THE CHALLENGES OF ISLAMIC TRADE FINANCE IN PROMOTING SMES IN IDB MEMBER COUNTRIES

Abd elrahman Elzahi Saaid Ali, PhD
Islamic Research And Training Institute, A Member of Islamic Development Bank Group

Abstract:
Accessing financing is one of the most formidable challenges facing Small and Medium Enterprises (SMEs); particularly in the least developing member countries (LDMC) of IDB. Given their low capital base, the availability of financial resources is essential for the SMEs growth. This research attempts to investigate the challenges and limitations facing the use of Islamic finance to promote Small and Medium Enterprises (SMEs) in IDB member countries. Secondary data from member Countries were collected and analyzed to identify the binding constraints in using Islamic finance in promoting SMEs. The findings of this study show- that despite of the recent growth of the Islamic institutions and the development of new Islamic financing products, still there is no favorable environment for Islamic finance to play vital role in the development of SMEs in the IDB member countries. The main reasons might be due to the weakness in the development of trade and the Islamic financing infrastructures. Given the uprising unemployment in many member countries, this study makes specific recommendations to the governments, Islamic banks management as well as IDBG to contribute in removing the challenges associated with accessing the sources of financing to encourage Islamic finance to further promote SMEs

Keywords: Islamic financing, SMEs' in IDB member countries

Introduction

Small and Medium enterprises (SMEs) play a vital role in promoting economic growth and creating employment and have spur social development(Cravoy *et al*, 2009). SMEs also help in regional development and export market expansion due to their aggressiveness compared to the large corporation. IDB member countries need to encourage the establishment of SMEs to help them in promoting their economic growth and reducing poverty through jobs creating and income generation. The previous evidences showed that SMEs contributed over 65% of total employment and over 55% of the GDP[1]. Accordingly many countries, developing or underdeveloped, largely depend on SMEs in promoting their economic growth and thus creating more jobs; which is vital for their prosperities. SMEs might help in solving the problem of high unemployment that exists in all IDB/MCs. That is because SMEs are more labor intensive which might be more appropriate if direct support given to them by the members and the IDBG.

The SMEs' support even becomes more important given the recent Arab spring in some IDBMCS such as Tunisia, Egypt, Yemen, and Syria, due to rising youth unemployment and economic slowdown. Nader K. and Ekta K. (2005) showed that the unemployment among the youth in some IDB member countries is more than 50%. Likewise, the report from the International Labor Organization on employment showed that the Middle East and North Africa (MENA) region has the highest unemployment rate in the world, at 10.3%. The unemployment is even higher among the youths in these regions which showed 26.3% for the Middle East and 27.1 for North Africa[2]. Reducing the level of unemployment is very important for the social inclusion and future economic security in the IDB member countries. Hence, strong and direct support from IDB member countries' government for the development of SMEs is rather vital.

[1] 2nd OECD Conference of Ministers Responsible For SMEs (2004)
[2] International Labour Office (2012)

Despite their vital role in building a competitive private sector and contributing significantly to employment growth, SMEs are facing more challenges around the world due to the recent financial crisis and Euro Zoon debt dilemma. One of the most serious challenges is the difficulty in accessing financial resources. The lack of financing prevents SMEs from contributing effectively to the economic prosperities because of their lower capital, higher risks and less competiveness. SMEs engage in many tradable activities domestically as well as cross borders. Hence, they require financing throughout their business process from the acquiring of raw materials during the pre-production stage until the final marketing of stage. Rocha R., *et al* (2011) have shown that SMEs become strategic tool for improving firm's competitiveness, generating employment, and raising the income.

The characteristics of the SMEs are not much different from country to country or region to region. The main common characteristics[3] of SMEs are the capital that the company invested, the number of employees or the firm's turnover. Other determinants of performance such as the management style, the location and the market shares are also assumed as important features for SMEs.

The recent global financial crisis and the consequent economic imbalances have their relative impact on the sources of financing of SMEs in many countries around the world. The lack of funding was one of the major factors that prevent the SMEs from investment and innovations and slowing their growth during 2007/2008 financial crisis[4]. The financial crisis exacerbated the shortage in the liquidity and increased the existing high risk associated with the SMEs. Being small, SMEs were exposed to many sorts of risks during the financial crisis.

Like the SMEs in the global markets, SMEs in the IDB/MCs were also exposed to severe business risk, financial risk and even legal regulatory risk. Business varies between the SMEs in each IDB/MCs, depending on the nature of the business, the readability of enabling environment and infrastructure, skillful human resources, quality of internal management control, legal regulatory system for SMEs and the adoption of technology which is necessary for reducing the cost and enhancing the productivity. Managing these types of risks is very essential for SMEs to survive because it results in reducing the financial losses, the cost of unexpected expenses and the expected losses on the firms' revenue.

IDB member countries are not excluded from this financing impact despite the existence of some major differences in their financial infrastructure and in the way their financial institutions operate. Meanwhile, the negative effect of the financial crisis on the available financing sources for business has highlighted the importance of using Islamic finance to promote business activities in general and develop SMEs in particular. This is because the evidences in Hasan M. & Dridi J. (2010) howed that Islamic financial institutions were resilience to the recent financial crisis. These results put more burdens on the shoulders of Islamic financial institutions in and outside the borders of the IDB member countries to support the growing demand for the emerging financial system. Based on the above arguments, this paper attempts to investigate the challenges facing Islamic finance in promoting SMEs in IDB Member Countries.

Literature Review, Methodology and Data Sources

Literature Review

Recent studies on SMEs can be classified into two areas. In one area, more efforts have been given to investigate- the role of the SMEs in promoting economic growth, increasing the employment opportunities and prospering the people. The other area focused on hinders facing the SMEs when trying to access the available financial resources. While the shortage of conventional finance has been given more attention in the literature following the recent financial crisis, the challenges facing Islamic finance as an alternative to the conventional finance has got little attention in IDB member countries, the home of Islamic financial institutions.

[3] European Commission (2009)

[4] Department for Business, Innovation and Skills (2012), The Impact of the Financial Crisis on Bank Lending to SMEs (www.nationalarchives.gov.uk/doc/open-government-licence)

The previous literature supports a positive impact of the SMEs on the economic prosperity. Coskun, et al (2002) studied the managerial issues faced by Turkish SMEs. In the light of their finding, they discovered that there was an obvious need for designing and employing a strategy to capitalize on the emerging opportunities and avoid threat in the new business environment Beck, et al (2005) investigate the relationship between the SMEs and both economic growth and poverty alleviation using the share of SMEs labor in the manufacture sector for 45 countries. The results showed that there is a positive relationship between economic growth and SMEs but did not support the claim of the impact of SMEs on poverty alleviation. Saleh and Ndubisi (2006) evaluated the development of SME in Malaysia. The results of their studied showed that Malaysian SMEs faced more challenges among them low level of technological capabilities, limited skills of human resources, low level of research and development, high level of global competitions, high level of bureaucracy in the government agencies and the problem in the internal sourcing of funds. Tambunan (2008) examined the recent development of SMEs in Indonesia and Thailand. He concluded that while the SMEs are important to the two countries, they faced more constrains in both countries such as lack of technical and managerial capabilities, access to large markets, access to finance, skilled workers and the lack of access to the business information. Cheok, Khoo Sin (2008), studied the success stories of Malaysia SMEs in accessing global markets. He showed that while a number of government programmes and incentives were offered to the SMEs in order to contribute to the national economic, the impact is limited. Olawale F. and Garwe D. (2010) studied the obstacles to the growth of new SMEs in South Africa. They specifically concentrated on the internal and external factors that influence SMEs in South Africa. They found the financial factor is the major obstacles for the establishing new SMEs in South Africa in addition to markets, management and infrastructure. Abor, J. and Quartey P. (2010), investigated the characteristics and contributions of the SMEs to the economic development in Ghana and South Africa. They found that SMEs contributed more than 90% in the two countries formal business. Despite of their great contributions to these countries economics and employment, their research results showed SMEs were facing more challenges such as access to the appropriate technologies, lack of management and trainings, limited access to international markets, laws and regulations and weakness in the institutional capacity.

Calice P., Chando, V. M. and Sekioua S. (2012), in thier recent survey SMEs in four East African countries, found that SMEs are considered a profitable business prospect and provide an important opportunity for cross-selling despite of a number of obstacles constrained the banking system engagement in this important sector. The mains obstacles stated by the findings were SMEs related factors, macroeconomic factors, business regulation, legal and contractual environment, the lack of more proactive government towards the segment, and some bank specific factors.

Results of the above literatures show that SMEs represent an important segment in economic growth and one of the essential contributors to an employment in the countries. It also showed there are common challenges facing the SMEs in the members countries related to the funding the segment, the availability of well-trained and skilled human resources and government specific factors. Another evidence from the literature shows that although there are more studies related to the SMEs, the role of Islamic financing and the challenges associated with it were not given much attention by these studies compared to their conventional counterparts. Despite of the previous evidences that indicated Islamic banks showed more resilience in the recent financial crisis which has negative impact on the available conventional sources of financing for the SMEs, the proposed alternative Islamic financing and its related environment have never given through investigation to pinpoint their capability and readability for the replacement.

The Methodology and Data Sources

This research paper investigates the challenges facing Islamic trade finance in promoting Small and Medium Enterprises (SMEs) in IDB member countries. The main objective of this study is to determine the challenges that hinder the adoption of Islamic finance to assist in the development of the SMEs in the member countries and suggest the possible potential supporting parameters to encourage its implementation. To reach this end data is collected from Islamic Banks Information System (IBIS/IRTI) and other relevant secondary sources and analyzed to achieve the research objectives.

The Overall Environment of Islamic Trade Finance in IDB Member Countries

Islamic trade finance refers to financing import and export through Islamic financing modes and instruments. Trade finance has become one of the major challenges facing SMEs today. The situation of trade finance even becomes more complicated due to shortage of liquidity and scarce financial resources due to the recent global financial crisis. Unlike the larger competitive corporate firms which have strong economical and political bargaining power, SMEs have lower capital, high risk and less competitiveness. For these reasons and in addition to the recent difficulties facing the conventional finance, Islamic trade finance becomes the legitimate alternative to provide SMEs with the required working capital, shrink the liquidity gap, reduce the risks of insolvency and may help in improving their competitiveness.

Good facilitating Islamic trade finance might play vital role to the growth of SMEs in the IDB member countries. Being very active in import and export trade and having budget constrain, SMEs always demand easy financing throughout their trade cycle, from the very beginning stage of pre-shipping until the final processing of their products. SMEs also need post-shipping financing. The efficiency and effectiveness of Islamic trade financing depends highly on the quality of trade infrastructure development and the readability of Islamic financing infrastructure in IDB member countries. Trade infrastructure development include the development of Energy, water, transportation (land and rivers), rural infrastructure, low cost technologies while Islamic trade financing infrastructure include the existence and empowered Islamic laws and regulations, suitable Islamic financing instruments and Islamic financial Institutions to provide full support to SMEs financing. Trade infrastructure and Islamic trade financing infrastructures are discussed in the following sub-section.

Trade Infrastructure Development in IDB member Countries

The quality and the development of the basic utilities such as energy, water, transportations (land and marine), warehouses, rural infrastructure, and low cost technologies are very essential for the Islamic trade finance. That is because the well-developed infrastructure enables SMEs to access trade financing and to promote business at low cost. The lack of the basic infrastructure facilities in any country create non-conducive trade environment, raise the cost and risk of trade financing and decrease the competiveness of the SMEs. Moreover, Islamic trade instruments depend on the concept of buying and selling (Ba'i), which means in any trade activity the parties expect either movement or storing of goods until the possession moves to another party. Hence, the success of Islamic trade financing necessitates the availability of enabling trade infrastructure environment.

In order for Islamic trade financing to play a major role in developing SMES in the IDB member countries, more efforts must be exerted to improve trade infrastructure of the majorities of MCs particular through the involvement of the private sector. SESRIC (2012) reported that the private sector did not contribute in any energy project for thirteen of OIC member countries and transport infrastructure project for eighteen of them for the past twenty years (1990 - 2010)[5].

Most of IDB member countries are having poor resources, civil wars, high political risks or high cost of unskilled labor to develop alone their trade infrastructure. In addition to that most of the government revenue of these countries is raised from tariff and tax which creates another trade barrier to the development of the SMEs. The nonexistence of encouraging climate to attract foreign direct investment or private sector to participate in the trade infrastructure development necessitates the intervention of IDB directly or indirectly through the recent innovated reverse linkages policy in the Member Countries Partnership Strategies (MCPS) introduced by the IDB in 2010.

Since many of IDB/MCs are not capable to develop their trade infrastructure without assistance from the more developed countries, the infrastructure development has been given high priority when IDB adopted its 1440H Vision. It represents one of the most important five pliers in the MCPS. A recent MCPS study showed that the weak over-land infrastructure, exorbitant transport costs and the high cost of financing and non-financial business services such as the administrative costs of doing business negatively affected the SMEs in Mali. Almost similar conclusion was indicated by the report of the related to Uganda MCPS [6]. Hence, the undeveloped infrastructure

5 SESRIC (2012), Private Participation in Infrastructure in OIC Countries, OIC Outlook Series

6 IDBG Member Country Partnership Strategy for Uganda (2011 – 2015)

represent one of the major obstacles which hinder Islamic trade finance to play appositive role in the development of the SMEs in most of the developing IDB member countries.

Islamic Financial Infrastructure Development

In order for SMEs and other similar borrowers to have easy and smooth access to Islamic financing, IDB member countries required to develop an adequate Islamic financial infrastructure. There are many factors influencing the development of Islamic financial sector. Among these factors are efficient supervision, regulations, well trained Islamic banking professionals and shari'ah supervisors and shari'ah audits expertise. The previous evidence[7] showed that impact of financial infrastructure on trade is not less than the trade barriers. Islamic finance cannot play vital role to promote the growth of the SMEs or even the prosperity of the larger Islamic corporations without favorable macroeconomic environment and better development of Islamic financial institutions.

Moreover, the affordability of Islamic financial instruments which to be discussed in the next section to the trade in general and SMEs in particular highly depends on the level of Islamic trade infrastructure. In order for Islamic trade financing to be effective and to have significant impact on the growth of the SMEs sector, IDB member countries need to provide enabling macroeconomic environment for Islamic trade financing by developing sound financial policies, good governance, and strong Islamic banking system.

Islamic trade finance access will be determined but not limited to the current trade performance of trade in IDB member countries, foreign resources, the degree of the indebtedness of these countries to the external parties, exchange rate policies and their legal environment. The current business performance of the IDB member countries is very essential for the development of Islamic trade infrastructure. The business performance might be determined by the level regulations such as labor wages, fiscal policies, inflation and uncertainty. There are a need for these countries to adopt very effective and inclusive Islamic legal framework which incorporate the accounting standards, corporate governance and bankruptcy law. IDB member countries have to develop Islamic legal and regulatory system to encourage promoting Shari'ah based trade financing system. The reality is that the majority of the IDB member countries either adopting conventional laws or mixed laws. The MCPS study for Turkey showed that the trade related regulatory factors such as the absence of specific accounting standards and the non-existence of the collaterals with the banking systems weakened the trade financing infrastructure and have negatively influenced the financial infrastructure, raise the risk of lending and prevent the SMEs from accessing finance in Turkey[8].

The availability of foreign resources in form of FDI and grants would improve the level of domestic business, help in technology transfer, accessing large market and hence positively influence Islamic trade finance and improve the country competitiveness. The previous study found that most of the IDB member members are not strong in attracting enough FDI[9]. Dabour, (2000) recommended that policy decision must be taken to give more incentive to attract FDI to IDB member countries. Therefore, IDB member countries need to exert more efforts and implement reasonable measures to attract more external financial resources to improve Islamic trade financing infrastructures that lead to economic growth. The external debt also has negative impact on Islamic trade financing and has drained the local finance from most of the IDB member countries. The evidence has proved that the external debt represents one of the bigger challenges to the member countries. Hamour (2000) showed that large group of OIC countries faced serious problems with their debts as well as shortage foreign currency. The shortage of foreign currency deteriorates the value of the domestic currency and constrains the country's ability to import goods and services. Thus the severe external debts and shortage of liquidity in the poorest IDB member countries might indirectly constrain the development of trade finance and brought unfavorable business environment for the SMEs' growth. Furthermore trade financing will be influenced by the exchange rate policies. IDB member countries have to develop appropriate exchange rate policy for better Islamic trade financing climate. Overvalued exchange rate lead to a reduction in exporters competitiveness and hence their ability in accessing the foreign markets.

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[7] United Nations, International trade center (2005), Trade Finance Infrastructure Development Handbook

[8] http://www.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IDB/CM/Publications/Parnership_Strategies/Turkey

[9] IDB Annual Report 1425H, Economic Cooperation Among Member Countries, Chapter two.

In addition to the above IDB member countries also need to establish Islamic trade related intuitions to support Islamic trade financing in general and SMEs in particular. Many IDB member countries used to keep almost all the ownership of the trade related financial institutions if any such as export credit insurance and export- import banks in the hands of the governments. Moreover, some governments may use these trade-related institutions to regulate the trading sector and hence create additional hinders for Islamic trade financing to play appropriate role to promote SMEs.

The trade related institutions may also include central banks, ministries of finance and ministries of trade. The central banks promote Islamic trade finance through the tools of Islamic financing supervision and regulations that have been developed by the ISFB as well as through the regulations of the foreign currencies. Ministries of finance on other hand might play an essential role in Islamic trade development through providing tax incentives to encourage particular trade sector such as SMEs. Other similar trade related institutions which is likely influence the development of trade finance are the ministries of trade which are responsible for regulating and implementation of country's trade policies.

Based on the above argument one can say the development of strong Islamic trade financial infrastructure including Islamic trade-related financial institutions are very essential for the growth of the SMEs. . The current evidence showed the developed Islamic banking accounting standards, regulatory and suppressions standards, shari'ah audit and Islamic corporate governance's standards are need to be compulsory implemented by all the IDB member countries central banks and another trade related financial instruments need to be designed to promote SMEs and microfinance institutions . Hence, to achieve better Islamic trade financing infrastructure development, IDB member countries need to develop highly efficient and effective trade related institutions and strictly implement the ready developed Islamic financial supervision and regulatory standards. Finally the availability of highly qualified staff in these Islamic trade-related financial institutions, adequate skills workers and entrepreneurs might also represent one of the major factors influence Islamic financing infrastructure.

The Recent Trend of Islamic Trade Finance

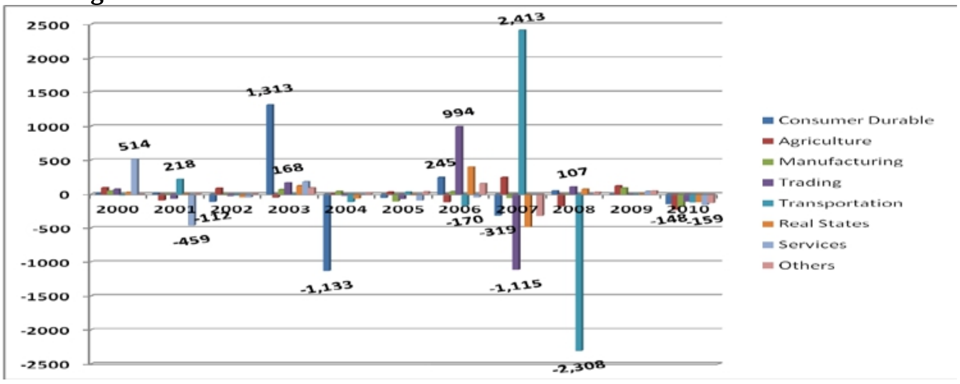
Islamic trade finance is a form of financing granted by banking based on Islamic legal concepts. It complies with the principles of Islamic Shariah law and promotes risk and profit sharing which replace fixed predetermined return. Almost all the available Islamic banks to some extend grant Islamic finance to corporate and SMEs trade activities. Due to the recent growing trend of Islamic banks in IDB member countries, more Islamic financing has been granted to different sectors. These sectors include consumer durable, agriculture, manufacturing, trading, transportation, real states, services and others. All these financed sectors it serve very vital areas for the Islamic trade finance either directly through financing the trading activities or indirectly through financing trade infrastructure development such as transportation and services sectors.

Despite the evidence attributed that Islamic were less affected by the recent crisis than the conventional counterpart in general, the financial crisis has great impact on the Islamic trading financing[10]. This shoed by analyzing the recent trend for Islamic trade financing for the period from 2000 – 2010 in all the three regions (Asia, Middle East and Africa) of the IDB member countries. It Islamic trade finance is the most affected among others sectors either during or posts the financial crisis dependence on the characteristics of each region.

Figure 1 showed that the Islamic trade finance grew negatively by more than 1000% during the financial crisis 2007 and is slowly recovered during the post financial crisis in 2008. This can be attributed to the closer linkage of the financial institutions in Asia to the Western financial institutions in many activities such export and import business other global financing.

[10] Global Economic Crisis: Islamic Banks: More Resilient to Crisis? IMF Survey Magazine: IMF Research, http://www.imf.org/external/pubs/ft/survey/so/2010/res100410a.htm

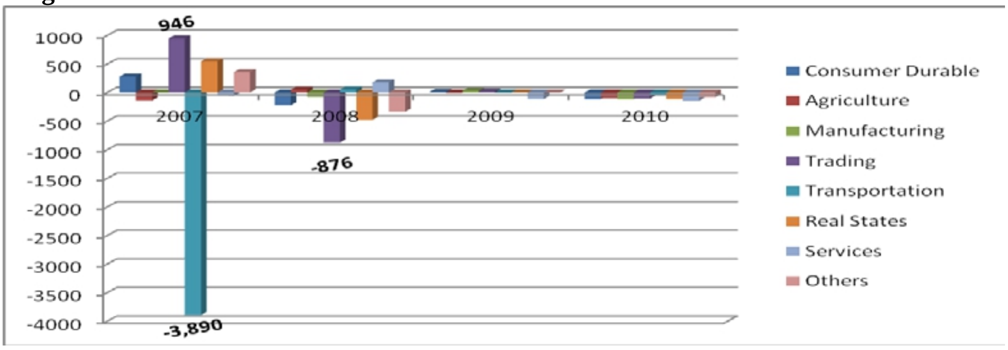
Figure 1: The Recent Trend of Islamic Trade Finance in Asia 2000- 2010



Sources: IBIS/IRTI

The global financial crisis also negatively impacted the Islamic trade financing in the Middle East region as shown in Figure 2. The Islamic trade finance dropped by more than 800% in the year 2008. The sharp declining in the Islamic trade financing in this region might attributed the post – financial crisis effect. This means that although Islamic banks resilience during the crisis but it has been impacted by the consequences of the crisis as shown by the trends. Likewise the consumer durable, manufacturing and the Real States are also negatively impacted.

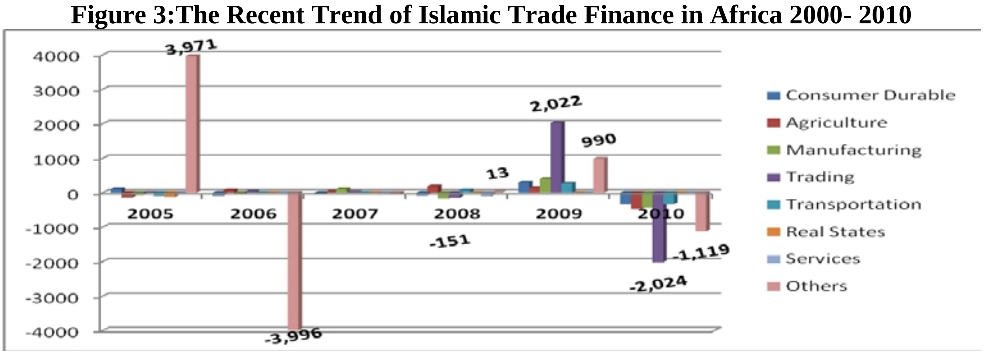
Figure 2:The Recent Trend of Islamic Trade Finance in Meddle East 2000- 2010



Sources: IBIS/IRTI

Figure 3 showed the trend of Islamic trade finance in Africa for the period 2000-210. As has been found in Middle East region, Islamic trade financing in Africa is negatively impacted during the post – financial crisis but less than that exist in the two others IDB regions. Islamic banks grant lower Islamic trade financing compare to the Asia and the Middle East regions during the recent financial crisis. This might be due to their lower scale and other challenges associate with their government polices and lower quality of trade infrastructures.

Figure 3:The Recent Trend of Islamic Trade Finance in Africa 2000- 2010



Sources: IBIS/IRTI

Challenges facing SMEs in IDBMCS

As has been discussed in the above argument the role of small and medium-size enterprises has become increasing essential for the IDB member countries prosperities. The World Bank recent study has shown that SMEs become strategic tool for solving more challenges for the governments such as the competitiveness, unemployment, and raising the national income (Rocha R., *et al* 2011).

Despite of these positive roles, SMEs nowadays are facing more internal and external challenges. These challenges might not limit to the IDB/MCs and different from country to country, region to region and from firm to firm depending on the diversity of the environment in which SMEs exist. The most common challenges face the SMEs worldwide are those associated with the recent global financial crisis. The recent financial crisis has constrained the SMEs due to the shortage and high cost of funding. The lack of financial funding due to the lack of the liquidity during and post the financial crisis has prevented the SMEs from investing in assets for growth, innovation and research and development, which slowed its growth.

Another the most important challenges faced the development of SMEs in IDB MCs are the infrastructure development. As previous discussed the infrastructure represent the most critical element for economic growth and hence for trade finance in some IDB member counties.. The rail network the most cost-effective in-land transportation carries only 4% of the entire total cargo and the road transportation is not good as the railway. The high costs of transportation and energy lead to lower energy consumption particularly in the production, which also raise its cost and reduce the country's competitiveness. The improvement of the weak warehouse is a priority requirement for Islamic trade finance. Unlike the conventional the efficient Islamic trade finance cannot be effective without some type of infrastructure such as the warehousing. That is because many Islamic financing modes such as Salam, Muzar'ah, Murabahah, Mudarabah, etc. depend on financing the product in kind and not the same as the debt financing that exist in the conventional banking system.

The regulations and the effective implementation of trade rules are the third challenge facing Islamic trade finance for IDBG member countries. Trade rules and regulations are called trade facilitation which means the systematic rationalization of procedures and documentations for trade that minimize the transaction cost while maintaining an effective level of government control[11]. The existence and efficient implementation of Islamic rules and regulations that associated with Islamic trade finance in general and SMEs in particular represent a big constraint for the IDBMCs. Fliess & Busquets C. (2006), found that the procedural barriers to trade such as arbitrary customs valuation, subjective interpretations, and arbitrary decisions of clearance goods through customs, technical barriers, laws and regulations regarding the various rules of trade represent one of the most obstacles for the development of SMEs in IDBMCs. Without more support and protection SMEs might exit the market under trade barriers let alone making profit. OKER (2002) showed that OIC member countries particularly those in Africa with vast land boarders are lacking trade infrastructure and resources and accordingly they depend on high custom duties in their economic policies and developed extensive informal economic sectors. Therefore, to promote effective development of SMEs which proved to be very vital for the county's economic growth, IDB/MCs need to replace trade facilitation with the traditional trade control policies. Trade facilitation might help in eliminating trade barriers, bureaucratic and regulations that involve hindrances to trade and eventually constrain the development of SMEs.

Conclusion

This study investigated the challenges facing Islamic finance to promote the growth of SMEs in IDB member countries. SMEs represent one of the important drivers of the economic growth and an essential labor intensive sector that might help in reducing the high unemployment in most of IDB member countries. The results of the research indicated that Islamic finance facing more challenges in order to play vital role in IDB member countries. The weakness in the trade infrastructure development, trade facilitation and the unreasonable Islamic finance infrastructure have created unfavorable environment for the SMEs to grow and prosper. Accordingly SMEs in the IDB/MCs become less competitive due to the high financing cost, traditional trade policies, high tariff and tax, compared to international standard. While SMEs can be one of the best partners in the economic growth, provide more jobs and raise the standard of living in the member countries, both governments and IDB as a multilateral bank, need to exert more efforts to provide sustainable and enabling environment for Islamic finance to give effective support to SMEs.

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