Box 6

SMALL AND MEDIUM-SIZED ENTERPRISES IN THE EURO AREA: ECONOMIC IMPORTANCE AND FINANCING CONDITIONS

This box reviews the key role played by small and medium-sized enterprises (SMEs) in the euro area economy as well as the financial situation and financing conditions that SMEs currently face across euro area countries.

The role of SMEs in the economy

SMEs are a keystone of the euro area economy, as evidenced by the fact that they represent the vast majority of firms (99.8%). Table A provides a few economic indicators which show the importance of SMEs in the euro area economy, breaking the category down into medium-sized firms (those with between 50 and 249 employees), small firms (between 10 and 49 employees)

Table A Importance of SMEs in the euro area economy

(as a percentage of total business economy, unless otherwise indicated; average for 2008-13)

Category	Number of employees	Percentage of firms	Employment	Value added	Productivity
Large firms	≥ 250	0.2	30	40	131
SMEs	< 250	99.8	70	60	87
Medium-sized	50 - 249	1.0	17	18	110
Small	10 - 49	6.7	22	20	91
Micro	0 - 9	92.0	31	22	71

Sources: European Commission 2012 Annual Report on European SMEs.
Notes: Data for 2011-13 are estimates. Productivity is measured as value added in nominal terms per employee and 100% is equal to the total productivity of the business economy.

and micro firms (up to 9 employees).[1] It shows that a very large proportion of SMEs are micro firms. SMEs also account for a large share of employment and value added in the euro area, with their share in the total business economy amounting to 70% and 60% respectively. Both shares are higher than those in the United States, where SMEs account for around 50% of both business employment and value added. Among SMEs, micro firms make the largest contribution to employment, whereas for value added micro, small and medium-sized firms each contribute about one-fifth of the total value added of the business economy. However, labour productivity, measured as valued added in nominal terms per employee,[2] is relatively low for micro firms (71% of overall business productivity) and high for large firms (131%). These apparent productivity divergences may reflect differences in labour skills and capital intensity, as well as factors not related to either input, such as technological dynamism. SMEs also play a less dominant role for euro area activity in terms of investment flows per person employed, which are around one-third lower in SMEs than in large firms. This suggests that SMEs make up around 50% of total business investment.

The economic importance of SMEs – in terms of employment and value added shares – is considerably above the euro area average in Greece, Spain, Italy and Portugal. These countries also have a high share of micro firms compared with the euro area average (see Table B). At the

Table B Importance of SMEs across euro area countries

(as a percentage of total business economy, unless otherwise indicated; average for 2008-13)

	euro area	BE	DE	EE	IE	GR	ES	FR	IT	CY	LU	MT	NL	AT	PT	SI	SK	FI
SME employment	70	67	62	78	70	85	76	64	80	82	68	76	65	68	79	70	58	62
SME value added	60	61	54	73	52	70	66	59	69	76	71	65	63	61	68	63	53	57
Percentage of micro firms	92	94	83	87	89	97	94	93	95	92	88	95	91	87	94	93	78	92
Productivity of micro firms	71	69	79	74	69	61	70	94	64	75	158	77	79	75	59	73	81	86

Sources: European Commission 2012 Annual Report on European SMEs.
Notes: Data for 2011-13 are estimates. Productivity is measured as value added in nominal terms per employee and 100% is equal to the total productivity of the business economy.

1 SMEs are often simply defined as companies with fewer than 250 employees, whereas the official definition of SMEs used in the EU is more detailed; for more information, see http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_en.pdf. According to the official definition, micro firms are those that have fewer than ten workers and turnover or assets of less than €2 million. The corresponding figures for small firms are 50 workers and €10 million; for medium-sized firms 250 workers, €50 million of turnover and €43 million of assets. Firms with figures above these levels are classified as large.

2 Labour productivity is often measured by valued added in nominal terms per employee in micro-based databases, rather than by volume of production per employee, which is the more standard measure of labour productivity in economics and in macroeconomic series.

same time, the productivity of micro firms in Greece, Italy and Portugal is comparatively low: they account for about 60% of total business productivity, compared with 71% for the euro area as a whole.

It is important to bear in mind that SMEs are a heterogeneous group of firms. Nine out of ten SMEs are micro firms, which typically have different characteristics from other SMEs. In addition, SMEs might belong to a group and thus not behave economically as independent SMEs. Furthermore, SMEs are often tightly integrated into the supply chain, alongside large corporations, and can hence benefit from privileged access to suppliers and to customer funding. Recent research shows that idiosyncratic shocks to a single firm can have sizeable aggregate business cycle effects, in particular if that firm is strongly interconnected with other firms in the economy, because input-output linkages generate co-movement between firms (network model). For both statistical (granular approach) and organisational (network model) reasons, large firms may in fact play a much bigger role in aggregate economic fluctuations than entailed by their mere share in employment or value added.[3]

Financial situation of SMEs in the euro area

SMEs display some idiosyncratic features in their financing structure. They turn to banks for their external financing more often than large firms do, and they are generally more likely to experience difficulty in obtaining funds. There are structural reasons for this: notably, SMEs are more opaque than other firms and their corporate capabilities more difficult to assess for creditors (i.e. owing to asymmetric information between lenders and borrowers), because their financial statements are less informative and their credit histories are usually shorter. These characteristics are compounded by fixed costs in external assessment and monitoring. All this leads to higher transaction costs for SMEs.

According to the most recently available data on individual firms, which go back to 2011,[4] about one-third of euro area SMEs are not financially indebted, with the proportion rising to 38% for micro firms and 40% for young firms.[5] Among the indebted SMEs, leverage ratios – defined as the sum of short and long-term debt over total assets – are higher than in the case of large firms. As leverage typically decreases as firms' age and assets (or sales) increase, the evidence confirms the commonly held view that young and small companies face larger obstacles to borrowing funds and that, once they borrow, they rely heavily on bank debt to finance their business. Structurally, SMEs also tend to be less profitable than large firms and to have considerably higher cash holdings, suggesting that SMEs need to build up liquidity buffers more than large firms.

These factors explain why credit sources tend to dry up more rapidly for small firms than for large companies during economic downturns, thereby disrupting the business and investment

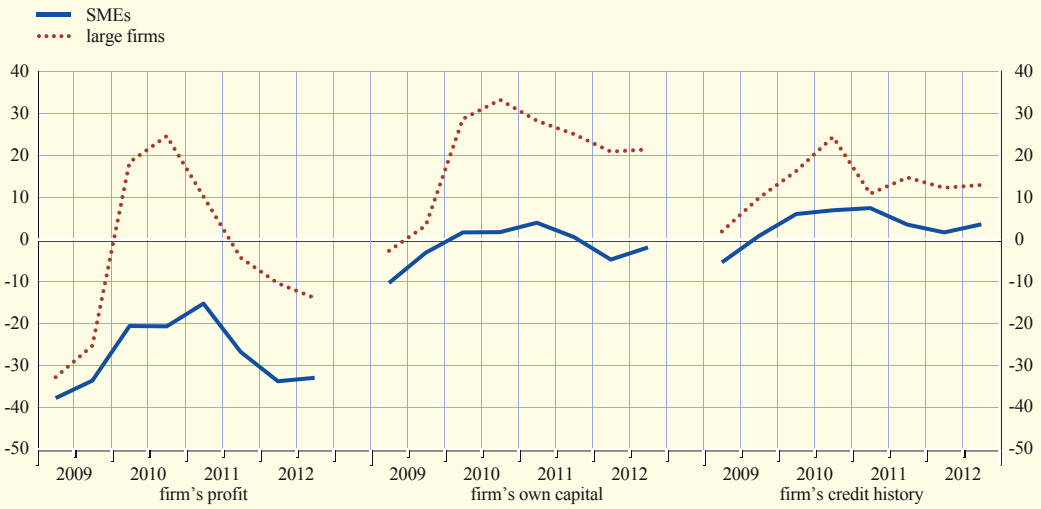
3 For more details on the network model, see Acemoglu, D., V.M. Carvalho, A. Ozdaglar, and A. Tahbaz-Salehi, "The Network Origins of Aggregate Fluctuations", *Econometrica*, 80(5), pp. 1977-2016, 2012; for details on the granular model, see Gabaix, X., "The Granular Origins of Aggregate Fluctuations," *Econometrica*, 79(3), pp. 733-772, 2011. For empirical evidence on Germany, see Wagner, J., "The German Manufacturing Sector is a Granular Economy", *University of Lüneburg Working Paper Series in Economics*, No 219, 2011, and for empirical evidence on France, see di Giovanni, J., A.A. Levchenko and I. Méjean, "Firms, Destinations, and Aggregate Fluctuations", *CEPR Discussion Paper*, No 9168, 2012.

4 These figures are based on the Bureau van Dijk Amadeus database. After data filtering, an unbalanced panel of approximately 2.5 million firms was obtained.

5 See "Corporate finance and economic activity in the euro area: Structural Issues Report 2013", *Occasional Paper Series*, ECB, *forthcoming*. The classification is based on the ceilings defined by the European Commission, as described in footnote 1. Young firms are defined as those that are less than three years old.

Chart A Change in financial health of euro area SMEs versus large firms

(over the past six months; net percentages of respondents)



Source: ECB (SAFE).
Note: Net percentages are defined as the difference between the percentage of firms reporting an increase for a given factor and the percentage reporting a decrease.

activities as well as the demand for labour of these firms to a greater extent. This has indeed been the case during the recent crisis in the euro area: according to evidence from the ECB's survey on the access to finance of small and medium-sized enterprises in the euro area (SAFE),[6] the profits and own capital of euro area SMEs have developed less favourably than those of large firms (see Chart A).

Financing conditions of SMEs in the euro area

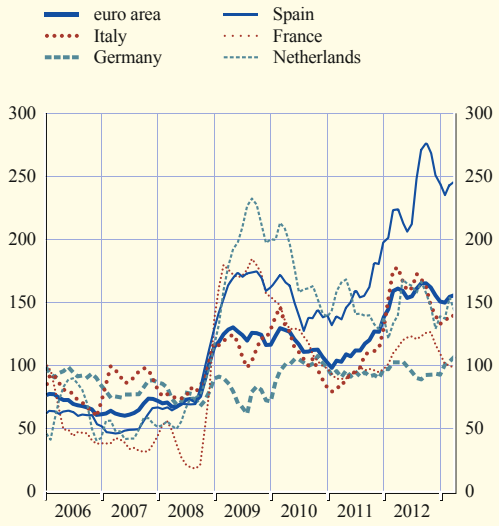
In addition to the deterioration in SMEs' financial situation during the crisis, SMEs in some countries are encountering difficulties in accessing finance owing to the fragmentation of the financial and banking markets. Sovereign spreads and macroeconomic weakness, in addition to borrowers' risk, are likely to influence financing costs. The fragmentation of euro area financing conditions is an impediment to the investment and growth opportunities of SMEs in particular, as they are traditionally highly dependent on banks.

A simple comparison between interest rates on small loans (assumed to be granted mainly to SMEs) and those on large loans shows that SMEs were paying on average around 150 basis points more than large euro area companies in April 2013 (see Chart B). Differences across countries remain considerable: in the same period the spread for Spanish SMEs was 250 basis points, while that for German SMEs was around 100 basis points. Looking at developments over time, spreads remained substantially higher for SMEs in Italy and Spain than before the start of the financial crisis, although they have declined since the last quarter of 2012. Hence, the general economic situation characterised by bank funding fragmentation and subdued loan dynamics in some jurisdictions constitutes a challenging environment for SMEs.

6 The results of this survey are published biannually on the ECB's website.

Chart B Spread between bank lending rates on small and large loans to non-financial corporations

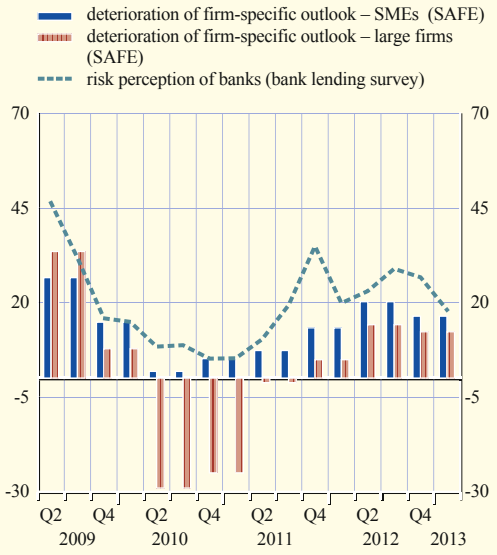
(basis points; three-month moving averages)



Source: ECB (MIR statistics).
Notes: Lending rates have been aggregated using new business volumes. Small loans are loans of up to €1 million, while large loans are those above €1 million.

Chart C Firm-specific factors affecting the availability of external financing and risk perception of banks

(net percentages)



Sources: ECB (bank lending survey and SAFE), ECB calculations.
Notes: See notes to Chart A. Risk perceptions of banks, as reported in the bank lending survey, are computed as the unweighted average of "general economic activity" and "industry-specific risk". "Firm-specific outlook" refers to changes in the sales, profitability or business plan of firms, as reported in the SAFE. SAFE data are biannual, so figures are reported twice, once for each of the two quarters covered by the survey. Negative values indicate an improvement.

Given the deterioration in SMEs' financial situation in an environment of weak economic activity, divergent bank funding conditions and banks' adjustments of their balance sheets, banks have generally been taking a more selective approach to supplying loans in order to preserve the quality of the assets side of their own balance sheets.

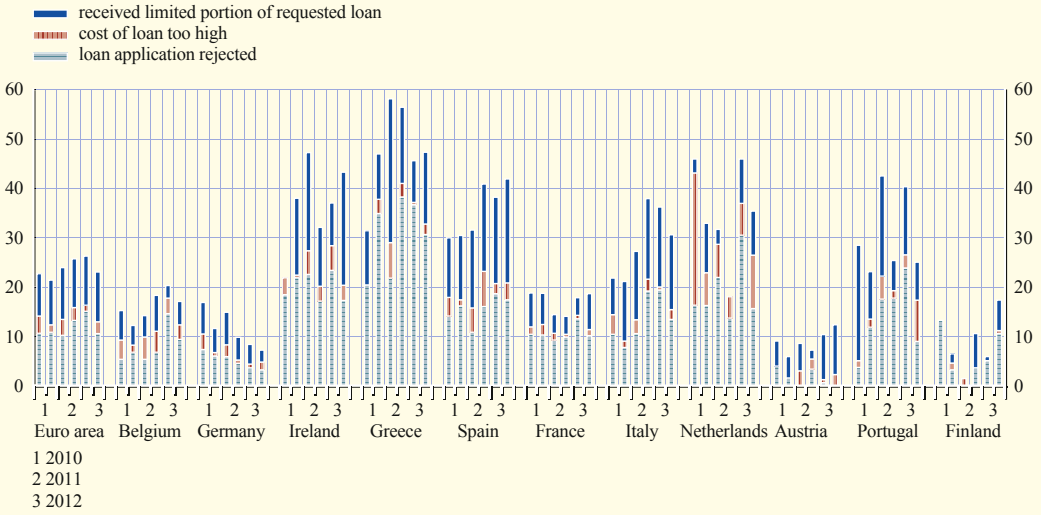
As shown in Chart C, banks' risk perceptions, as reported in the euro area bank lending survey, concerning overall economic activity as well as industry and firm-specific developments have played an increasing role in the net tightening of credit standards on loans to enterprises since 2009. This evidence is mirrored by the results of the SAFE, with participants reporting that the firm-specific outlook, in particular of SMEs, continues to weigh on the availability of external financing (in terms of sales, profitability and business plan).

Against this background, SMEs typically experience greater obstacles than large firms in obtaining bank loans. An indicator of the obstacles faced in obtaining bank loans can be constructed on the basis of the SAFE questions regarding the outcome of bank loan applications by SMEs. The indicator is constructed by adding together the percentage of SMEs that applied for a bank loan[7] but were rejected, the percentage that received only a portion of the amount for which they had applied, and the percentage that did not take up a loan because borrowing costs

7 On average, between 2009 and 2012 23% of all euro area SMEs applied for a bank loan.

Chart D Obstacles experienced by SMEs in obtaining bank loans in selected euro area countries

(percentage of respondents)



Source: ECB (SAFE).
Base: SMEs that applied for a bank loan.
Note: Total financing obstacles are defined as the sum of the percentages of SMEs which applied for a bank loan but were rejected, which received only a limited part of the amount for which they had applied, or which did not take up the loan because borrowing costs were too high. The chart refers only to those SMEs that applied for a bank loan.

were too high.[8] This indicator shows that nearly one-quarter of euro area SMEs that applied for a bank loan during the period from 2009 to March 2013 faced some sort of financing obstacle (see Chart D).

In most countries, the most common form of obstacle was the rejection of a loan application, followed by receipt of a limited portion of the funds requested, whereas only a limited number of SMEs turned down a loan owing to high borrowing costs. At the same time, the level and pattern of financing obstacles have been heterogeneous across euro area countries. For instance, in the last survey wave (referring to the period from October 2012 to March 2013) financing obstacles were reported by SMEs to be very high in Greece, Ireland and Spain (with more than 40% of firms that had applied for a bank loan encountering obstacles), moderate in Belgium, France and Finland (less than 20%) and low in Germany and Austria (around 10%), reflecting the considerable heterogeneity in borrowing conditions.

As SMEs are often unable to switch from bank credit to other sources of external finance, they are more likely to be affected by outright rationing of credit provision than large firms. Difficulties in borrowing, which affect not only SMEs' day-to-day activities, but also their ability to grow, could easily transform liquidity constraints into solvency risk.

Conclusion

SMEs play an important role for the euro area economy in terms of employment and value added. Their economic importance is even greater in the euro area countries experiencing more

8 A broad definition of financing obstacles may also include discouraged borrowers, i.e. firms that do not apply for a bank loan owing to fear of rejection.

acute financial tensions. At present, in many parts of the euro area, SMEs are experiencing greater difficulty in obtaining bank loans than large firms and have to pay higher financing costs. Access to finance remains challenging, in particular for young SMEs and SMEs in stressed euro area countries.

All in all, the difficulties encountered by SMEs point to the importance of structural policies to support SME financing. In this context, the European Commission and the European Investment Bank (EIB) are exploring joint risk-sharing instruments which would combine EU budget resources with the lending capacity of the EIB and the European Investment Fund, as well as resources from national promotional banks, to finance special activities in EU priority areas. Overall, the Eurosystem is willing to contribute to efforts to support SME financing, in particular in view of the impaired transmission of monetary policy. At the same time, while central banks can help to ensure funding and maintain price stability, thereby contributing to sustainable economic growth, fiscal consolidation by euro area governments as well as structural reforms to restore competitiveness in product and labour markets are urgently needed in order to increase the rate of sustainable economic growth.