



SUPPORTING JOB CREATION AND INNOVATION THROUGH MSME DEVELOPMENT IN MENA

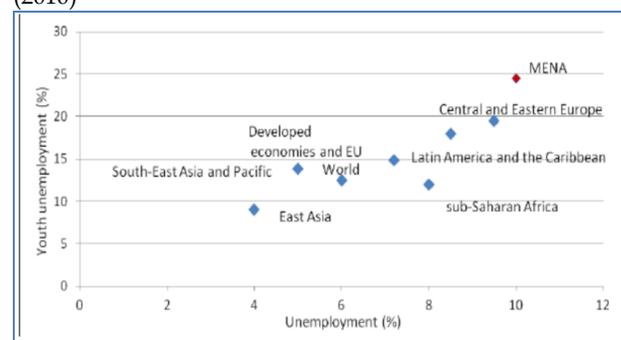
Peter McConaghy¹

Introduction: Employment generation is a critical challenge facing policymakers in the MENA region, particularly since the Arab uprisings as citizens challenge governments to provide greater economic and social opportunities. Unemployment levels in MENA are above those of any other region (see figure 1), while the labor force participation rate remains stubbornly low. Three out of four working-age women do not participate in the labor force, constituting 80–90 percent of MENA’s inactive workers (World Bank 2012). Unemployment is further complicated by the demographic bulge the region is facing. The number of young people (ages 15 to 24) increased from 44.6 million in 1980 to 88.1 million in 2010—doubling in 30 years (UN Population 2010). At around 25%, the youth unemployment rate exceeds that of any other region in the world (IMF 2012; see figure 1). The lack of good employment opportunities in the region is reflected in high levels of informality: in no MENA country does the formal private sector employ more than 20% of workers (World Bank 2012).

In recent years, policymakers have prioritized developing Micro, Small, and Medium-Sized Enterprises (MSMEs) to address the employment challenge in MENA. SMEs account for 20–40% of all private sector employment in MENA and contribute more than 50% of GDP output in the region (World Bank 2012). A small proportion of high performing MSMEs have the potential to grow

into internationally competitive companies, generating significant economic benefits through raised productivity, employment, and economic stability (Nasr and Pearce 2012). MSMEs, however, often lack the financial and investment services needed to access finance. They typically suffer from operational inefficiencies that hamper productivity and growth. In addition, many MSMEs in the MENA region find it difficult to expand since many markets are dominated by a small number of privileged and well-connected firms. Finance from banks remains all but shut off to new and small firms, while early stage seed financing and business incubation services for new firms is nascent. Addressing these challenges to MSME growth and competitiveness is central to overcoming employment and economic development challenges in the region.

Figure 1: Total & Youth Unemployment by Region (2010)



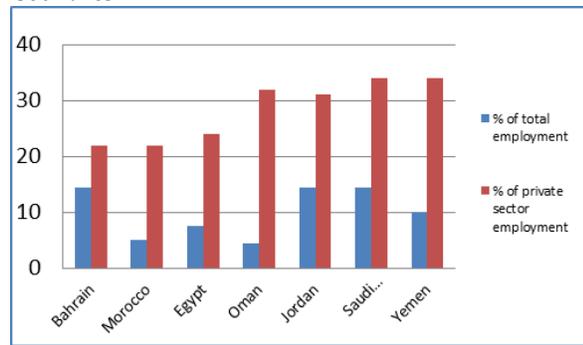
Source: IMF and ILO Data, 2010

The MENA MSME Landscape: There are approximately 19–23 million MSMEs in the MENA region (IFC-McKinsey 2011). MSMEs represent between 80 percent and 90 percent of all formal sector enterprises, and an even higher proportion if informal enterprises are

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taken into account (Nasr and Pearce 2012). Only 10% of the total SMEs are formal. The number of formal SMEs is significantly lower for transition countries such as Egypt (6%) or Yemen (5%). This is congruent with the employment trends in the MENA region. The typical non-GCC MENA country is estimated to employ as much as 67% of its labor force informally (Loayza & Wada, 2010). Overall, SMEs account for 20-40% of all private sector employment in MENA and contribute to over 50% of GDP output in the region (World Bank 2012) (see figure 2).

Figure 2: SMEs as Employers in select MENA Countries



Source: World Bank development indicators

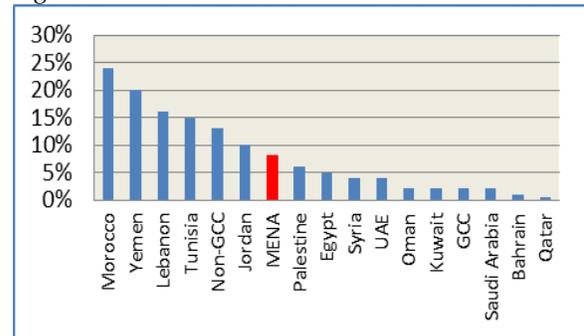
Access to Finance Constraints in MENA:

Access to finance remains highly unfavorable for MSMEs – the total estimated financing gap for MSMEs in MENA is USD \$320-\$390 billion (IFC-McKinsey 2011). Only 8% of total Bank loans go to SMEs in MENA, although this figures ranges widely from 24% in Morocco to 2% in the GCC (see figure 3).

Significant risk aversion and high collateral requirements amongst banks make it very difficult for MSMEs to receive credit. Recent studies have shown that over half of the SMEs who apply for a bank loan are rejected (Al-Yahya and Airey 2013). Banks generally require much more stringent collateral and guarantor requirements from MSMEs than from larger enterprises. Banks usually charge much higher interest rates and fees to MSMEs because of the time and cost of completing due diligence procedures on small firms. The high number of informal MSMEs further hinders access since there are licensing and registration requirements to receiving a loan. While

microfinance can be an important source of finance for households and micro businesses, it is generally not well suited for SMEs as the credit provided is too small to cover long-term business needs. Similarly, microfinance outreach is limited, reaching only 1.8% of the adult population.

Figure 3: MENA Share of SME Loans of Total Loans



Source: Union of Arab Banks/World Bank Financial Flagship Report 2011

Bridging the Finance Gap through World Bank Assistance:

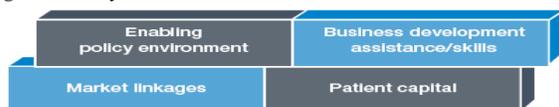
Since 2010 the World Bank has implemented a series of projects supporting access to finance on a commercial basis for MSMEs and providing incentives for banks to lend. The Egypt Enhancing Access to Finance for SMEs project began in 2010 and provides \$300 million dollars (\$150 for microfinance institutions; \$150 for credit and small enterprise finance) in liquidity support. To date the project has supported 3,000 SMEs and 27,000 micro enterprises. The project has contributed to creating 80,000 jobs and has served 4,941 female-owned microenterprises. The Egyptian government is seeking \$300 million in additional financing for the project because of significant demand from participating financial institutions (PFIs). A similar \$50 million project in Tunisia – effective since 2011 – is disbursing rapidly and has led to a 10% increase in the total number of MSME loans made by PFIs.

MENA FPD projects have also sought to enhance MSME access to finance through reducing bank risk aversion by sharing downside losses. The Morocco SME Guarantee Facility Project, approved in June 2012, provides \$50 million to support partial credit guarantees to mitigate credit risk on loans to MSMEs.

An Integrated Approach to Address Market Bottlenecks Affecting MSMEs:

While financial constraints remains a key impediment to MSME growth and employment creation in MENA, technical assistance can help address bottlenecks at the enabling environment as well as at the firm and market sub sector levels (see figure 4). With regards to policy and regulation, reform is needed to reduce the cost, time, and inefficiencies surrounding doing business. MENA countries on average rank 98 out of 185 countries in the 2013 World Bank Doing Business indicators. Support is also needed at the level of MSMEs themselves, in order to, *inter alia*, improve operational efficiency, upgrade business processes, improve internal controls and risk management, and expand to new markets. Firm-level demand studies demonstrate that business skills and business development assistance (BDA) are perceived by many SME owners to be nearly as important as access to finance (Al-Yahya and Airey 2013).

Figure 4: Key Pillars for MSME Reform in MENA



Source: Al-Yahya and Airey 2013

Market Linkages and Business Development Assistance:

Business Development Services (BDS) have been a core focus of World Bank projects for some time. Tunisia's Export Development II project provided matching grants (50% financing subsidy) to firms for assistance in marketing and facilitating access to foreign markets. The \$37 million dollar facility - operational between January 2005-September 2012 - generated incremental exports of \$550 million and served 1,239 firms, many of which were first time exporters. An impact evaluation conducted by the World Bank found that annual export growth was 38.9% higher for assisted firms compared to a control group in 2004-2008.² The World Bank is currently negotiating a third export development project for Tunisia (\$53 million) which will focus on enhancing export capacity

² Gourdon, J., JM Marchat, S. Sharma, and T. Vishwanath. *Ex-Post Impact Evaluation of an Export Promotion Matching Grant: Tunisia's EMAF II*. Rep. No. 40. Washington: World Bank, 2011. Print. MENA Knowledge and Learning.

of value-added industries including ICT and healthcare. The project design will focus on making grant schemes sustainable through embedding them in permanent government structures.

More recently the World Bank has developed a \$4.9 million MSME revitalization project in Yemen which provides 50% financing for up to 400 fresh graduates to complete internship programs. The program also includes 400 firms with matching grants (50% of the cost) for business development upgrading of firms. The project is particularly important given significant contractions in the economy due the recent the political and security crises.

In order to integrate TA across the region and to provide resources to quickly respond to client requests, the World Bank, along with the IFC launched in 2012 a \$30 million technical assistance facility to build the capacity of financial institutions for sustainable financing, and support MSME business development services through advisory services and policy support. The facility focuses on three broad pillars: a) legal, regulatory, and institutional reforms; b) advisory services to PFIs; and c) support and training to MSMEs.

Letting Gazelles Run - Unlocking the Power of Startup Firms:

Studies on SMEs (which account for the majority of private sector employment in MENA), note that only 10%-15% of them generate 50-80% of new SME jobs (Holzl, WIFO 2008). Research in this area demonstrates that net job growth comes from large firms and startups (qtd. in Freund 2011). One reason why SMEs tend not to create the most jobs is that they often have inefficient business processes that make them less productive than larger enterprises. Recent research (Haltiwanger 2010; Zarutskie 2013) finds that startups account for a significant portion of job and productivity growth and younger firms disproportionately hire young employees. These findings suggest that policymakers should be promoting start-ups and fast growing young firms (gazelles) to achieve strong employment outcomes, rather than broad-based promotion of SMEs.

Policies to Identify and Expand gazelles:

Using data from Investment Climate Assessment (ICA) enterprise surveys, Stone and Badawy (2011) found that Egyptian SMEs that grew an average of 20% or more over more than 4 years provided workers with more formal training and received international quality certification. Other variables linked to fast growing firms include having a company website, being less than 10 years old, experiencing fewer power disruptions, and using foreign-licensed technology. The analysis also shows that innovation is consistently linked to firms whose workforce includes 5% or more of university graduates. These findings direct policy attention towards education, training, quality systems, and technology use to promote SME-based employment growth.

Business Incubation and Early Stage Investment:

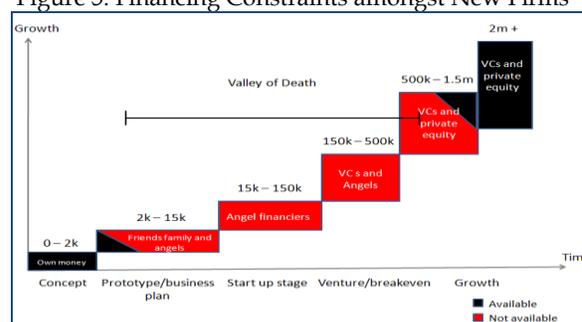
In MENA only 6.3 new businesses are formed per 100 people, versus 11.4 in other developing country regions³ and 42 in high-income countries. Startups require financing in the range of \$50 thousand to \$1million - the range commonly referred to as the valley of death (see figure 4). In the developed world entrepreneurs with innovative business ideas can rely on an ecosystem of financing and mentoring through angel investors, business incubators, and business development support programs, this is largely absent in MENA.

Promoting Innovation and Early Stage Investment:

Recognizing the significant gaps in the innovation and investment ecosystem for new startups firms, the World Bank recently launched a US\$30 million dollar project in Lebanon to encourage the equity investment market to increase early stage investment finance for financially viable new, and existing innovative firms. The project's main component comprises an Innovation in SMEs funding program (the iSME Fund). The iSME Fund provides two sources of financing: i) US\$2.5 million for Concept Development Grants (CDGs); and ii) US\$25 million for equity investment in seed, early/venture, and growth stage firms. The project - the first operation of this type in the entire World Bank - is expected

to create 70 new startups with over \$67 million in equity leveraged through the project.

Figure 5: Financing Constraints amongst New Firms



Source: World Bank 2012

Looking Forward: Addressing the employment challenge in MENA requires a coordinated set of policy interventions that combine access to finance for MSMEs with direct business development services, early stage investment for new firms, and broader reforms to the business regulatory and legal environment. Moving forward, greater attention will be placed on integrating impact assessments into projects to better understand the causal effects of implemented interventions. Similarly, efforts will be prioritized to target women and youth with access to financial services and training towards greater employability and economic resilience. These coordinated actions, backed by strong commitments of governments in the region, can lead to sustained job creation critical to long-term outcomes in MENA.

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³ Includes Latin America and the Caribbean, South Asia, Africa, and Eastern Europe and Central Asia region