Financing Ukraine's Critical Small and Medium-Sized Enterprises

The Role of IFIs and DFIs

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Importance of SMEs in the Ukrainian Economy

Small and medium-sized enterprises (SMEs) form the backbone of the Ukrainian economy. SMEs are widespread across sectors in Ukraine, including agriculture, machinery, construction, and technology, and will play a vital role in reconstruction efforts.

Before the Russian full-scale invasion in February 2022, Ukraine’s economy had been on an upward trajectory, and despite a dip due to Covid-19, trends remained positive. The gross domestic product (GDP) growth rate improved from −9.8 percent in 2015 to +3.4 percent in 2021. SMEs played a significant part in this growth as they constitute 99.97 percent of total registered businesses in Ukraine. These small businesses employed almost 82 percent of the Ukrainian workforce, or 7.4 million people, and generated 65 percent of total sales in goods, works, and services in the country.

The invasion in 2022, however, prompted a sharp decline in economic activity, with GDP falling as much as 30 percent. Small businesses suffered immensely: a survey by the European Bank for Reconstruction and Development (EBRD) showed that the average SME earned 43 percent less and employed 22 percent fewer people between February and December 2022.

Almost a year after the invasion, business has now started to stabilize. SMEs continue to show resilience despite facing severe challenges. Only 6 percent of the SMEs surveyed by the EBRD have suspended all activity, while 57 percent have managed to maintain activity at prewar levels. To do so, these businesses have started to use short-term forecasting on a month-to-month basis to help them...
adapt and reallocate resources quickly in response to uncertainty. Their strategies include expanding into new markets, relocating to safer areas (including other countries), diversifying business activities, and finding new funding sources such as grants to continue operations.

**Challenges SMEs Face**

As work toward reconstruction begins, it is vital that Ukraine not only rebuild the economy and recover from losses due to war but also seize the opportunity to modernize the SME sector with an eye toward integration into the European economy. Many SMEs face high debt burdens, increased operational costs, and a worsened liquidity crunch. Uncertainty due to the war has “led to investors remaining cautious and banks focusing funds on more conservative, established relationships” with larger companies. SMEs often struggle to demonstrate creditworthiness and provide the collateral required by traditional banking systems, significantly hurting their access to external financing. One analysis by the UN International Organization for Migration (IOM) mission in Ukraine highlights the lack of available financial resources as one of the top three issues micro, small, and medium-sized enterprises (MSMEs) face.

Yet 46 percent of small businesses in Ukraine have “never used external financing,” and many remain “uninformed about alternative financing support programs,” relying on self-financing instead. Even in the prewar era, private equity investments in SMEs remained low, accounting for only 0.025 percent of GDP in 2019. This is in large part because SMEs face more challenges in accessing funds compared to larger enterprises, such as lack of information and uncertainty regarding the complicated procedures for acquiring financing. As a result, SMEs in Ukraine have an unmet financial gap of $29 billion per year and 87 percent are in need of funding.

External financing and information about it will play a critical role in finding a comprehensive and sustainable solution to these challenges. External financing can provide capital, expertise, and market opportunities that may not be readily available domestically. It can help SMEs rebuild their operations, invest in infrastructure, and seize growth opportunities.

Various mechanisms can be used to give small enterprises access to more funds and global financing markets. Tools such as credit lines, risk insurance, and guarantees from international banks can help drive private investment and increase SMEs’ funding, as well as improve their access to information by employing uniform rules.

Capacity-building initiatives will be essential to ensure a level playing field for SMEs. Liquidity-risk mitigation through trade finance can allow small businesses to meet immediate financial obligations and provide the necessary resources to seize market opportunities and adapt to changing market conditions. Without sufficient liquidity, SMEs will struggle to access necessary working capital. Creating an enabling environment will also be essential; this will involve deregulation, rebuilding infrastructure, ensuring efficient logistics chains, and developing social infrastructure to support SMEs.

Many MSMEs continue to operate after having relocated within and outside Ukraine. These businesses face a unique set of challenges, from loss of production capacity because of fewer personnel and resources to lack of funds for renting and installing new equipment.

Reconstruction efforts need to go beyond aid. The SME sector will be at the heart of Ukraine’s economic transformation and modernization, and private capital will be vital for these businesses to continue to
play a significant role in employment generation. They will be essential in reconstruction efforts, capacity and skill building for refugees, and the reintegration of displaced people and demilitarized personnel.

**The Role of IFIs and DFIs in Supporting Ukraine’s SMEs**

**WHAT TOOLS DO SMES NEED?**
Development finance institutions (DFIs) and international financial institutions (IFIs) can be pivotal in supporting Ukrainian SMEs through various support programs, including grants, equity, loans, and guarantees.

Guarantees will be fundamental, as they can help encourage new participants to enter the Ukrainian market. Currently, most SMEs only focus on managing cash flow rather than bringing in new investment. By providing loan guarantees, financial institutions can assume some responsibility for an SME’s debt in case of default, thus reducing the risk for lenders and enabling SMEs to access more significant loan amounts, negotiate better terms, and enhance their creditworthiness.

Other key tools include blended financing and impact investment. By combining different types of capital and leveraging donor support, blended financing can reduce risks, lower interest rates, and enhance SMEs’ overall financial viability. Moreover, through impact investment, which involves deploying capital to generate measurable social impact, investors can mobilize private capital toward SMEs that create both financial value and positive social change, ultimately helping SMEs secure funding while having a positive effect. Many in the large and growing impact-investment community will be interested in opportunities that contribute to Ukraine’s overall economic reconstruction and address the war’s effect on access to basic human needs such as healthcare, housing, and water. Attracting private investors and mobilizing additional private capital with donor support will be imperative to drive SME development in Ukraine.

Tailoring financing solutions to the diverse nature of SMEs will also be necessary. It is essential to recognize SMEs’ varying needs, sectors, and characteristics and customize financing approaches accordingly. For instance, companies producing for the broader European market may require specific capital tools to support their export-oriented activities. Meanwhile, SMEs involved in agricultural processes may have distinct financing requirements related to their supply chain, equipment, and market access. Understanding these differences will enable the provision of targeted financial solutions that address the specific needs of each segment.

In the current environment, it is paramount to provide capital tools that are aligned with capacity building, technical systems, and network integration. SMEs often require funding and support to enhance their operational capabilities, adopt advanced technologies, and build strategic business relationships. By ensuring financing addresses these critical factors, investors significantly improve the chances of successful outcomes.

It will likewise be important to identify opportunities that both show potential for growth and support reconstruction; for example, improvements in the information technology (IT) sphere can also help integrate Ukraine into the European market and solve cross-border logistics challenges. By understanding the IT sector’s unique requirements and growth potential, tailored financing solutions can address the specific needs of digitized SMEs.
WHAT CAN IFIS AND DFIS DO TO ENABLE ACCESS TO FINANCE?

SMEs are widespread and play a significant role in all sectors of the Ukrainian economy. The need for investment in reconstruction will also be immense. Therefore, most sectors—including agriculture, digital services, infrastructure, energy, construction, healthcare, and housing—require immediate financing. Each can benefit from different types of support programs. Given the immense needs and far-reaching impact of the SME sector, IFIs’ main priority should be to coordinate and deconflict the critical support they can provide.

IFIs and DFIs can take several steps to facilitate SMEs’ access to financial support programs. First, it is essential to simplify the rules and procedures for issuing support mechanisms such as grants, loans, and guarantees. One of the significant challenges SMEs face is navigating complicated procedures to access funds that DFIs disburse through banks. By harmonizing procedures, sharing due-diligence information, and standardizing applications, DFIs can streamline the process, making it easier for SMEs to navigate financial support.

Second, transparent and accessible information on available financial support programs will be crucial. Many MSMEs do not know about the various opportunities financing institutions offer. Establishing centralized sources of information, such as through the European Banking Authority (EBA), can help small businesses access comprehensive and updated information on financial support programs.

Finally, engaging non-bank financial institutions as intermediaries can also facilitate SME access to finance. These institutions can navigate the complexities of the banking system on their behalf and offer tailored solutions for different SME segments.

CURRENT EFFORTS TO SUPPORT UKRAINE’S SMES

Work is already underway to support SME financing in Ukraine. The EBRD has programs that provide capital to banks to help SMEs and has expanded its support across sectors. In total, the EBRD has committed €3 billion funds in 2022-2023 and has already invested €1.7 billion in Ukraine in 2022, including support for SMEs, and has mobilized an additional €200 million through partner banks. Efforts are underway to include start-ups and SMEs in procurement processes. In addition, the EBRD is carrying out programs to provide support, flexibility, and opportunities for women and youth, both within Ukraine and for refugees.

Additionally, the U.S. International Development Finance Corporation (DFC) is offering loan portfolio guarantees to banks to support SMEs in Ukraine, including a $15 million guarantee to Bank L'viv. In April 2023, the DFC also signed a memorandum of understanding with the Ukrainian Ministry of Economy to provide war risk insurance and identify and develop private sector projects that will attract investment.

Conclusion

SMEs are vital to the Ukrainian economy and will play a key role in reconstruction efforts following the war. Despite facing high debt burdens, increased operational costs, and limited access to traditional financing, SMEs have shown resilience and continue to operate. DFIs and IFIs can support SMEs by simplifying applications for financial support mechanisms, connecting such mechanisms to capacity building and technical support, providing clear information on available programs, engaging non-bank financial institutions as intermediaries, and tailoring financing solutions to the diverse needs of
SMEs. Mobilizing private capital through blended financing and impact investment approaches can further enhance SMEs’ operations. By addressing challenges, enabling access to finance, and fostering an enabling environment, DFIs and IFIs can contribute to the recovery, growth, and integration of Ukrainian SMEs into the European market, ultimately driving the country’s economic transformation and modernization.

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The aim of the bipartisan and international CSIS Ukraine Economic Reconstruction Commission is to produce a policy framework that will help attract private sector investments to support Ukraine’s future economic reconstruction. To support the commission, CSIS will convene a series of working groups to examine a range of issue-specific areas that are critical for reconstructing and modernization of the Ukrainian economy, including in agriculture, energy, and transportation and logistics, as well as addressing the impact of corruption on private sector investment.

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