88, and an additional 30 million colones will be allocated for FY89.

## D. Other Mission Efforts

The Mission's Rural and Urban Development (RUD) and Community Development (IRD) Offices have worked to coordinate their efforts with the Private Enterprise Promotion (PRE) Office in order to maximize usage of the PEMER and FERN lines of credit in rural areas. In addition, RUD and IRD have supported various initiatives that rural SMEs. Among others, these include support for: 1) Save the Children's Community Development Programs; 2) CONADES small producer groups credit schemes; 3) COMCORDE integrated éastern regional development efforts; and 4) FEDECCREDITO.

### 1. Youth Entrepreneurial Development (519-0311)

The project has provided support to the Salvadoran Junior Achievement Program (Empresariors Juveniles) to expand its business skills and computer literacy training activities to three additional cities outside of San Salvador. The project targets high school students and serves to make them aware of private enterprise, imparting to them basic concepts of business. While entrepreneurial training should continue to be provided to this group of potential SMEs, it is not the kind of SME development program in the current strategy.

2. Small Producer Development Project (519-0229)(B)

The project was initiated in 1980 as a means to establish an efficient and effective credit system through which A.I.D. and local currency funds would be made available to rural and urban poor. The project was implemented by FEDECCREDITO and its 61 affiliated credit agencies throughout El Salvador. LOP funding was $14.25 million ($9.25 million grant and $5.0 million loan). $9.7 million of total funds were used to establish a Small Producer Development Credit Fund.

With 61 semi-autonomous "cajas," or credit unions, throughout the country, FEDECCREDITO is the largest network of its kind. However, in addition to being inefficient (with a combined default rate of 48 percent), the cajas are highly subsidized, charging only from six to twenty-one percent interest, depending on the credit line. While in theory the network represented by the cajas could serve to channel credit and attendant services to SMEs throughout El Salvador, the history of FEDECCREDITO makes that a less than optimal alternative. The one possible exception is the present IRD project which provides 23.5 million colones to FEDECCREDITO conditioned upon decentralized disbursement by 10 designated cajas. By avoiding the more centralized operation, it may be possible to make FEDECCREDITO cajas more responsive to SME borrowers. However, the protections against mismanagement and inefficiency which are possible in a private lending institution, do not exist in the public sector. That is, the cajas would still be funded from a line item in the national budget and not subject to the discipline of a self-financing organization.

E. Other Donor Efforts

1. IDB

The IDB funds several small projects ($500,000 or less per project) to support existing organizations which in turn provide support to small and medium enterprises. Recently, the IDB provided a grant of $500,000 to PROPEMI to allow it to expand its program (renamed as PROMISAM) into the eastern region of the country. PROMISAM has been slow to get off the ground, due largely to its orientation toward small and medium enterprises, instead of microenterprises, which are by far the largest SME group in the region; and IDB restrictions on providing credit and training to enterprises engaged in commercial activities (which constitute the majority of SMEs in the region). Only those enterprises involved in productive and/or industrial activities may be assisted; based on IDB's belief that the promotion of commercial activities will produce inflationary effects.

2. Save the Children

Save the Children implements a variety of integrated community development projects throughout El Salvador. In support of these efforts, USAID/ES provided an OPG of $4.8 million. Beginning in 1986, Save the Children initiated the development of village banks, drawing upon the resources of existing community development networks and extension personnel. To date, 90 village banks have been established (primarily in rural areas), as have to three fledgling village bank associations.

3. Foster Parents Plan

In late 1988, Foster Parents Plan began to support the development of village banks, based upon the FINCA model, with on-going support provided by Foster Parents Plan extension personnel. To date, 4 village banks have been established (in the vicinity of San Salvador), and an additional 20 new banks are planned for this year. All village bank members are women. Foster Parents Plan has not received funding from A.I.D.

4. FINCA

FINCA was a pioneer in the development of the village bank model, which was designed to promote a participatory development process. Using the FINCA model, village bank members determine both the structure of the bank and the pace of its growth. FINCA provides minimal start-up and on-going assistance to the banks. Many PVOs involved in the development of village banks have modified the FINCA model to include more extensive technical assistance during the start-up phase, in addition to on-going extension services. According to these PVOs, this has resulted in lower initial collapse rates and greater motivation of bank members.

5. GTZ/AMPES

The AMPES credit program was established in June 1988, with the assistance of GTZ, in order to provide credit services to AMPES members. Credits range between 500-5,000 colones, with real interest rates of 35-40%. To date, over 300 credits have been extended with a zero default rate. The program has achieved 70% self-sufficiency, and is expected to reach complete self-sufficiency by August 1989.

The success of the AMPES program to date is in large part due to extensive outreach provided by its credit extension agents during the application process. Success may also be attributed to the way in which AMPES has emulated many aspects of informal lending practices (ie. immediate credit application processing (3-10 days), daily, weekly, or monthly repayment terms available upon request, and vigorous collection procedures).

6. COMCORDE

COMCORDE is a Salvadoran PVO, headquartered in San Miguel, which supports a variety of integrated community development, infrastructure, and regional development initiatives for the eastern region. In addition to these efforts, supported by the Mission's Infrastructure and Regional Development Office, COMCORDE provides credit and training to SMEs along the lines of the PROPEMI model. Recently, COMCORDE also initiated the development of four village banks in the region and is now working with local community groups and municipal governments to expand these efforts. COMCORDE bases its program on a vigorous outreach and promotion component.

F. GOES SME Initiatives

A review of current GOES small and micro enterprise assistance programs, specifically FEDECCREDITO, revealed major weaknesses in relying on the public or quasi-public sector to provide credit and ancillary services to SMEs. It is little secret that FEDECCREDITO and other similar institutions, such as FIGAPE, have suffered from inefficiencies, irregular lending practices, and cronyism.

Three important conclusions can be drawn from this review of current and recent SME initiatives by USAID/ES and other donors. First, those programs which have had the greatest impact in terms of number of beneficiaries reached have implemented vigorous outreach and promotional components. Second, credit programs which have best served the needs of the borrowers, and which have enjoyed the lowest default and delinquency rates have relied heavily on on-going extension and follow-up activities. Third, there continues to remain a group of SMEs at the lowest pre-micro levels which is not served by current interventions.

V. Constraints

There exist several constraints to greater SME development, which can be categorized broadly as policy and institutional.

A. Policy

Although SMEs operate outside the formal economy, they are affected nonetheless by a series of public policies, laws and regulations. Indeed, the principal reason that so many SMEs, microentrepreneurs in particular, do not take steps to enter the formal sector is that the opportunity costs imposed by regulations are perceived to be too high.

Many policies exist which either directly or indirectly affect SME development. In formulating an approach to foster policy dialogue and reform, it is essential to maintain focus. That is, efforts should be geared toward working to bring about reforms of those policies, regulations and bureaucratic practices which have the greatest and most immediate impact on SMEs. At this juncture, at least four principal policy and policy-related constraints can be identified as requiring change:

1. Interest Rates

Interest rate caps imposed by current policy serve as a hinderance to making credit available across-the-board, but particularly to SMEs due to the smaller size of the loans and greater need for assistance in the credit application process (even assuming to begin with that the commercial banks were more receptive to working with SMEs, which they are not). The interest ceilings act as a disincentive to banks to make loans and result in widespread violations of the spirit, if not the letter, of the law. The fact of the matter is that banks and public IFIs do not provide anywhere near the kind of credit and access to credit which are in demand.

2. Business Registration Requirements

If the GOES is genuinely interested in recruiting increasing numbers of SMEs into the formal, tax-paying sector, it needs to devise ways to reform and streamline the current business registration process. However, while such solutions may be readily apparent, they are not always so easy to apply. This is especially the case with regard to public policy and administration, where strong vested interests are created and an almost reflexive resistance to change exists. With a more private sector oriented government soon to take power, however, some of these impediments, such as registration requirements, may be now more susceptible to reform than in the past.

3. Statutory Impacts

There are several laws, including the labor code, regulatory law on commerce and industry operations, and the credit and auxiliary institutions law, which impact small and micro businesses entering the formal arena. While some of these have clear social benefits, such as the Social Security Act, nonetheless, because of the economic onus they place on these marginal enterprises, they also act as barriers to inducing SMEs to join the formal economy. This legislative panoply should be reviewed and suggestions made for reform, perhaps through discrete application of amended legislation which would take into consideration the special needs of SMEs.

### 4. Taxation

While tax laws are more discretionary than other legislation in their application to SMEs, record keeping and other requirements still constitute a burden for micro businesses in particular.

A successful SME development strategy will have to address these and attendant policy constraints as part of a comprehensive effort. But, once again, it is important to consider policy dialogue and reform as an initiative project independent from one providing credit and support services directly to SMEs. Changes in policy and regulations tend to be long term. The needs of SMEs are immediate and basic, and while they can and are being met at the micro level, much more remains to be done.

## B. Institutional

### 1. Credit

Due to infrequent participation in the formal economy, inability to meet bank lending requirements, and the reluctance of most formal financial institutions to lend to SMEs, many SMEs face overwhelming unmet credit requirements. Persistent problems of availability, accessibility, and terms of credit have dampened significantly SME viability and growth.

#### o Credit Accessibility

In 1987, the Monetary Board established 15% and 2.5% portfolio lending requirements for small businesses and microenterprises, respectively. In general, small businesses have had adequate access to credit through the formal banking sector. However, lack of credit accessibility through established financial institutions represents the most serious constraint to microentrepreneurs. These entrepreneurs are simply unable to access even designated SME credit lines. Typically, microentrepreneurs lack prior credit histories, are unable to meet lender collateral requirements, are unfamiliar or have little experience with formal lending institutions, have low levels of education, and are faced with heavy demands on their time which make the opportunity costs of the lengthy application processes unaffordable. For their part, formal financial institutions have little interest in making loans for which they cannot hope to recover their actual costs, due to interest rate caps imposed by the Monetary Board, and often blatantly discriminate against SME borrowers.

o **Credit Availability**

Although credit lines have been designated by the Monetary Board for small businesses, actual credit availability is unknown. ESF/local currency credit lines, administered by the BCR, have suffered from slow and cumbersome loan approval and disbursement processes. A substantial amount of credits has been approved and transferred from the BCR to the commercial banks. However, due to bureaucratic delays, these credits are no longer needed by rural borrowers (who tend to have cyclical credit needs), and are thus neither disbursed, nor returned to the BCR credit line to be made available to other SME borrowers.

The majority of credit provided to microentrepreneurs is made available by informal lenders, friends and family members. Availability of this type of informal credit does not appear to be a constraint. For both types of credit, however, further study would be useful to determine more precisely actual credit availability.

o **Terms of Credit**

Maximum interest rates which may be charged by formal financial institutions are determined by the Monetary Board. At present, the maximum allowable rate is 21% per annum. This does not allow the banks to recover the cost of lending to SME borrowers, so that these institutions regularly impose "transaction charges" which serve to increase the effective interest rate charged to these borrowers.

Financial institutions repeatedly expressed a preference for medium to long term credits, and/or the establishment of lines of credit as a means to increase cost recovery on loans to small borrowers. However, microentrepreneurs, in particular, typically have short-term credit needs and are unfamiliar with the concept of credit lines. Their preference is for immediate repayment of one-time loans.

Informal lenders, which are widely used by microentrepreneurs, especially market women and ambulatory vendors, frequently charge interest rates ranging from 10 to as high as 100% per day, and collect on a daily basis.

2. **"Entrepreneurial Mentality"**

SMEs, particularly pre-micro and microentrepreneurs, tend not to consider themselves as entrepreneurs engaged in productive activity. Instead, they view themselves more as "getting by" or "making ends meet." Furthermore, in those cases where entrepreneurial activity supplements income earned from a salaried position, the tendency is to define oneself as a paid employee. The result is that these entrepreneurs neither recognize nor appreciate the value of their entrepreneurial talent and contribution to the economy.

Where an "entrepreneurial mentality" has been instilled in SMEs through outreach and training programs, these business persons more clearly recognize the importance of their entrepreneurial role in the economy. This, in turn, has resulted in a stronger entrepreneurial orientation and higher levels of motivation and self-esteem.

An additional impediment to the development of an entrepreneurial mentality in entrepreneurs who have participated in SME programs, has been the tendency of some of these programs to provide credit, training and, other services at highly subsidized rates, without stressing the need for eventual self-sustainability. Such programs have served to stifle rather than encourage an entrepreneurial mentality, and have also created expectations and dependencies which cannot be served indefinitely.

### 3. Management

Many credit institutions which were established to serve SME borrowers, or which administer SME credit lines, have been ineffective in providing credit to SMEs due to both overall mismanagement and the lack of commitment on the part of management to service SME borrowers. FEDECCREDITO is perhaps the largest and most obvious failure. But private sector institutions, too, have also been less than effective in providing needed credit services to SMEs. The same is true of some NGO programs, notably some of the IESC sub-projects (e.g., Universidad Nueva de San Salvador, Universidad Politecnica and the ISVPM) which, through inefficient program management, were unable to serve their clients. (By contrast, other SME programs are exceptionally well run, such as COMCORDE and AMPES.)

## VII. Program Interventions

Before proceeding to the discussion on strategy options for dealing with the constraints to SME development, it is important to review the various types of interventions which can be considered, citing the role they play in strengthening the SME sector. While unquestionably all SMEs could potentially benefit from the several types of support, it is clear that some require only selected assistance. Current SME initiatives address many of the major impediments to greater development at the enterprise level, although their combined efforts still fall short of demonstrated need. In addition, it may be suggested that balance of payments and the Technical Support, Policy Analysis and Training impact issues of public policy indirectly affecting small and micro businesses.

Given limited resources and the need not to create a dependency on outside assistance, it is essential to target precisely on specific needs, by type of SME, recognizing the fact that some assistance, specifically credit, is required by all. Similarly, program interventions need to be used and/or developed which can serve individuals, groups and communities. Some programs now limit their services only to individuals, while others work just with groups. While in some instances this makes sense in that it has proved effective, such as in the case of the FINCA banks which include only groups of women, it is still critical for the Mission to insure that its resources are reaching the widest population feasible.

A. <u>Credit</u>

The one need which is common to all SMEs is credit. This is a continuing requirement of all businesses irrespective of size, product or service. The estimate that at least 81,000 small scale enterprises existed in El Salvador in 1987, indicates the rough order of magnitude of the demand for credit. However, credit availability and accessibility remain a problem. Only in small measure is this beginning to be offset by the several programs already in existence, in particular the village banks. The Mission needs to expand upon these efforts and reach many more SMEs. A specific strategy option to achieve that end is discussed under "Strategy Options."

B. <u>Outreach and Extension</u>

Of the current SME programs which appear to be the most effective, with the possible exception of FINCA, all rely to some degree on outreach and extension. By working with SMEs, <u>extensionistas</u> serve as a fundamental underpinning of program success. This kind of "appropriate level" human contact between project technicians and borrowers has yielded extremely positive results in the case of the AMPES program (zero percent default), somewhat less so in PROPEMI (7 percent default). The Save the Children Village Banks project, while a different type of credit program, has, with close guidance from their extension staff, been able to register highly positive results as well.

While SME assistance projects should be firm in taking measures against creating dependencies on the part of their clients, and should let market forces generally determine the success or failure of SMEs, minimal extension and outreach are necessary and not inconsistent with the goal of SME self-sufficiency.

## C. Technical Assistance and Training

The major SME development and credit projects do not provide technical assistance per se. Some, such as Save the Children and PROPEMI, make available training, which actually functions in part as a type of technical assistance, particularly for imparting basic business skills. Others, notably EXPORSAL, receive Mission funds to train artisans to serve as suppliers to the business itself. While training for SMEs may be necessary in many cases, the Mission needs to exercise care that projects do not result in what amounts to a subsidy to private companies.

Training does meet an expressed need, although in the case of PROPEMI, for example, it is a condition for obtaining credit. No similar obligation exists with respect to TA. The need and demand for technical assistance and training should be addressed in the PID, as it is reasonable to suggest that those two types of interventions may be more in demand than is presently thought to be the case. This is especially so with respect to marketing - i.e., assisting micro enterprises specifically in accessing markets.

## D. Community Development

Integrated community development efforts have been undertaken by organizations such as the Salesian Brothers, COMCORDE and Save the Children. The basic thrust of these strategies is to work with communities and/or groups rather than individuals. Community and group organization techniques are especially appropriate for pre-micro entrepreneurs, who are able to benefit from the mutual reinforcement made possible by a group environment. This approach has been successfully implemented by COMCORDE, Save the Children, Foster Parents Plan and CONADES. In the case of microenterprises, the integrated community development "model" is probably not necessary; and for the transitional and small business, it would be inappropriate.

## E. Combinations

While the PID will develop specific intervention alternatives, the overall strategy should be guided by the need to make available credit as the central strategic approach. A network of ancillary support services already exists, with which linkages should be established. But the paramount need for providing credit, on appropriate and manageable (and non-subsidized) terms, should not be lost in a project attempting to be so "comprehensive" as to result in a series of diluted interventions. That is, the strategy should be to focus on one basic need (credit), channeling enough resources to that tend to achieve a measurable impact.

### F. Policy and Institutional Reform

Aside from program interventions dealing directly with SMEs to assist them in obtaining credit and improving business performance, another important program intervention includes efforts to bring about policy and administrative réforms. Principal policy and institutional constraints have already been identified, and projects need to be designed to help promote public policy mixes which enhance SME development and encourage and speed up their entrance into the formal sector. Similar initiatives need to be expanded with respect to reform of administrative practices in the public sector, especially in those institutions which most directly affect the ability and willingness of small and microenterprises to take the steps necessary to join the formal economy.

## VII. Strategic Principles

Development of an SME strategy and program ideally rests on a set of strategic principles to guide and maintain the integrity of the program. Six strategic principles are offered here:

### A. Beneficiary Orientation

Within obvious constraints of the need to comply with AID regulations and Congressionally imposed limitations, it is essential for program interventions to be designed based on the needs of the beneficiaries. Loan terms and even amounts should reflect patterns convenient to the needs and abilities of the borrower, rather than program managers.

### B. Flexibility

Both the strategy and SME initiatives undertaken by the Mission must incorporate a degree of flexibility to permit effective attainment of project goals. Conditions change over time, and to be successful, any program strategy must be able to modify its structure and procedures, within the general framework of its strategic goals, to accommodate such vicissitudes.

### C. Focus and Complementarity

Mission efforts must maintain a clear focus and not become splintered into a multitude of unrelated SME activities. Given the fact there exists a network of PVOs and other organizations already providing a range of services to the SME sector, the Mission project should not duplicate assistance, but expand resources and develop linkages with projects providing complementary support.

D. SME "Graduation" vs. "Sustainability"

The concept and objective of "graduating" micro enterprises to a more advanced "type" of microenterprise or small business should be modified. While some microenterprises will and should "graduate," this should not necessarily be a goal or measure of success. Instead, assistance should be provided to make SMEs basically "sustainable," increasing profitability and viability at lower SME levels. The fact is that most SMEs will not or need not "graduate" to have become viable, permanent, and successful businesses, providing employment, creating economic activity and generating tax revenues.

E. Targeting

As a matter of strategic principle, it is necessary to design SME initiatives based on the distinct needs of the beneficiaries. This can be achieved in part by use of the typology. In addition, however, it is necessary to take into account other factors, including:

- Economic sector - understanding the distinct credit needs of beneficiaries. SME farmers, for example, need longer term credit and are subject to weather cycles. Senoras del mercado need only short term (daily, weekly) credit. The different credit needs by sub-sector need to be developed in the PID.

- Geographic location - controlling for the distinct needs among rural, urban and marginal communities.

- Beneficiary level - permitting loans to individuals, groups and communities.

F. Inclusiveness

A final strategic principle is that of inclusiveness. While maintaining a clear focus, SME initiatives should attempt to reach as many beneficiaries as feasible, creating project guidelines which permit broad scale participation.

VIII. Strategy Options

A successful SME development strategy needs to be comprehensive in scope, integrating several different kinds of intervention modes to meet the various needs of the SME sector. Given the heterogeneity of the SME sector, it is equally essential that policy and especially programmatic initiatives be designed to target on the distinct needs of the four types of enterprises: a) pre-micro; b) micro; c) transitional micro; and d) small business. Based on recognition of these types, the proposed strategy seeks to: 1) support new initiatives designed to reach those SMEs at the pre-micro level which have been excluded from existing programs; 2) expand upon and complement current SME initiatives in order to assist the vast number of SMEs at the micro level which are presently not reached by these programs; 3) expand support for existing credit, technical assistance and training programs which have effectively served SMEs to date; and 4) seek to promote public sector policies supportive of mainstreaming SMEs into the formal sector. Within this context, two main strategic components can be identified: policy and program. The successful development of SMEs, especially their incorporation into the formal economy, will depend in part on a comprehensive strategy, applied at both the macro (policy) and micro (enterprise) level.

### A. Policy

Efforts to address the major policy and institutional constraints to SME development should be initiated as part of a comprehensive SME development program. Presently, there does not exist any effective institutional mechanism to represent the interests of the SME sector in the policy and decision making processes. As a result, no concerted initiatives have been undertaken to foster public dialogue, examine policy alternatives for strengthening the SME sector, nor promote the necessary policy and administrative reforms to make public institutions more responsive to the needs of SMEs. This is a critical need, as levers to produce desired policy outcomes must be identified and activated.

While the needs of the SME sector are immediate, however, they are not exclusively short-term. Many policy reform initiatives in support of SME development can and should be undertaken immediately under the auspices of the Mission's on-going policy dialogue with the GOES and various private sector development projects. Concurrently, longer-term support should be provided for an institution able to work closely with the new government and to serve as a permanent policy interlocutor for the SME sector. In a practical sense, there is only one organization which fits this criterion: the Legislative Commission of FUSADES. By working with SME associations and the various small and microenterprise assistance projects, FUSADES could spearhead an effort designed to address the policy and institutional concerns of the SME sector, conducting the requisite analyses and making presentations before appropriate government officials.

### B. Program

#### 1. Current Efforts

At the program, or enterprise level, several types of projects already exist to address the range of needs faced by SMEs, and are funded by both USAID/ES and other donor agencies. Despite these initiatives, and the successes they have achieved, the limited scope of their activities has not allowed them to make the desired aggregate impact on the national economy. Current efforts include training, technical assistance, outreach and extension, follow-up and credit. The strategy proposed here contemplates continued and expanded support of the majority of these current efforts (see chart for recommended funding levels by project), along with the introduction of a large credit program, to forge a comprehensive SME development program. In other words, the strategy proposes a programmatic vehicle to provide a critically needed credit component, which will also be able to coordinate with existing disparate SME projects, including those furnishing technical assistance and training. The vehicle will also assist policy reform efforts by sharing information with respect to the impact of policies and regulations on SMEs, along with recommendations for needed changes.

The review earlier in this paper indicates that current efforts are addressing a range of SME needs at the various enterprise levels. However, more needs to be done to expand services to include ever larger numbers of SMEs. While it is clearly unrealistic to expect that all SMEs can or will be reached by Mission efforts, it is possible to expand coverage substantially, particularly in the credit area. The proposed strategy envisions "piggybacking" on these and non-Mission funded projects to expand the scope of its impact and avoid duplicating efforts.

2. <u>Strategy Options</u>

Credit is far and above the most universal need of the SME sector. Existing formal financial institutions have been incapable and generally unwilling to provide credit on acceptable terms to the vast majority of SMEs, particularly at the pre-micro and micro levels. While in many cases, informal lenders meet a significant credit demand, terms are typically usurious - although it is safe to assume that there is a low default rate. In order to respond to this basic credit need, a separate program should be established to reach those SMEs which are presently not serviced by the formal credit sector.

Five program options were considered to carry out the strategy, and their relative strengths and weaknesses assessed.

a) <u>Intermediary Financial Institution</u>:

Creation of a private IFI was considered as an ideal alternative or model. While such an organization could be considered in most ways to be the preferred option, the time required to make it fully operational would be too lengthy to accommodate the immediacy of existing needs. The strengths of the

IFI would have been its ability, as a private organization, to seek self-sufficiency and operate efficiently, at arm's length from the kinds of political pressures confronted by a public credit institution such as FEDECCREDITO. The IFI would have included an outreach and extension program, follow-up and referral services for clients seeking technical assistance and training programs operated by other organizations. Creation of an IFI was considered conceptually to be an ideal alternative or model. As a new, private free-standing organization it would have been able to achieve the kind of independence required to permit it to develop its own positive institutional identity and credibility. The IFI would have charged interest rates and transaction fees sufficient to allow it at a minimum to recover costs. Finally, the IFI would have been able to develop a business as opposed to a "program" image, creating among SME borrowers a set of realistic expectations based on a business rather than a service relationship.

While the IFI would have been a credit institution, it also would have provided essential ancillary services, including outreach and extension, follow-up and referral to other programs for clients seeking or needing technical assistance and/or training. In addition, it would have established linkages with other credit institutions in an effort to expand the base of potentially available credit to SMEs.

The major reason for rejecting the IFI as a viable alternative is that the time required to make it fully operational would be too lengthy to accommodate the immediacy of existing needs.

<u>Recommendation</u>: Eliminate from consideration.

b) <u>FEDECCREDITO</u>

FEDECCREDITO was considered a possible vehicle through which a SME credit program, with emphasis on microentrepreneurs, could be channeled. FEDECCREDITO has a network of 61 cajas throughout the country, the largest of its kind. It is an institution established to make available subsidized credit to small and micro businesspersons. However, it has been highly inefficient and subject to irregular business practices. As a result, the use of its funds has been significantly unproductive, effectively curtailing the amount of loan funds available to SMEs.

<u>Recommendation</u>: FEDECCREDITO should continue to manage the existing local currency credit lines and the RUD supported rural and urban development project. Further USAID support should be conditioned on its performance under new management over the next two years.

### c) Village Banks

A third option, as the mechanism through which credit could be provided to SMEs, are the village bank projects - Save the Children, Foster Parents, FINCA and COMCORDE. However, these projects are neither individually nor collectively able to absorb and manage the magnitude of funds required to meet projected demand. Second, the village banks operate only with pre-micro groups, effectively excluding individual borrowers and other than pre-micro-SMEs. Similarly, small community development and SME training projects, specifically the Salesian Institute, the Knights of Malta and Fe y Alegria, are not equipped to manage the kind of program under consideration.

Recommendation: Continue to fund those organizations involved in the development of village banks at the levels recommended in the Funding Requirements Chart.

### d) Credit Lines

A fourth option is to continue to provide SME credit through the ESF/Local Currency credit lines administered by the BCR. However, these programs have suffered from slow and cumbersome loan approval and disbursement processes, resulting in only 62% disbursement of available credit. Furthermore, the two credit lines available through formal financial institutions have targeted rural SMEs, and have not been generally accessible to microenterprises. Even the recent consolidation of ESF/Local Currency credit lines into a "Pequena Empresa" line is not likely to overcome this problem.

Recommendation: Local currency generations from the ESF program should continue to be allocated to the "Pequena Empresa" line of credit in order to serve those SMEs able to operate within the formal financial sector. However, USAID/ES and the BCR should cooperate more closely to streamline the approval/disbursement process, better track loans disbursed, and return undisbursed funds for on-lending.

### e) PROPEMI

PROPEMI is the most viable option to manage the proposed SME credit program. It has several strengths which make it the clear, perhaps only, choice. First, PROPEMI has a proven track record in successfully managing a sizable SME credit program. Second, through its excellent outreach and extension efforts, in particular, PROPEMI has established for itself a credible presence in the poorer communities in San Salvador, where thousands of SMEs operate. Third, as a result, it has the kind of institutional knowledge and experience required to manage the credit program being proposed. Fourth, PROPEMI staff are skilled professionals, making it possible for the organization to be able to start program operations relatively quickly. Fifth, aside from FEDECCREDITO, which already has been rejected as a viable option, PROPEMI is the only organization institutionally capable of implementing the program. Sixth, as a private not-for-profit organization, PROPEMI is comparatively insulated form the kinds of political pressures which have so hampered FEDECCREDITO.

In order to meet the objectives of the SME strategy in a timely, complete and effective fashion, it will be necessary to use PROPEMI as the vehicle through which to implement the SME credit program. As an integral part of the effort, PROPEMI will also establish linkages with existing Mission-funded projects (see chart) currently furnishing limited credit and technical assistance to microentrepreneurs.

## IX. Proposed Option

A credit program, known as PROPEMI II, will be established in PROPEMI to make available credit to SMEs, especially those microentrepreneurs not served by other programs. In addition, PROPEMI II will incorporate necessary ancillary services to support its credit functions, specifically outreach and extension, follow-up and referral. Other PVO credit programs, i.e., the village banks, will continue to provide credit to their constituents, although village banks as such will be eligible to seek loans from PROPEMI II.

The project would meet a widespread need for SME access to credit, particularly for microenterprises (i.e., as distinct from pre-micro, transitional and small businesses), which tend not to be specifically targeted by current projects. At the same time, it would strengthen and expand availability of and access to credit across the entire spectrum of SME types. In addition, the project would coordinate the delivery of existing disparate technical assistance and training services offered by USAID/ES funded PVOs.

To the extent possible, technical assistance and training will be made available by PVOs to SMEs referred by PROPEMI II. The thrust of the program, however, will remain on providing greater availability of and access to credit for SMEs.

In many ways, this option is a reconstitution of the IFI in an established institution - FUSADES. While this alternative does not allow the institutional independence envisioned in the IFI, it does have the advantage of providing an immediate and credible organizational base from which to begin program operations quickly.

A. Program Structure and Functions

The following diagram displays the program structure, indicating the major components and their interrelationships.

PROPEMI II would be used to establish a $3 million fund in local currency to provide loans to SMEs, focusing in particular on microenterprises which are presently unserved or underserved by other projects. The program will be mandated to respond to the specific needs of individual SMEs and SME groups through the provision of: 1) credit; 2) outreach and extension; 3) follow-up; and 4) technical assistance referral.

The program will focus on providing individual SMEs, SME groups and communities (eg. village banks) with access to credit. As such, lending policies will be designed to allow maximum lending flexibility, at all times keeping in mind the unique credit needs of SME borrowers. Flexibility, however, will not be maintained at the expense of sound banking principles. Interest rates charged will be structured to recapture the cost of lending. Loan amounts will be established according to the applicant's ability to repay. There will be no cap on the number of loans to a borrower.

Borrowers will be encouraged to maintain minimum balance savings account. Those who do, will be eligible for reduced rates of interest on loans, although interest rates will at all times be set in order to cover the cost of lending.[1]

1. Outreach and Extension

An integral programmatic component of the program will be outreach and extension. This is a key activity for at least three reasons. First, outreach is the basic "marketing tool" to reach those SMEs most in need of credit and other assistance. Second, extension is a way of maintaining visible contact with the client base, both insuring compliance with repayment terms and offering support. It is important, nevertheless, to insure that extension does not become a form of sustained technical assistance. The third reason is to determine actual individual (or group) credit needs and conduct repayment analyses. Finally, efforts will be undertaken to coordinate PROPEMI II outreach and extension with the local PVOs.

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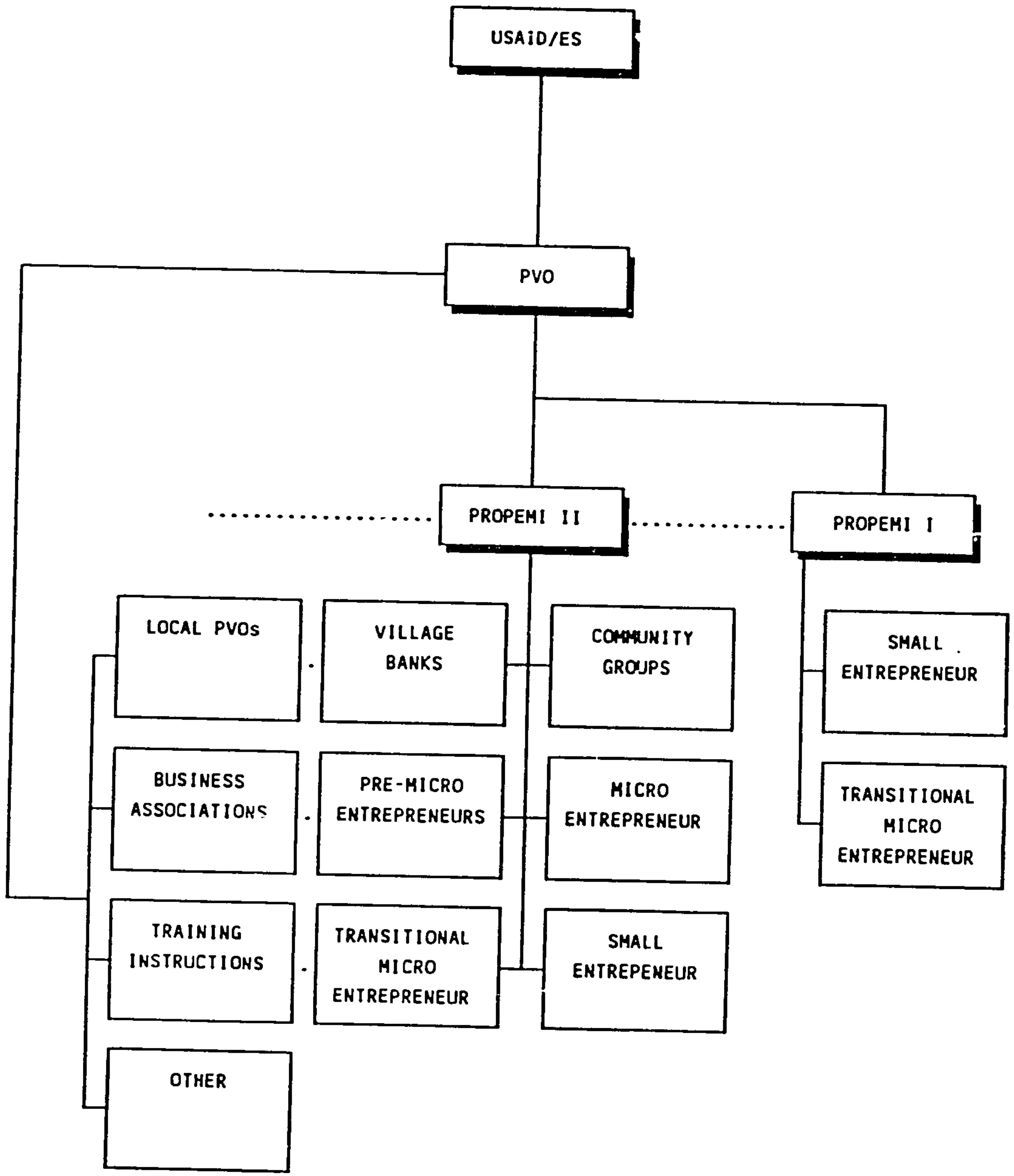
1 Under present law, interest rates may not be charged in excess of Monetary Board guidelines. Until interest rate reform can be enacted, PROPEMI II will follow these guidelines. To cover the costs of the program, PROPEMI II will apply "transaction charges" similar to those applied by AMPES and several commercial banks.



USAID/ES
PVO
PROPEMI II
PROPEMI I
LOCAL PVOs
VILLAGE BANKS
COMMUNITY GROUPS
SMALL ENTREPRENEUR
BUSINESS ASSOCIATIONS
PRE-MICRO ENTREPRENEURS
MICRO ENTREPRENEUR
TRANSITIONAL MICRO ENTREPRENEUR
TRAINING INSTRUCTIONS
TRANSITIONAL MICRO ENTREPRENEUR
SMALL ENTREPENEUR
OTHER

### 2. Follow-up

Based upon the experiences of PROPEMI I, AMPES and Save the Children's village banks, it is clear that the success of SME credit programs in El Salvador is directly correlated to the level of on-going outreach and follow-up. The greater PROPEMI II's familiarity with the day to day operations of the SME, the better it will be able to intervene as necessary in order to assist SME borrowers to meet repayment obligations. Thus, program extension agents will provide follow-up services, including close monitoring of repayment, immediate intervention in cases in which the borrower is experiencing repayment difficulties, and assistance with subsequent credit applications.

### 3. Technical Assistance Referral

PROPEM II will not provide technical assistance, except in the determination of credit needs, preparation of credit applications, and where repayment capacity is thought to be at risk. It will, however, maintain close institutional linkages with those organizations providing such services.

Extension agents will work together with the SME throughout all stages of the credit process to identify technical assistance and training needs. If specific needs are identified, the extension agent will then refer the SME to the most appropriate support service group or organization for training and/or technical assistance.

Although technical assistance and/or participation in a formal training program will not a pre-requisite for credit approval, extension agents will assume a proactive role in the identification of technical assistance and/or training needs.

Technical assistance and/or training will not be financed by PROPEM II. However, SME borrowers may apply for credit to cover such costs.

### 4. Linkages

PROPEMI II will establish working relationships with other SME projects, including those providing training, technical assistance and credit. It will also collaborate with the companion project dealing with policy, legal and administrative reform. Cooperation will be established with both USAID and non-USAID funded efforts. Among other benefits, such arrangements would result in greater outreach to bring potential borrowers into contact with PROPEMI II, expanding the scope of its services and generating more economic activity.

In addition to those microentrepreneur borrowers covered by its own outreach program, PROPEMI II will make credit available to SME individuals and groups referred by the PVOs listed in the chart. It will serve as a credit source to village banks, SME community groups, pre-microentrepreneurs, microentrepreneurs transitional microentrepreneurs, and small businesses, although primary focus will be on microentrepreneurs. Similarly, graduates from PROPEMI I will have access to PROPEMI II loans funds, after exhausting their three loan limit.

B. Clients

PROPEMI I would retain its present functions and structure. In other words, it would be a stand alone program, operating as the other PVOs furnishing assistance to SMEs. Its graduates could be referred to PROPEMI II for credit, as needed. It would not have an operational or line relationship to PROPEMI II.

1. Local PVOs

Local PVOs currently providing training and technical assistance would continue to serve their SME clients as at present. In addition, they would be able to refer their participants to PROPEMI II for credit. Conversely, PROPEMI II clients could be referred to PVOs (including PROPEMI I) for TA and training.

2. Village Banks

Village banks would be eligible for PROPEMI II credit, either for initial or subsequent capitalization. Indeed, with the additional resources PROPEMI II represents, village banks could expand their coverage significantly.

3. SMEs and Community Groups

Individual SMEs on their own, as well as community groups would be eligible for credit from PROPEMI II. It is envisioned that these borrowers will constitute the large majority of PROPEMI II clients, and be initially contacted through the programs' outreach efforts. Emphasis will be placed on reaching micro-entrepreneurs, especially the great majority who are presently unserved by existing programs.

C. Implementation

As PROPEMI takes on the additional responsibility of the credit program, it will need the support of FUSADES. While suggestions have been made to "spin off" PROPEMI from FUSADES, and make it a stand alone SME service organization, this is neither feasible nor desirable. First, there would be great resistance from FUSADES and PROPEMI. Second, as part of FUSADES, PROPEMI represents the interests and needs of the poorest economically active population from within the country's leading and most influential private sector organization. Third, as such, PROPEMI will be able to work more effectively from within FUSADES to encourage it to share the lead in pushing for the policy, administrative and legal reforms necessary for SME development.

1. US PVO

A US PVO would be awarded a grant to provide three basic services: 1) manage sub-grants to the Mission-funded locally-based PVOs currently furnishing training, technical assistance and credit to SMEs; 2) provide direct technical assistance to PROPEMI in setting up and operating the credit program, which would be known as PROPEMI II, in contradistinction from the original PROPEMI project, or now PROPEMI I; 3) be responsible to USAID/ES for overall management and coordination of the program. Both PROPEMI I and PROPEMI II would be located and operated within the current legal and administrative structure of FUSADES.

2. Phasing

The ultimate goal of the program should be to extend credit opportunities as widely as possible. Ideally, PROPEMI II branches should extend throughout the country, making available loans to SMEs in the urban and rural areas outside San Salvador. This would help both to develop these other areas and stem migration to the capital. To begin with, however, the program needs to start modestly, expanding its operations elsewhere as its capacity and resources permit.

PROPEMI I has proven to be highly effective in providing credit, technical assistance and training to transitional and small entrepreneurs. Thus, the Mission should support, to the fullest extent possible, the expansion of PROPEMI I program both within and outside of San Salvador.

3. Self-Sufficiency

PROPEMI II will work to become a self-sustaining private financial institution. By charging market interest rates (or their equivalent in transaction costs), and working closely with its clients, it will be able to recover costs to the extent it can insure its continued operation. The need and demand for credit is a permanent condition of all businesses, including SMEs, so that the PROPEMI II will be able to function like any successful business (albeit as a not-for-profit corporation).

### D. Caveats

Finally, it is important to state four caveats by way of maintaining expectations at a realistic level, as well as providing additional guidance in application of the SME strategy to the design of the project.

#### 1. Dependency

Perhaps the major caveat is the need to guard against creation of dependency attitudes among project beneficiaries. It has already been demonstrated that many micro entrepreneurs, for example, obtain credit on a routine basis from usurers and are able to repay it. The project strategy contemplates providing credit at market rates. To do otherwise, would create an artificial dependency, eventually producing significantly negative consequences, either as the subsidy terminated or the national budget had to absorb it indefinitely. Finally, as a Mission and AID goal is to bring SMEs into the economic mainstream, they must play by the market rules of the game.

#### 2. Permanent IFI

While the objective is not to create SME dependency on subsidized interest rates and soft loans, it has to be recognized that only a permanently established private credit institution, as the one suggested in the "model," will be able effectively to serve the credit needs of SMEs, especially pre-micro and micro entrepreneurs. Ideally, of course, this will become a self-sustaining organization.

#### 3. Public IFI

The strategy specifically does not contemplate use of a public or quasi-public institution as the mechanism through which to channel credit services to SMEs. Even if a new governmental institution were established to implement the project, the problem of public perception would remain. That is, as a public entity, such an institution would be considered not a serious credit organization, but another governmental resource for loans which would not have to be repaid. Given past experience, this is a safe assumption. Moreover, it would be extremely difficult for a public institution to recover costs, as its political character would make it vulnerable to subsidization and mismanagement.

### E. Funding Requirements

The following chart displays the funding needs for the proposed strategy, by program intervention and local/US currency. The total recommended for a three year period is $24.765, of which

$18.565 would be in local currency.

The programs listed on the chart represent the spectrum of services required in order to bring about development of the SME sector. They include existing efforts as well as the proposed IFI "model." One currently Mission funded program, Empresarios Juveniles, has been eliminated from the strategy, as its mandate falls outside the scope of the present strategic objectives. Instead, it is suggested that Empresarios Juveniles be funded out of a separate program account.

While reliable and complete data still do not exist, it is possible to make some highly tentative projections with respect to anticipated quantifiable project outcomes. It is expected that ______SMEs will be served by the set of programs listed in the chart. Of that number, ______will be provided credit. A more accurate and informed judgment obviously cannot be made until a demand analysis is conducted.

Qualitative outcomes will include: 1) establishment of an effective, self-sustaining institution capable of meeting the credit needs of SMEs; 2) creation and expansion of small and microenterprises; 3) increased income opportunities for SMEs; 4) generation of jobs; 5) expansion of an entrepreneurial class; 6) improved policy, legal and administrative framework impacting SMEs; 7) expansion of the formal economic sector.

## FUNDING REQUIREMENTS (US $ 000s)

| PROGRAM | CAPITALIZATION | OPERATIONS | TOT |
|---|---|---|---|
| PROPEMI II | 3,000 | 2,500[2] | 5,5 |
| PROPEMI I | 2,400 | 600 | 3,0 |
| Save the Children | 1,125 | 0 | 1,1 |
| Foster Parents Plan | 675 | 0 | 67 |
| FINCA | 450 | 0 | 45 |
| Chamber of Commerce | 0 | 100 | 10 |
| Fe y Alegria | 0 | 40 | 4 |
| Salesian Institute | 0 | 25 | 2 |
| Comcorde | 450 | 100 | 55 |
| FEDECCREDITO | 12,700[3] | 0 | 12,70 |
| CONADES | 100 | 0 | 10 |
| OEF | 0 | 500[4] | 50 |
| | $20,900 | $3,865 | $24,76 |

All figures represent equivalent dollar amounts in local currency.

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[2] Includes US$1.0 million in US currency.

[3] Includes US$4.7 million in US currency for on-going IRD project.

[4] Represents US$500,000 in US currency.

[5] US$12.065 million total funding excluding ESF/Local Currency Credit Line and IRD projects administered by FEDECCREDITO.