Ch. 3: Improving Access to Finance to Unlock SME Growth Potential in Emerging Markets-South Korea Example

Introduction

Small and Medium Enterprises (SMEs) are vital drivers of economies in numerous countries, especially in emerging markets like South Korea. SMEs form the majority of businesses worldwide and significantly contribute to contemporary economic growth, job creation and global economic development (Siu, 2005; Nieto and Santamaria, 2010; Mugisha, et al., 2020). Despite their immense importance, SMEs often face obstacles in accessing financial support from sources such as equity financing, traditional banks, venture capitalists and business angels which sets them at a disadvantage compared to larger organizations. Consequently, they often resort to alternative means of financing such as personal savings, contributions from family and friends, and internal funds to initiate and sustain their entrepreneurial ventures.

SMEs face several obstacles in securing financing from investors. A primary factor contributing to this challenge is the relatively low returns offered by SMEs, which makes investment in them less appealing, especially in today's highly competitive global market. Moreover, many SMEs are seen as having limited financial transparency and weak internal controls, elevating the risk and uncertainty associated with investing in them. The absence of an extensive credit history and collateral assets further diminishes their attractiveness to potential investors and lenders (Mugisha, et al., 2020). Adding to the difficulty is the marginalization of SMEs by various stock markets, which impose complex documentation and regulatory requirements, acting as barriers to equity finance. These hurdles make it arduous for SMEs to access the necessary capital from the investor community.

There are numerous studies that have examine access of financial support to SMEs growth and innovation in emerging economies. For example, Pham, et al., (2023) investigated the innovation outcomes on access to finance for SMEs in Vietnam; while Kato (2021) stated that despite proliferation of SMEs in emerging markets, access to sustainable financing for the survival and growth of SMEs is still low and scanty. Further, the International Finance Corporation (IFC) estimates that 65 million organisation, accounting for 40% of formal micro, small and medium enterprises in emerging markets, have an unmet financing need of $5.2 trillion annually, which is equivalent to 1.4 times the current level of the global micro, small and medium enterprises lending (World Bank, 2023). While bank loans are the most available source of external source of finance for many SMEs, however, SMEs finds it difficult to obtain finance from traditional banks.

South Korea, one of the Asian tiger's economic successes has created a large industry of SMEs who act as the backbone of the country's economic performance (Tierno, 2019). Korea has some of the most supportive and vibrant policies for SMEs, including an abundant supply of government-backed loans, due to their role as an engine of growth for employment. Support for SMEs is poised to remain strong as the country undergoes a strategic shift toward inclusive and innovation-led growth (Tierno, 2019). However, critics suggest that government's data and programmes point to poor performance among SMEs.

This book chapter seeks to examine the critical role access to finance plays in enabling growth and expansion for SMEs in emerging market economies with a focus on South Korea. This chapter evaluates the unique financing barriers SMEs face in emerging markets compared to developed economies. Also, the chapter critically discusses how lack of funding sources for SMEs hinders their growth prospects. The rest of the chapter provides a critical overview of SMEs operation in South Korea, overview of emerging Markets and SMEs, SMEs financing gaps in emerging markets with a focus on South Korea. This is followed by a discussion on the risk assessment capabilities, collateral requirements for SMEs lending and the role of government in providing finance to SMEs via grants and other regulations/policies. Further discussion was carried out on the comparison for financing for SMEs in south Korea and Italy.

Emerging Markets and SMEs

Emerging markets represent developing nations that are increasingly participating in the global business arena. They exhibit certain characteristics akin to developed markets, yet they have not fulfilled all the criteria for full development (OECD, 2021b). The identification of emerging markets, as outlined by the International Monetary Fund (2021), relies on attributes such as sustained market access, global economic relevance, and the ability to attain middle-income levels. Given that Small and Medium-sized Enterprises (SMEs) serve as engines of growth and form the backbone of every economy, their significance and influence within emerging economies cannot be overstated (Abbasi, et al., 2017). SMEs play a pivotal role in the development of economies, particularly in developing and underdeveloped regions, and their contributions to emerging markets are of paramount importance. These contributions encompass job creation, economic development, and income generation, as emphasized by the

International Labour Organization (2019), which refers to SMEs as "engines for economic growth and social development."

The global significance of SMEs, with a specific focus on emerging markets, is closely tied to their contributions and the imperative for these enterprises to expand. These drivers span both economic and social realms. Emerging markets are poised for advancement and require additional impetus to progress to the next phase of development (Duttagupta & Pazarbasioglu, 2017). To facilitate and sustain this progress, supportive structures and institutions are essential, with SMEs playing a central role.

The multifaceted roles of SMEs extend from employment creation to fostering innovation, reflecting the inherently entrepreneurial nature of these businesses. In emerging economies, a significant portion of the workforce is employed by small and medium-sized enterprises, with the World Bank estimating that 70% of formal jobs are generated by SMEs (World Bank, 2023).

Another pivotal function of SMEs is their support for local communities. Many SMEs are rooted in these local communities, and their contributions to these areas are of paramount importance. Unlike larger corporations, SMEs can thrive in smaller communities due to their size and operational characteristics. SMEs in local and small communities often collaborate and support each other's growth, relying on fellow smaller businesses for raw materials and other supplies. This interconnectedness fosters community development and economic resilience.

Overview of SMEs Operation in South Korea

This section offers a concise overview of Small and Medium-sized Enterprises (SMEs) and their operational characteristics. According to the World Bank (2023), majority of global businesses fall within the SME category, accounting for approximately 90% of all businesses and generating nearly 50% of job opportunities in most countries (Yoon, 2023).

In the year 2020, South Korea boasted around 7.3 million SMEs, while the count of larger corporations stood at approximately 9,300 (Yoon, 2023). SMEs are primarily characterized by their financial metrics, including revenue, assets, and the number of employees, which typically fall below specified thresholds (Liberto, et al., 2023). It's worth noting that these thresholds can vary among different jurisdictions, with individual countries often establishing unique guidelines for SME classification based on sector-specific or industry-specific criteria.

For instance, the United States classifies SMEs by considering ownership structure, employee count, earnings, and industry. In the U.S., a manufacturing firm with fewer than 500 employees fall within the SME category (U.S. Small Business Administration, 2023). In contrast, South Korea employs a different criterion, defining SMEs in terms of the revenue they generate. Specifically, not-for-profit enterprises with total assets not exceeding 500 billion South Korean won are classified as SMEs (Yoon, 2023).

South Korea, like many emerging economies, exhibits a sizable population of less productive businesses coexisting with large, highly productive conglomerates. It is estimated that the SME sector in South Korea contributes significantly to employment, representing approximately 86% of the workforce, while 99% of enterprises fall into the SME category (OECD, 2021a). Ownership structures in these businesses commonly involve partnerships or family ownership, where management and ownership interests are often closely intertwined. As noted by Liberto, et al. (2023), the conventional concept of separating ownership from management may not be readily applicable to these enterprises, as owners frequently maintain active involvement in the day-to-day operations of their businesses.

SMEs financing gaps in emerging markets with a focus on South Korea

One of the primary roles of the financial sector is to facilitate the provision of funding to individuals, as well as private and public organizations. Periodically, disparities may arise between the amount of funding required and the availability of financial resources. When the financial sector is unable to adequately supply funding to small and medium-sized businesses, it is referred to as a "financing gap" (OECD, 2021a). While financing gaps exist in all economies and sectors, they tend to be more pronounced in emerging markets.

In the context of SMEs operating within emerging markets, a financing gap denotes the difference between the financial resources SMEs need for their operations and growth, and the amount of funding that is accessible to them (Parrott, 2023). SMEs encounter greater challenges in securing bank loans and other forms of credit when compared to larger corporations. The magnitude of this financing gap varies from one region to another. According to the International Finance Corporation (IFC), SMEs in developing countries grapple with an annual financing gap of approximately $5.2 trillion (World Bank, 2023). This gap is attributed to factors unique to SMEs and the broader economic contexts in which they operate. In the case of South Korea, a multitude of factors hinders most SMEs from accessing financial resources from banks, capital markets, and other financing providers and these factors include (IMF, 2020):

Undeveloped financial structure: the financial structures in Korea like many emerging markets is not well developed and this hinders SMEs in accessing finance. Banks and other financial institutions are mostly based in the towns and cities and SMEs may not have access as they are prevalent in the rural areas with no or limited banking facilities.

Regulatory barriers: Strict regulations and complex documentations can restrict SMEs from access finance from formal financial institutions as small business do not have robust system to enable them to meet these regulatory requirements.

Volatility and Uncertainty: Emerging markets such as Korea have unstable economies with volatility in market. Providers of finance are unwilling to offer credit to SMEs in these economies due to the high risk of default.

Lack of Financial Literacy: Financial management is core to the sourcing of funding for every business. However, SMEs owners in Korea do not have the financial literacy to understand financial management and therefore unable to navigate the complexities of financial sector financing.

Lack of collateral: Most financial institutions may require collateral as a form of security to secure a loan. SMEs have limited asset base and may not be able to provide sufficient and appropriate collateral required for a traditional loan.

As SMEs operate on a small to medium scale, there are prevailing issues with resource acquisition. These constraints include limited access to finance, capital, and human resources. One of the key constraints facing SMEs is access to finance. The next section discusses the barriers to accessing finance by SMEs.

Barriers to accessing debt financing from banks and creditors by SMEs in South Korea

Small- and medium-sized enterprises (SMEs) often encounter challenges when seeking to obtain debt financing from financial institutions and creditors. These impediments can encompass stringent eligibility criteria, such as elevated credit score thresholds and collateral prerequisites, which may pose formidable obstacles for smaller enterprises to satisfy. Additionally, the absence of a robust financial track record or limited business history can serve as formidable barriers to securing debt financing (OECD, 2019).

The economic progress of South Korea is predominantly steered by large enterprises; nevertheless, SMEs continue to hold a pivotal position within the economy. They constitute a staggering 99.9% of all enterprises and contribute to 87.5% of the nation's workforce (Liang, 2017; Kim & Lee, 2018). The total count of domestic SMEs in South Korea stands at 7.3 million, collectively employing 17.3 million individuals, constituting 87.9% of the total employment as at 2023 (Yoon, 2023). These statistics underscore the significant role played by local SMEs in the Korean economy. The substantial workforce engaged by SMEs underscores their vital role in generating employment opportunities and propelling economic growth. However, hindered by financial barriers, these indispensable contributors to the economy may encounter difficulties in their expansion endeavors. Limited access to funding can impede their capacity to invest in cutting-edge technologies, recruit additional personnel, and expand their operations, potentially leading to a deceleration in economic development and a dearth of employment opportunities in South Korea.

In South Korea, where the establishment of venture capital remains underdeveloped, banks serve as the primary source of financing for SMEs (Yoshino et al., 2019). SMEs encounter heightened financing constraints in comparison to larger corporations, attributed to factors such as information opacity and the absence of audited financial statements (Hasan et al., 2017; Lu et al., 2022). This lack of transparency poses formidable hurdles for SMEs in attracting potential investors and securing loans from financial institutions. As noted by Pan et al. (2017), small businesses grapple with difficulties in accessing both financial and non-financial credit information, leading to suboptimal credit assessments within credit guarantee systems due to limited collateral and information acquisition challenges.

The dearth of audited financial records further diminishes SMEs ability to establish creditworthiness and financial stability, exacerbating their financial constraints. Moreover, SMEs in Korea confront additional hurdles stemming from the dominance of large conglomerates in the market. These conglomerates often enjoy preferential treatment from financial institutions, thereby intensifying the challenges faced by SMEs in securing funding. Consequently, numerous SMEs grapple with impediments to their expansion and growth, which, in turn, hinder the overall economic development of the nation.

Another major barrier to accessing debt financing from banks and creditors by SMEs is the lack of collateral or assets that can be used to secure loans. This is particularly challenging for women entrepreneurs, who may face cultural norms that limit their access to assets, as highlighted by Ahmetaj et al. (2023). Furthermore, the larger financial market framework can pose impediments to the accessibility of equity financing for SMEs. These obstacles encompass information imbalances between SME management and financial institutions, elevated transaction expenses, and substantial interest costs, all of which can act as limitations for SMEs.

The challenges confronting SMEs extend beyond banking obstacles, encompassing a broad spectrum of barriers that are contingent on factors such as size, geographic location, and their position within the supply chain (Hong et al., 2019; Migilinskas et al., 2013; Vidalakis et al., 2020; Saka & Chan, 2020). As noted by Blach (2020), among the most formidable impediments encountered by SMEs are the ambiguities within tax regulations and accounting standards. These hurdles introduce an element of unpredictability and intricacy into SMEs' financial operations. Furthermore, the lack of clarity in tax legislation and accounting standards amplifies the administrative burden on SMEs, diverting their attention and resources away from innovation and constraining their ability to effectively compete in the market. To effectively address these challenges, it is imperative for South Korean policymakers to establish clear and consistent tax regulations and accounting standards tailored to the specific needs of SMEs.

3.4 Risk assessment capabilities and collateral requirements for SMEs

Risk assessment capabilities and collateral requirements for SMEs are critical for lenders to make informed lending choices to small and medium enterprises. Lenders may be hesitant to grant credit to SMEs unless they have a thorough understanding of the risks involved and adequate collateral to minimize those risks. Research indicates that SMEs are riskier than larger enterprises, making it even more vital for lenders to thoroughly examine the amount of risk before issuing a loan to an SME (Long et al., 2022).

Risk can be assessed by examining criteria such as the SME's financial records, credit history, and industry performance. Lenders may also analyze SME's company plans, management teams, and market competitiveness to assess their prospects for success and payback. Lenders can make better-informed judgements and reduce the risk of default or financial loss by properly analyzing these factors. Researchers typically assess credit risk by analyzing firm data and identifying three main groups: demographic, financial, and credit history (Long et al., 2022). These three categories offer vital insights into the possibility of a default and assist lenders in making informed decisions. Age, income level, and work stability are examples of demographic data that may reflect a person's ability to repay debt. On the other hand, financial data are concerned with a company's financial health, such as profitability, liquidity, and leverage ratios. Credit history analyses previous borrowing and repayment trends to assess an individual's dependability to satisfy financial obligations. Researchers collectively examine these three groups.

Several methodologies are employed when assessing risks in SME financing. Some methods include qualitative risk assessment, which focuses on subjective evaluations and descriptions of the risk likelihood and effect. Another method is quantitative risk assessment, which includes assigning numerical values to risks based on the likelihood and probable consequences. Researchers employ a network approach to evaluate credit risk in SMEs, incorporating relational risk features that aid in modelling complex systems, understanding the system structure, trust propagation, and contagion risk (Buldyrev et al. 2010; Zha et al. 2021 and Long et al., 2022).

Collateral is security for lenders, providing insurance in case of borrowers' inability to repay loans. SME's collateral positively impacts their creditworthiness according to Wasiuzzaman et al. (2020). This means that the more collateral a SME possesses, the more likely it is for banks to view it as creditworthy. In the case of a default, the lender may take and sell assets such as property, equipment, or inventory.

Role of government in providing finance to SMEs via grants and other regulations/policies

SMEs are crucial in any economic growth of countries. As with most governments, the South Korean government has continually emphasized support for these businesses. Thus, various programs, policies and financial incentives have been implemented by the government to support the growth of SMEs and make them more competitive (IMF, 2020). Some of the financial support provided by the Korean government include the following:

Start- up Centres

There are start-up centres established by South Korean government which serves as innovation centres which offer support services to SMEs. The support include access to networking, finance and mentoring (Yoon, 2023).

For example, in 2017, Korea established the Ministry of SMEs and Start-ups, this was to replace the previous Small Medium Business Administration. The Ministry operates in 13 regional offices and their mandate is to coordinate the policies of the national SMEs and micro enterprise policies (OECD, 2023).

Low interest loans

The government in collaboration with financial institutions (both government and private owned banks) with low interest loans and specialised lending facilities. Credit guarantee programs are available to SMES, they aim at enhancing access to loan in the form of acting as partial guarantors of loans. Thus, government guarantees loan for SMEs who meet all the requisite requirements. For example, between 2017 and 2018, the Korean government guaranteed loans increased by 2.8%. The overall amount of lending to SMEs is estimated to be KRW 4.4 trillon in 2018 (OECD, 2023).

Tax Incentives

The provision of tax incentives is also a means of supporting SMEs. According to Yoon (2023) the Korean government provides reduced tax rates, tax incentives, reductions in local taxes and tax rebate for research and development projects.

Research and development subsidies.

One important aspect of businesses is the ability to develop through research. Most research project can be very expensive and become a constraint for most SMEs. IMF (2020) stated that there are subsidies available in Korea which supports and encourage small business to pursue various research programs. The support is in the form of grants, subsidies to cover research and development costs incurred.

Potential Solutions to address challenges facing SMEs in South Korea

Faced with numerous barriers and challenges that hinder the progress and performance of SMEs in accessing finance for their operations, the following potential solutions can be implemented to address these issues. Some of the potential solutions to mitigate SMEs financial challenges could include establishment of more specialised banks for SMEs financing with support from government; establishment of credit union for SMEs; provision of adequate training of SMEs staff to enhance their skills in finance sourcing and government credit guarantee schemes to SMEs.

Establishment of more specialised banks for SMEs financing with support from government

There is the need to diversify the financing channels of SMEs in Korea by establishing specialised bank that deals mainly with SMEs financing, At the moment there are very limited financial institutions in this area, one good example is the Industrial bank of Korea (IBK) which acts as an SME bank. The bank was established in 1961 as a public bank under the industrial Bank of Korea Act to provide 70% of its loan portfolio directly to SMEs whose access to finance is limited and constrained (Niazi, et al., 2021). Since its establishment, the bank has issued policy loan, credits and financial bonds to SMEs until its privatization in 1994.

This is what one specialised bank can achieve. It is therefore justified to conclude that having a sizeable number of specialised banks focusing on SMEs finances can be a good remedy for tackling SMEs difficulty in accessing finance.

Establishment of credit union for SMEs

Another potential solution to SMEs financing problems is for SMEs to address the problem themselves and this can be solved by the establishment of Credit Unions to provide credit and guarantee collaterals for SMEs who want to source finance from other financial institutions. According to McKillop and Wilson (2015) credit unions are cooperative financial institutions with no profit motives providing financial services to their members. Credit unions distinguish themselves from traditional financial institutions by focusing on building social capital and empowering their members. Their primary function involves mobilizing savings and allocating resources to benefit their members. When SMEs unite to establish credit unions, members can secure sufficient funds for their operations, circumventing some of the challenges associated with obtaining financing from traditional banks. Members of SME credit unions stand to gain advantages such as enjoying low interest rates.

As of 2020, there are about 888 credit unions in South Korea with 6.15 million members and assets of US8.1billion (Ahn 2020). The members of these credit unions are primarily individuals and SME membership is nonexistent.

In alignment with the ethos of the Credit Union movement, Credit Unions actively participate in corporate social responsibility (CSR) initiatives, extending social financing, and bolstering the social economy to foster the creation of social value. Ahn (2020) emphasizes that the fundamental philosophy of credit unions centers around providing financial support to members and facilitating the generation of social value. This philosophy is consonant with the objectives of SMEs, which typically operate with the aim of benefiting society and are regarded as the backbone of economies. Collaborating with credit unions is posited as a strategic approach to addressing financing challenges and promoting the shared goals of social contribution.

Adequate training of SMEs staff to enhance their skills in finance sourcing.

There is always a financing gap when discussing accessibility of finance; and SMEs are usually squeezed out as investment in SMEs are perceived as high risk (Parrott 2023). One of the reasons is limited or non-existent internal controls, financial reporting and sourcing skills of employees of SMEs. It is therefore important that employees of SMEs are given the necessary training to improve on their financial reporting skills thereby enhancing their chances of accessing finance from the traditional financial sector. Extensive research has shown that there are clear benefits for SMEs who engages in skill training and development for their employees. For example, Vos and Willemse (2011) acknowledges innovation through knowledge and education is the way forward for the worldwide economy and for SMEs, a proper way out of the crisis. SMEs in South Korea must therefore focus on leveraging training skills of their workers. Only 43% of the SME’s have a training and development plan for their employees, and 39% reported that some desired training skills have not been carried out (Vos and Willemse 2011; Lee 2016). Thus, limited financial and credit situation does not allow SMEs to invest in training programmes for their workers compared with bigger organizations to merit government assistance. Therefore, there should be a targeted approach by the Korean government to promote training of SMEs to enhance their accessibility of finance.

Government credit guarantee schemes to SMEs

Another solution to mitigate the impediments face by SMEs in accessing credit facility within South Korea involves augmenting the allocation of credit guarantee schemes by the government specifically tailored for SMEs. For example, in 1976, the South Korean government established the Korea Credit Guarantee Fund (KODIT) with a focus to provide credit guarantee to SMEs in South Korea. As of 2022, its total capital fund stands at S8.3 billion (Korea Credit Guarantee Fund, 2022). Government-backed guarantee loans constitute a form of credit subsidized by the government, shielding lenders from the risks associated with loan defaults. While the overall provision of government guarantee loans across various sectors in South Korea has shown an upward trend since 2011, the proportion of these loans directed towards SMEs has exhibited a decline since 2012 (OECD, 2020). Addressing the hurdles faced by SMEs necessitates the South Korean Government to augment the allotment of government guarantee loans specifically allocated to SMEs. This strategic initiative aims to empower lenders to offer loans to SMEs at reduced interest rates, fostering a more conducive environment for their growth and sustainability.

Comparing South Korea's SME financing landscape with Italy

South Korea has traditionally been perceived as a significant business economy, with a reliance on conglomerates referred to as chaebols, whereas Italy boasts a considerable presence of small and medium-sized enterprises within its economy (Albert, 2018). The differences in the nature of respective economies have resulted in variations in the financial landscape for SMEs in both countries (Lee 2015). In South Korea, the government has been expanding policies for SMEs and startups by streamlining the startup process and providing better opportunities to attract investment (Lee 2015). These regulations have resulted in an increase in the number of start-ups and enhanced access to capital among South Korean SMEs. In 2020, the number of SMEs in South Korea increased to 7.3 million from 6.9 million from the previous year (Statista, 2023). This growth in the number of SMEs indicates a positive impact of the government's initiatives on South Korea's entrepreneurial ecosystem. Increased access to financing has enabled SMEs to develop and contribute to the nation's economic growth.

Small and medium-sized businesses account for 99.9% of Italian corporations, with micro-businesses accounting for about 95% (OECD, 2022). In Italy, trade credit is a vital source of funding for Italian businesses (Agostino and Trivieri, 2014). Trade credit allows businesses in Italy to obtain goods and services from suppliers without immediate payment, providing them with flexibility and liquidity. This form of financing is particularly important for small and medium-sized enterprises (SMEs) in Italy as it helps them manage their cash flow and maintain their operations smoothly. Similar to South Korea, the Italian financial system is bank-based, with stock markets playing an insignificant role (Deloof and La Rocca, 2015). Due to strict lending standards and a lack of collateral, SMEs in Italy may experience difficulties obtaining traditional bank loans. According to OECD (2022), a Bank of Italy survey on Industrial and Service Firms found that the SME rejection rate rose to 6.1%, half the peak reached in 2012 but 2 percentage points higher than the previous year. Thus, Italian SMEs could also benefit from bank financing by using it to create relationships with suppliers and negotiate better terms and prices.

Case study of SMEs in South Korea that Faced financial challenges.

After the Asian financial and economic crisis of 1997/1998, there were series of bankruptcies among major corporations which significantly impacted on Korean SMEs (Gregory et al., 2002). This downturn forced many SMEs into bankruptcy due to a credit shortage stemming from policies aimed at stabilizing the exchange rate, tight monetary measures, and a steep decline in both domestic and regional demand and sales, particularly in 1998. To illustrate the gravity of the situation, SME bankruptcies surged from 11,600 in 1996 to 17,200 in 1997, peaking at 22,800 in 1998 during the height of the recession (Gregory et al., 2002). Despite these challenges, the economy exhibited an impressive recovery from 1999 to mid-2000. However, economic growth has since decelerated, compounded by the aftermath of the events in New York in September 2001.

Conclusion:

SMEs face significant financial gaps that impacts on their economic growth, expansion, and innovation. There are many areas of economic policy by the South Korea government effort which has helped to improve financial access to SMEs including tax incentives, low interest loans and start-up centres which act as incubation centres for SMEs to access financial support and training. Financial policies for SMEs in South Korea were the effort of political and economic choices of modernization strategy of the Korean government's control of the economy and social matters. However, challenges still exist for SMEs growth and innovation in emerging economies. However, these efforts are with some challenges such as government guarantee credits and collaterals to secure bank loans.

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