Chapter 2
Role of SME Sector

2.0 Introduction

2.1 In India, SME sector has remained high on the agenda of the Government since independence. The special thrust to this sector has been consistent with multiple objectives of employment generation, regional dispersal of industries and as a seedbed for entrepreneurship. The contribution SMEs has been remarkable in the industrial development of the country. It has a share of over 40 per cent of the gross industrial value added in the economy. About 50 per cent of the total manufactured exports of the country are directly accounted for by the sector. In terms of employment generated, this sector is next only to agriculture sector, employing approximately 283 lakh people. Today, the number of SSI units is estimated to be over 118 lakh in India. Being generally low capital intensive, these suit the Indian economic environment with scarce financial resources and large population base. In addition, it is highly labour intensive and has a scope for building upon the traditional skills and knowledge. Finally, the sector produces a wide range of products, from simple consumer goods to highly precision and sophisticated end products. Some important indicators included in Table 1 provide an idea about the precise role played by the sector in India’s economic development.
<table>
<thead>
<tr>
<th>Year</th>
<th>Units (No. lakh)</th>
<th>Production in (Rs. Crore)</th>
<th>Employment (No. lakh)</th>
<th>Prod. per employee (Rs.000) at 1993-94 prices (2002-03)</th>
<th>SSI Exports</th>
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<td>At 1993-94 prices</td>
<td>At current prices</td>
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<td>2004-05P</td>
<td>118.53</td>
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<td>418263</td>
<td>282.82</td>
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P: Provisional
 -: Based on the Growth rate of 7.44 per cent, which is the average growth of last year.

Note: Data have been revised since 1990-91 on the basis of the findings of the Third All-India Census of SSI units.

Source: Report of Ministry of Small Scale Industries, Government of India, for different years.

2.2 Promotion and Development of SME Sector : Non-credit Inputs

2.2.1 The Government of India has been consciously developing policies and created a large public sector infrastructure to support the development of SMEs. The important elements of promotion policies comprise features such as reservation of the items to be produced, preferential purchase of products, tax exemptions, provision of credit guarantee, subsidized support schemes, credit under priority sector lending from the banking system and a large network of public sector business and technical service providers. During the peak of protection granted to the SSI sector in the mid-1980s, about 900 products were reserved exclusively for SSI production. Protection policies have been essentially designed for small enterprises, whose products were targeted for the domestic market, while exporting and trading units have been exposed to competition. Support for the sector, provided mainly through a large network of public
sector agencies, is for entrepreneurship development, training, marketing, export, technology transfer and consultancy. Nodal implementing authorities have been continuously modulating the policy framework relating to SMEs in tune with the developments in the sector. Besides providing credit facilities through the banking system and the term lending institutions, a variety of support measures and schemes have been conceived and made operational by the concerned authorities. It would be an interesting exercise to make a review of non-credit inputs provided by development agencies promoted by the govt. and the RBI. These non-credit inputs are related to 1) Infrastructure facilities 2) Quality of human resources and skill formation 3) Entrepreneurship development and managerial competency 4) Supply of raw materials 5) Technology up gradation 6) Marketing 7) Other facilities created during globalization and economic reform process. Details of the same are as under:

i) **Infrastructure Facilities**

Availability of adequate infrastructure facilities i.e. power, road connectivity, transport facilities, energy, water, ports and airports are important to the robust performance of the small-scale sector. Poor quality of power and interruptions in the power supply often damage the plant and machinery/equipment of the units. In order, therefore, to cater to various infrastructure requirements of the SSI sector, the Government has established State Industrial and Infrastructure Development Corporations (SIIDCs), Small Industries Development Corporations (SIDCs) and Housing and Urban Development Corporation (HUDCO). These state level organizations are catering to the infrastructure requirements in select areas of their respective states. However, the penetration of these organizations appears to be inadequate in terms of geographical coverage and number of units as the benefits of the infrastructure provided by these institutions is by
and large accruing to the small units in the organized sector (registered units), which are only a fraction of the total number of small units. Therefore, there appears to be a need for an extended coverage of the operations of these institutions to ensure that the small units in unorganized sector too secure the necessary basic infrastructure facilities for their operations. This calls for a change in the existing policy guidelines of these organizations. In addition, they are expected to show their concern for the development of unorganized units which are in a large number. State Electricity Boards need to take a fresh look at their approach to the supply of power to the small sector, in terms of providing uninterrupted and quality power. This is specially evident in those states which have a larger share in total SSI units in the country. In particular the units in backward states are severely hit by non-availability of power supply. Consequently the rate of mortality of these units is high in such states. Facilitating public-private partnerships, attracting Foreign Direct Investment (FDI) into basic infrastructure as well as for establishment of industrial parks for small sector are the options already under consideration by relevant authorities. These need to be expedited. One solution to the infrastructure problem lies in increased emphasis on cluster development, which will factor into account the development of required infrastructure facilities in an organized manner for the cluster as a whole. Therefore, there is a need to strengthening of the National Cluster Development Programme and setting up of functional industrial parks. This has been the major focus of the govt. policies to promote a large no. of units by adopting the cluster approach.

ii) Quality of human resources and skill formation

Improvements to skill formation and learning mechanisms in small sector have a substantial impact on productivity and value addition. In the context of facing both domestic and external
competition, the quality of workforce is an important factor in the productivity of small sector. There is a conspicuous shortage of qualified workforce in the Indian SSI sector, which has to cater to the sub-contracting work of large technology-oriented corporations in the new economic environment. The responsibility of skill up-gradation and providing training to the labour force in small sector is vested with a network of institutions like Small Industries Development Organization (SIDO), Small Industries Service Institutes (SISIs), Technical Consultancy Organizations (TCOs), Process & Product Development Centres (PPDCs), District Industries Centres (DICs), Regional Testing Centres (RTC}s), Central Footwear Training Institutes (CFTIs) and Tool Rooms. These Institutes are expected to provide training to labour force in better and improved technologies at a nominal fee. The coverage of the training provided by these institutions is mainly to the city-based and registered units. Here also, if a cluster-based approach is adopted to impart training, the outcome would be more productive. These Institutes have to monitor both registered and unregistered units functioning under their jurisdiction, make a continuous evaluation of their training and skill requirements and accordingly, evolve programmes. In addition, banks also have been conducting training programmes to impart knowledge and skill for financing of SSI units.

The surveys conducted by Reserve Bank revealed that majority of the banks are arranging sensitization programme for their branch level officials.

iii) Entrepreneurship development and managerial competency
Establishment of a small unit in India continues to be on the basis of an already existing family venture or a venture similar to the existing family unit, rather than experimenting with a novel
business idea through innovation. The majority of SME owners in India manage the enterprises themselves, with few possessing the skills to draft medium to long-term business plans. The lack of managerial and technical know-how seriously inhibits innovative start-ups and business diversification. Conceiving new business ideas, making viability studies and market research, scanning the domestic and external markets are a part of the entrepreneurship development programmes. In the changed economic environment with customer seeking diverse and efficient products, the various training institutions need to redefine their roles in entrepreneurship development and provide a dynamic focus to their programmes. Strengthening National Entrepreneurship Development Board, devising comprehensive plan for promotion of rural entrepreneurship fostering close linkages with premier institutions engaged in management and entrepreneurial training and adoption of “turn-key concept” for entrepreneurship training may be considered on priority basis. During the seventies, banks started conducting Entrepreneurs Development Programme (EDP) for the first generation entrepreneurs. Of late, they have stopped organising the same. In the process, there is no attempt to train the second generation entrepreneurs who have received the charge from the first generation entrepreneurs. In addition, the training of entrepreneurs should be done from time to time to expose them to new areas of entrepreneurship development.

iv) Supply of raw materials

The problem of obtaining steady supply of raw materials of desirable quality at reasonable prices is one issue cited by the small units. In order to obtain these inputs, SMEs have to compete with export markets, as well as with larger firms. Moreover, tariffs imposed on high quality imported inputs, as
as lengthy import procedures place the Indian small units in a less competitive position. The Planning Commission had quoted in the Ninth Plan document that in actual practice, the small sector tends to get more or less a ‘residuary’ treatment in raw material distribution. The problem of raw material availability has been among the important factors responsible for under-utilization of the capacities in the small industries sector. In recent times, the prices of various inputs like steel, cooking coal and oil are on increase and unless price stabilization mechanism is conceived, the small units may not be able to cope with the volatile prices of critical inputs. In order to overcome the difficulties with respect to availability of various raw materials, earlier the Industrial Policy Statement had envisaged introduction of a scheme for building up of a buffer stock of essential and scarce raw materials. It was envisaged that the existing set-up of National Small Industries Corporation at the Centre and the Small Industries Development Corporations at the State level would be utilized to facilitate raw materials supply. These Corporations would have to make a precise assessment of the present and future needs of raw materials of small-scale units on some realistic norms, and arrange for distribution particularly at the places of concentration of units. Though these measures were prescribed long ago, the small units continue to complain about inadequate supply of raw materials. Probably, the schemes in operation in this regard need to be reviewed. Efforts need to be strengthened to assist SME units to develop their own web site so that their supply requirements, suppliers list, etc., shall be made available. This would facilitate them to obtain raw material at competitive price and on timely basis.
iv) **Technology upgradation**

Majority of the small units continue to use traditional methods of production and old technology. Given their poor access to equipment, the Indian small units lack quality control and product standardization. This leads to a situation, where the small sector products are less competitive in the national and international markets. The task of technology upgradation of small sector has been entrusted to National Small Industries Corporation (NSIC), Small Industries Development Organization (SIDO), Small Industries Service Institutes (SISIs), Regional Testing Centres (RTCs), and various Process & Product Development Centres (PPDCs). The development of suitable tools and prototypes is being undertaken by Prototype Development Centres. The Sericulture Research Institutes and stations attempt improvement in practices in mulberry cultivation and silkworm rearing. Besides, a host of other organizations like the Council for Scientific and Industrial Research, Indian Council of agriculture Research, Institutes of handloom Technology, etc., are also involved in small sector research activities. However, effective translation of these research and development efforts is still to be achieved and consequently, the impact remains insignificant. Efforts would, therefore, need to be made to identify a focal point to coordinate the research and development activities of various research organizations and boards engaged in the field of small industries. Finance is also made available by Small Industries Development Bank of India (SIDBI) for technology upgradation. But there is lack of awareness on the part of units about schemes of SIDBI. Various schemes of technology upgradation should be canvassed widely.

v) **Marketing**

The marketing problems of small industries in India flow from their scale of operation, lack of standardization, inadequate
market intelligence, competition from large-scale units and insufficient holding capacity. A large number of small units continue to depend substantially on middlemen for marketing of their products. Most small units confined to markets that are within their immediate proximity. Bulk of the small units’ production is done on an order basis with a small proportion done on a continuous basis. Small units suffer from the absence of a competitive network of wholesalers and trading companies that could introduce their products into domestic and foreign market, and provide them with pertinent market information. The available marketing and distribution channels are Government owned. The available marketing and distribution channels are Government owned. The National Small Industries Corporation, the Small Industries Development Organization, the Small Industries Service Institutes and SIDCs provide market intelligence and assistance to small entrepreneurs to some extent. It is necessary to evolve a well co-ordinated approach in the direction of demand forecasting, collection and collation of market intelligence to strengthen and expand internal marketing infrastructure with a view to making it small sector producer-oriented. In the field of government purchases there is need for identifying more items for exclusive purchase from the small scale sector and developing a system for close monitoring at different levels. The policy of price preferences to the products of small-scale units would need be continued. While firm-level strategies are fundamental to development of exports by small units, there is a need to have a centralized co-ordinating body that would provide a range of services including establishment of international subcontract exchanges, conducting studies on export potential, market intelligence, exchanging of trade delegations, participating in international trade fairs, etc. Along with this, the SME units should be encouraged to develop their own web site for marketing of their products. For participation
international fares and exhibitions, financial assistance should be offered to entrepreneurs.

vi) Other facilities due to globalization and economic reform process

The small sector has been exposed to certain challenges in the wake of globalization process taking place worldwide. Competition has become increasingly fierce among the global and regional economies and enterprises, including small units. The impact of the agreements under WTO to which India is a signatory brought in certain challenges to the small-scale sector. The main outcomes of WTO-stipulated requirements will be brought about through reduction in export subsidies, greater market access, removal of non-tariff barriers and reduction in tariffs. There will also be tighter patent laws through regulation of intellectual property rights under the TRIPS Agreement which lays down what is to be patented, for what duration and on what terms. Programmes to establish and strengthen linkages between MNCs and Indian small sector units through improved technology and quality upgradation are critical in this context. Similarly, a programme for FDI-Small sector linkage needs to be considered. Such a linkage calls for a comprehensive and complex set of reviews and policy adjustments. In both developed and developing countries, there is mounting evidence that clustering and networking helps small enterprises to raise their competitiveness. Strengthening of bilateral and international co-operation for ensuring international co-operation and promoting joint ventures, sector specific development programmes with the assistance of UNIDO and UNDP would be beneficial. It is also beneficial to establish a SME trade hub with various international and multilateral organizations in the region. Besides, rating of small scale units by professional bodies is also coming into being. Credit Information Bureau of
India Limited (CIBIL) is set up to provide critical information about the SSI unit to banks and financial institutions. In this way, there are many more facilities created for development of SSI units.

2.3 Recent Developments in SME Sector – A Cross-country Perspective

2.3.1 Considering the vital role played by the SMEs in economic development, both developed and developing economies provide a host of incentives and financial and non-financial support them to ensure the smooth functioning of the sector. These facilities, incentives and special schemes broadly consist of providing financial support and promoting venture capital, offering consulting solutions, receivables financing, setting up of small business incubators, leasing finance, extending soft loans, grants, and government guarantees for entry into public tenders, setting up of special state-owned financing companies, providing interest subsidy schemes, creation of business angel networks (wealthy individuals who finance SMEs), promoting micro-finance programmes, extending tax concessions, etc.

2.3.2 The system of financing the small units differs from country to country. The North American financial systems are centered on stock markets where firms have better access to external equity financing. At the other end, the Continental Europe has a long tradition in loan financing due to the bank centered financing system. Increased competition in financial markets in developed countries, led banks and other financial institutions to launch a number of initiatives to serve financing needs of SMEs effectively. These include reducing information asymmetry of small units and high risks by using credit scoring systems (as automated statistical method to assess the risk of default of a credit applicant), reducing costs of lending by applying latest
information technologies and improving financing services for small units. New Zealand has introduced a scheme called ‘BIZ Investment Ready’ which aims at innovative businesses and entrepreneurs seeking funds to expand, diversify or commercialize a new concept. It helps businesses and entrepreneurs to develop a greater understanding of issues around funding and can provide assistance to seek and secure private investment of up to NZD 5 million. European Union has devised a scheme to facilitate the contacts between SMEs and banks and other financial institutions, by making a beginning to develop a ‘code of good practice’. Philippine has instituted a financing programme called SME Force (SME Financing for Organizationally Competent and Excellent Franchise Businesses), which is a franchise development financing facility that will be implemented with the participation of the franchisers’ organizations. Coupled with the captains of industry, this programme seeks to develop backward and forward linkages among and between leading businesses and SMEs in the domestic economy.

2.3.3 Draft report of the internal group to Review Guidelines on Credit Flow to SME sector, RBI, May 2005 shares some interesting information relating to various developments in promoting and development of SSI sector. This information relates to various aspects concerning promotion and development of the sector. Review of such information, particularly in respect of venture capital funds, loan guarantee, tax incentives and other incentives in different countries is discussed as under:

1. Venture capital funds
Various countries have promoted the venture capital investment for meeting the financing needs of SMEs. To widen the scope of venture investments, newer agents have been allowed to take
part in venture financing. Japan has a framework for issuing bond to family and friends to mitigate financing constraints faced by micro-enterprises and start-ups. Some local governments in Japan are providing support for enterprises issuing privately placed bonds for a small number of investors. Japan also used public funds to establish three Small and Medium Business Investment Consultation Co. Ltd. in 1963 to support the SMEs. Another innovative method to encourage commercial banks to provide loans to micro-enterprises can be found in Chile. The Chilean Social Investment Fund (CSIF), created in 1993, uses a market-based subsidy to induce banks to provide micro finance. In several countries, venture capital provides an important link between innovation and finance, providing capital market access to small innovative firms. Pension funds account for the largest source of Venture Capital Funds (VCFs) in the United States. Korea enacted the Special Measures Law in 1997 for promoting Venture Businesses by liberalizing provisions for venture capital investments by institutions, including banks and pension funds. The Korean government takes a more direct approach to alleviate the perceived funding gap of the sector by extending direct funding the provision of guarantees to strengthen the domestic venture capital industry. The presence of institutional investments in venture capital markets in Israel is barely visible because of strict restrictions on local institutions’ investments in venture capital markets. Although the US venture capital market developed largely without government assistance, the government had established the Small Business Investment Company (SBIC) programme in 1958 to stimulate the development of the venture capital industry. SBICs are privately owned and managed investment firms, which have access to loan financing, called “leverage”, by issuing debentures, which are guaranteed by the US Small Business Administration.
A Loan Guarantee Programme, known as 7 A programme, was established to provide guarantees that will facilitate lending to small business which are unable to secure financing on reasonable terms through normal lending channels. The German BTU-scheme provides a number of lessons for countries interested in developing a national venture capital market. The BTU-refinancing scheme offers long term loans to investors combined with a partial default guarantee.

The pension funds in Finland have emerged as important sources of funds to SMEs. To attract prospective informal investors in venture funds, the Ministry of Economic Affairs of Netherlands, sponsors various road shows. UK has taken lead in promoting regional venture capital funds (RVCFs). There will be at least one RVCF in each of the nine English regions specializing in the provision of small-scale equity (less than GBP 500,000) on a strictly commercial basis to SME businesses with growth potential. The aim of RVCFs is to provide SMEs with growth potential, access to risk finance at the right time.

2. Loan Guarantee Scheme
Countries such as USA, France, etc. have set up ‘guarantee funds’, which are partly/fully financed by the State, in order to enable them to share part of the risk related to granting of credit by banks. In 2001, Mexico created a National Guarantee System that promotes collaboration between financial institutions and local Governments. In Canada in Small Business Loans Act (SBLA) programme was launched to fill the debt-financing gap for SMEs. The UK Small Firms Loan Guarantee Scheme (SFLG) was also devised to address a perceived market failure in SME financing by targeting viable business propositions that lack an established track record or collateral.
A unique two-tier structure of credit supplementation for SMEs exists in Japan. The Credit Guarantee Corporations (CGCs) provide financial institutions with credit guarantees on the repayment of SME loans. In return, SMEs pay guarantee fees to CGCs to secure credit guarantees. The Japan Small and Medium Enterprise Corporation (JASMEC) insures these guarantees on payment of insurance premiums by CGCs.

3. Tax Incentives
Traditionally, a number of countries have granted direct tax incentives to promote venture capital. Canada has one of the most generous venture capital tax incentives, where investments in venture capital funds receive tax credits and qualify for tax deductions under the Registered Retirement Savings Plan (RRSP) rules. The United Kingdom provides tax relief to individuals or business angels who invest in ordinary shares of qualifying companies through the Enterprise Investment Scheme (EIS). The Venture Capital Trust (VCT) scheme in the United Kingdom also offers tax incentives to individuals investing in pooled investment funds, known as VCTs, which invest in unquoted companies. The capital gains tax concessions in the venture capital industry has also been recognized as an important policy incentive. Chinese Taipei’s 1983 legislation allowed up to 20 per cent tax deduction for individuals investing in qualified VCFs. This was also extended to corporate investors in 1991. It has been recognized that these tax incentives have had a positive impact on the growth of venture capital industry in Chinese Taipei. Israel’s recent tax incentives exempt foreign investors from capital gains tax on investments in local VCFs and in high technology startups.
4. Other Incentives
Many Organisation for Economic Co-operation and Development (OECD) countries have introduced special SME provisions in export credit systems to encourage small exporters. These include information programmes, simplified application procedures, special export insurance and guarantees.

2.4 Bank Credit to SMEs
2.4.1 During the past, bank credit to SSI sector has gone up by almost 100 per cent i.e. from Rs. 29485 crores in 1995-96 to Rs. 65355 crores in 2003-04, showing an annual growth of 10.7 per cent. This credit went up further from Rs. 76114 crore in 2004-05 to Rs. 90239 crore in 2005-06, showing a growth rate of 18.55%. But this credit supply is found to be inadequate in terms of the minimum of bank finance of 20% of the production value, as suggested by the Reserve bank of India. In 2004-05, it is just 18.19% (Table 2). This has given a rise for borrowing from the money lenders by the SMEs.

### Table 2
Bank Credit to SSI

<table>
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<tr>
<th>March end</th>
<th>Credit to SSI (Rs. in Crores)</th>
<th>Growth Rate (%)</th>
<th>Production (Rs. in Crores)</th>
<th>Growth Rate (%)</th>
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<td>2006</td>
<td>90239</td>
<td>(18.55)</td>
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2.4.2 Further, as per the third Census of SSI, only 4.55% of the units (438404) had outstanding loans as on March 31, 2002 with institutional sources. Consequently, they are forced to rely on retained earnings and financial support from family and friends to launch or expand their business. This calls for special efforts to bring in the units under the ambit of credit institutions. Further, the Tenth Five Year Plan has targeted a high GDP of 8% p.a. and growth 12% p.a. for the SSI sector. This target of 12% is in line with the past achievements of the SSI sector and its potential to grow fast in the coming years. In particular, with the economic liberalisation and financial sector reforms in India, there are numerous opportunities for SSI units to expand and diversify their business. Further, in WTO environment, efficient SSI units shall make a major break through in their business operations. India signed Uruguay Round Agreements and became a member of WTO in 1995. Thus, SSI sector has a bright future. To materialize this dream, credit support should be liberally extended.

2.5 Conclusion

2.5.1 The SME sector enjoys a pivotal role in Indian economy due to its impressive achievements in terms of value of production, employment, exports, removal of regional disparities, etc. Hence, it deserves support from the Government and the RBI. Further, much needs to be done in strengthening credit flow to the SSI sector. In the next chapter, it is attempted to assess credit flow to the sector over the years and identify issues associated with credit flow.
References

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