

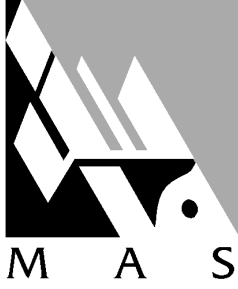


Palestine Economic Policy Research Institute (MAS)

**Towards Policies that stimulate
Adequate Financing to Small
and Medium Size enterprises**

Naser Abdelkarim

2010



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The Palestine Economic Policy Research Institute (MAS)

Founded in Jerusalem in 1994 as an independent, non-profit institution to contribute to the policy-making process by conducting economic and social policy research. MAS is governed by a Board of Trustees consisting of prominent academics, businessmen and distinguished personalities from Palestine and the Arab Countries.

Mission

MAS is dedicated to producing sound and innovative policy research, relevant to economic and social development in Palestine, with the aim of assisting policy-makers and fostering public participation in the formulation of economic and social policies.

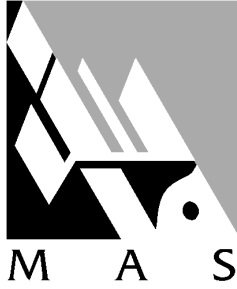
Strategic Objectives

- ♦ Promoting knowledge-based policy formulation by conducting economic and social policy research in accordance with the expressed priorities and needs of decision-makers.
- ♦ Evaluating economic and social policies and their impact at different levels for correction and review of existing policies.
- ♦ Providing a forum for free, open and democratic public debate among all stakeholders on the socio-economic policy-making process.
- ♦ Disseminating up-to-date socio-economic information and research results.
- ♦ Providing technical support and expert advice to PNA bodies, the private sector, and NGOs to enhance their engagement and participation in policy formulation.
- ♦ Strengthening economic and social policy research capabilities and resources in Palestine.

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Palestine Economic Policy Research Institute (MAS)
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Foreword

Funding is considered to be a major problem that has always been a significant obstacle facing the launch or the expansion of small and medium enterprises, especially for new enterprises with no credit history. This prompted the Palestinian Monetary Authority to obligate banks to offer loans according to a fixed percentage of their total deposits. Subsequently, the Palestinian Monetary Authority issued a new instruction to reduce the upper limit of investments abroad for bank deposits. These measures led to the expansion of lending, though most of which did not go to finance investments or activities of small and medium enterprises.

The specificity of the Palestinian multi-currency monetary system grants banks the power to invest deposits in numerous countries abroad. This places the Palestinian borrower in competition with potential borrowers from the mother countries of the currencies in use in the Palestinian territories. The structure of the Palestinian monetary system and the dominance of the Arab banks have added new dimensions to funding problems. The policies of credit, its risk assessment and granting decisions are often done outside the Palestinian territories in line with the policies of central banks in charge of supervising these banks. As a result, borrowing decisions do not necessarily take into account the prerequisites for Palestinian development.

This study seeks to examine the reasons for the continued lack of affordable and adequate funding for small and medium enterprises, despite the substantial liquidity of the banks operating in the occupied Palestinian territories. It also aims to suggest solutions that would provide adequate funding in terms of size, conditions and procedures. Finding adequate solutions to the funding problem of small and medium enterprises will have a major impact on the overall economy, due to the significant contribution of these enterprises to the Palestinian economy and their widespread geographically and sectorally.

This study constitutes one of a series of research studies about fighting poverty through the development of small and medium enterprises. The series aims to identify the difficulties that hinders their development and to identify policies that can improve their performance in areas regarding the legal framework, infrastructure, financing, promotion and other policies.

On the occasion of the publication of this study, I would like to thank our partners at the International Development Research Centre (IDRC), who supported its preparation, and I thank, the Palestinian Federation of Industries and members of the Specialized Industrial Unions, researchers, reviewers and discussants who participated in the workshop for the internal and public debate of the study and contributed to its enrichment.

Samir Abdullah
Director General

Executive Summary

This study aims to diagnose and analyze the structures of financing small and medium-sized Palestinian establishments with regard to types, sources and costs. It also aims to define the main problems faced by those establishments in assuring the financial resources needed for their continuation and development. The study also presents policy proposals that can improve the financing possibilities and conditions available for small and medium-sized establishments.

Primary and secondary sources of data and information were used to achieve the study's objectives. The primary statements were represented by a field survey of a sample of those establishments to identify presently available sources of financing, as well as problems faced in this connection. The survey will be conducted through two means, which are: to find out and analyze the contents of general budgets (lists of financial position) prepared by a sample of such establishments. The secondary sources are represented by statements and data issued by official and unofficial bodies and organizations regarding this sector and sources of its financing. Special attention in this regard is paid to materials published by the Palestinian Central Bureau of Statistics regarding economic establishments operating in the Palestinian territories, and by the Palestine Monetary Authority and other bodies connected to the Palestinian financial sector.

The study reached a number of conclusions that can be summarized as follows:

- ✧ Small and medium-size establishments continue to suffer from a low level of provided financing. Most establishments are in need of external financing to increase and develop their activities. Around 62% of queried establishments agreed that they needed external financing. The percentage of establishments in the services sector that need external financing was relatively high, reaching 76%; whereas it decreased in the commerce sector to 48%. However, the percentage of establishments that did not need external financing at all was around 12%. They were centered in the commerce sector.
- ✧ Personal contributions (owned capital) generally constituted the prime source of financing for small and medium-size establishments. This source composed the highest rate, 78.1%, of the sample's establishments when asked to define the most presently used source of

financing in their establishments. Bank loans and banking facilities occupied the second place with 8.2%. Both internal financing (realized undistributed profits) and commercial credits came in third place with 2.7% for each.

- ✧ The role of banks is considered important, but did not reach the required level. The achieved average increase in deposits in banks operating in Palestine was not accompanied by a similar increase in available credit facilities, which did not exceed 32% of deposits at the end of the first quarter in 2009. This is due to a very complicated and cautious policy followed by Palestinian banks in granting credit facilities, because of high degree of risk in the Palestinian economy. Also, demand for credit facilities is generally weak, due to the low level of investment opportunities that the semi-closed Palestinian economy provides.
- ✧ The continued existence of programs by small lending institutions is dependent on foreign aid sources, as most of them operate in accordance with agendas of donor states, a fact which reduces their possibilities and abilities to meet increased demand for loans. At the same time, the size of the loans offered by them does not coincide with increased demand for bigger loans to finance the activities of the different establishments.
- ✧ It can be noted the existence of a gap between the demand for different sources of financing and the opportunities provided to those establishments to meet their financing needs. All this underlines the need to bridge the gap through united efforts by the different institutions responsible for financing processes, in addition to the role of the government in formulating laws, setting policies and drawing programs that can provide solutions to the financing problems faced by owners of small and medium-sized institutions. Such institutions have an important role to play in moving forward the process of economic and social development in Palestine.

Based on these conclusions a number of recommendations were formulated, which can improve the opportunities and conditions of financing available to small and medium-size business establishments operating in the territories of the Palestinian Authority. The recommendations are on different levels; some are on the official governmental level, and others are on the level of the establishments themselves. A third part is on the level of the financing institutions operating in the territories of the Palestinian Authority and the international donor institutions. Most outstanding of those recommendations were as follows:

1. Adoption of an appropriate necessary legal and organizational framework that can stimulate this kind of financing, on condition that it provides the controlling authorities with the ability to set a minimum for credit facilities provided by banks and other institutions extending loans to small and medium-size establishments.
2. Strive to set up a united national fund specialized in providing loans and financial incentives to small and medium-size establishments, especially the entrepreneurs.
3. Grant banks financial privileges, such as tax exemptions for profits obtained from activities of financing such establishments. This is to encourage banks to finance small and medium-size establishments with low interest rates, in addition to lowering the obligatory reserves required of banks in proportion to the amount of money used to finance small and medium-size establishments, as well as other incentives.
4. Strive to create coordination mechanisms with international and local institutions and organizations that provide assistance and support to small and medium-size establishments. This is in an attempt to reach a systematic approach to develop and raise the level of those establishments, instead of concentrating on profit competition among those establishments.
5. Look into the possibility of creating a fund for guaranteeing loans provided to small and medium-size establishments, which can contribute to reducing the obstacles connected to the increase and multitude of guarantees required from loan seekers.
6. Attempt to establish anti-bankruptcy programs or funds that provide interest-free loans for long periods of time to establishments facing difficulties for a certain period of time.