

The Widening Financing Gap and Micro, Small and Medium Enterprises in India

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Abstract

Micro, Small and Medium Enterprises are widely spread throughout the globe and constitute approximately 90% of the total enterprises in most of the countries. They are responsible for generating a major share of employment. They contribute significantly in industrial production and exports. In India too, the role of MSMEs is crucial in the overall industrial growth. In the last few years, the MSME sector has reflected a higher growth compared to the overall industrial sector. Most of the current multi-million dollar enterprises have their origin in MSMEs. Nevertheless, MSMEs in developed and developing countries are still facing a number of difficulties and obstacles that are impeding and complicating their operations and growth. Access to external finance to MSMEs has become more costly and troublesome while their accessibility has sharply declined. MSMEs' financing constraints limit their investment opportunities and stagnant growth. Access to finance is widely perceived to be an essential factor for firms, and especially MSMEs, to maintain their daily business operation as

well as to achieve long-term investment opportunities and development targets. The manner in which the financial institutions and banks operate in the developing countries is biased when compare MSMEs with large enterprises. MSMEs find it relatively harder to get access to finance from these financial institutions. Banks generally show lack of interest when it comes to getting involved with MSMEs. Timely access to finance is one of the most important factors which determine the competitiveness of MSMEs. The present paper attempts to identify various factors that are responsible for widening of the financing gap in the MSME sector. The researcher tries to highlight the various factors that contribute significantly in Credit Rationing for MSMEs. This paper is based on extensive review of literature on Micro, Small and Medium Enterprises. The review showed that MSMEs are much more credit constrained as compared to the large enterprises and the financing gap is widening.

Keywords: MSME, Constraints, Financing Gap, Credit Rationing, Debt Demand

INTRODUCTION

Micro, Small and Medium Enterprises are widely spread throughout the globe and constitute approximately 90% of the total enterprises in most of the countries. They

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crucial in the overall industrial growth. In the last few years, the MSME sector has reflected a higher growth compared to the overall industrial sector. One of the significant characteristics of a flourishing and growing economy is a vibrant and blooming MSME sector. MSMEs play a pivotal role in the development of a nation. They contribute to socioeconomic development in various ways; namely, by creating employment for a rural and urban growing labour force and providing desirable sustainability and innovation in the economy as a whole. Most of the current multi-million dollar enterprises have their origin in MSMEs. Nevertheless, MSMEs in developed and developing countries are still facing a number of difficulties and obstacles that are impeding and complicating their operations and growth.

In the last few years, the MSME sector has reflected a higher growth compared to the overall industrial sector. With its quick responsiveness, adaptability and innovative approaches in the recent years, this sector has shown a commendable endurance to survive the effects of recession. In India too, the role of MSMEs is crucial in the overall industrial growth. With its quick responsiveness, adaptability and innovative approaches in the recent years, this sector has shown a commendable endurance to survive the effects of recession. The conventional wisdom argues that the inadequate financing of MSMEs is to a significant extent rooted in supply-side features. The manner in which the financial institutions and banks operate in the developing countries is biased when compare MSMEs with large enterprises.

MSMEs find it relatively harder to get access to finance from these financial institutions. Banks generally show lack of interest when it comes to getting involved with MSMEs. Timely access to finance is one of the most important factors which determine the competitiveness of MSMEs.

Access to external finance to MSMEs has become more costly and troublesome while their accessibility has sharply declined. MSMEs' financing constraints limit their investment opportunities and stagnant growth. Access to finance is widely perceived to be an essential factor for firms, and especially MSMEs, to maintain their daily business operation as well as to achieve long-term investment opportunities and development targets.

The onset of globalization, with expanded regional economic integration in the context of East Asia, has intensified the competitive pressures on regional MSMEs in both domestic and international markets. Despite their perceived weaknesses, related to their relatively small size and limited resources, the region retains a dynamic, entrepreneurial and increasingly internationalized MSME sector (Hall, 1995, 1999, 2002). MSMEs have not been swept away with the process of globalization and regional integration, but, rather, their role and contribution have evolved as they attempt to retain a competitive position in the domestic and global marketplaces (Harvie, 2002; Harvie and Lee, 2002, 2005; OECD, 2006a). This has involved the adoption of effective business strategies in response to global competition, as well as meeting the needs of the new economy with its emphasis on knowledge, skill and innovation as key



sources of competitiveness. Those enterprises most able to respond flexibly and adaptively to rapidly changing regional and global markets will be the most successful (Harvie, 2002). A critical issue is how best to ensure that they fully participate in the business opportunities that will present themselves, including the adoption of international strategic alliances involving other MSMEs and participation in global and regional value chains, or production networks with multinational enterprises. Knowledge and production networking participation by MSMEs enables them to combine the advantages of their flexibility, arising from small scale, with the advantages of economies of scale and scope (OECD, 2006a).

Access to funding is the lifeblood of any enterprise, enabling it to grow, and to generate more output and employment (Ang, 1992; Beck et al., 2005, 2006, and 2008; Berger and Udell, 1998; Chittenden et al., 1996; OECD, 2006a, 2006b, 2006c; Vos et

al., 2007). There is considerable evidence to support the contention that SMEs, in particular, face a number of obstacles and problems in accessing finance, mainly related to their limited resources and perceived risk by lenders (Cassar and Holmes, 2003). This is particularly problematic, and worrisome for policy makers, given that MSMEs and entrepreneurship are widely recognized as being the key sources of dynamism, innovation and flexibility in advanced industrialized, emerging market and developing economies, and are major net job creators in these economies (OECD, 2006a, 2006c). In developing economies, in particular, MSMEs make a significant contribution to employment and national income. Without access to finance MSMEs are unable to invest, impairing their capacity to: improve productivity; raise competitiveness; promote innovation; generate employment; and contribute to economic growth and development (OECD, 2006a).

REVIEW OF LITERATURE

Stiglitz & Weiss (1981) stated that the exclusion of SMEs from credit markets in the region is chiefly due to three sets of factors. First, their inherent lack of transparency, absence of suitable collateral and poor track record exacerbate information asymmetries, resulting in acute credit rationing.

Hossain (1998) stated that the inability to access credit is one of the major bottlenecks of MSMEs, as most of the developing economies have poorly

developed banking sectors. For most developing and transition economies, the common challenges for SMEs typically include financing, overcoming institutional, legal and administrative barriers and accessing network support.

Hallberg (2001) argued that financing for the SME sector has emerged popularly in the recent few years and it has become a debatable topic for the economists as well as policymakers. This has become immensely important because SMEs



account for the majority of units of a country and play a key role in employment generation.

Schiffer & Weder (2001) stated that financing is a greater obstacle for SMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies. A crucial element in the development of the SME sector is access to finance, particularly to bank financing, given the relative importance of the banking sector in serving this segment. According to a report of World Bank, access to finance is perceived as one of the main obstacles in doing business.

Dallago & McIntyre (2003) stated that SMEs are not themselves sufficient for growth without the proper development of institutions and support structures.

Beck, Demirguc-Kunt, Laeven & Maksimovic (2004) conducted a survey which included 10,000 firms from 80 countries, the fundamental factors to which depends the enterprises' access to finance. The study highlighted the relationship between the access to finance for enterprises and their characteristics, such as age, size and propriety structure. From this perspective, the authors found that young firms of small size face greater obstacles when they seek to obtain financial resources. The study also highlighted the relationship between the degree of economic and financial development of a country (expressed through the degree of

financial intermediation, the level of capital market development, the efficiency of the legal framework, the GDP per capita) and the access to finance for enterprises. Furthermore, the study concluded that the institutional development is the most important feature that explains the differences between countries in terms of financing obstacles faced by enterprises.

Beck, Demirguc-Kunt & Maksimovic (2005) concluded from a study on small and medium sized firms from 54 countries that small and medium-sized enterprises are faced with financial and legal constraints and corruption issues in a much greater degree when compared with the large firms, thus the impact of these constraints on the firm growth is inversely proportional to the size of the firm. Moreover, the authors also noted that the financial and legal system development and the process of reducing corruption help to relax the constraints faced by small and medium-sized firms.

Bari, Ali & Haque (2005) examined the key constraints faced by the SME sector in Pakistan, including lack of access to credit, excessive government regulation, an arbitrary and exploitative tax administration system, a weak technological base, and the lack of business support services. They also provided a set of concrete strategic recommendations to address such constraints in order to promote SME growth for greater income generation and employment creation.



Beck, Demirguc-Kunt, Laeven & Maksimovic (2006) studied around 10,000 firms and found that 39% of smaller firms were financially constrained, 38% of medium sized firms were financially constrained and only 29% of the large size firms were financially constrained. It was also found that the smaller firms generally take 13% points lesser external finance than the large size firms and lack of access to external finance is a major bottleneck for the MSME sector.

Venkatesh & Nguyen (2006) pointed out that the achievement stage for any particular MSME is to have adequate access to external sources of finance. An important aspect for MSME sector development is access to finance particularly from financial institutions.

Beck & Demirguc-Kunt (2006) highlighted that access to finance is an important growth constraint for MSMEs and financial and legal institutions play an important role in relaxing this constraint. The authors also noted that innovative financing instruments can help facilitate MSMEs' access to finance even in the absence of well developed institutions.

Colluzi et al. (2009) confirmed that the probability of facing financing constraints is even larger for small and young businesses. In addition, there is an influence of the industry level: manufacturing and construction are more often constrained than firms in other industries.

Small firms find it difficult to obtain commercial bank financing, especially long-term loans, for a number of reasons, including lack of collateral, difficulties in proving creditworthiness, small cash flows, inadequate credit history, high risk premiums, underdeveloped bank-borrower relationships and high transaction costs (**IFC, 2009**).

De Haas & Van Horen (2010) analyzed the syndicated loan market and how banks adjust their lending behaviour during a financial crisis and found that the reduction in bank lending during the crisis can at least partly be attributed to banks' increased monitoring and screening efforts.

Ayadi & Fanelli (2011) argued that the constraints in access to finance are an impediment to MSME development, which rests on the combination of three pillars: enhanced capacities, an enabling environment and appropriate financing conditions.

Mach & Wolken (2011) analyzed the effects of credit availability on small firm survivability over the period 2004 to 2008, and found that credit constrained firms were significantly more likely to go out of business than non constrained ones.

Ardic, Mylenko & Saltane (2011) analyzed, using statistical data, the macroeconomic and institutional factors that are influencing the MSMEs' financing through loans. Similar to other studies, the authors found a positive correlation between the overall economic



development (measured by income per capita) and financial development (measured by the ratio of private credit to GDP), on the one hand, and the MSMEs' financing level, on the other side. Moreover, the authors demonstrated that the financing level of MSMEs depends also on the legal framework and the overall business environment.

Naidu & Chand (2011) highlighted that the inability to obtain external financing, inability to obtain internal financing, insufficient capital and start up costs are the common financial problems of MSMEs. The study revealed that the inadequate credit from banks is the major reasons for finance problems of Micro Enterprises.

Mishra & Brahme (2011) pointed that the major reason for not seeking credit by the MSMEs was lack of information about credit and lack of required security. Formal financial intermediaries, such as commercial banks, usually refuse to serve poor households and micro-enterprises

METHODOLOGY

The study is primarily based on qualitative literature survey method. It facilitates in depth analysis of the issues related to MSMEs and the widening financing gap for the MSME Sector. Extensive review of the literature provided useful insight about the various factors that are responsible for the widening of the financing gap in the MSME Sector. The present study is exclusively based on secondary data which has been collected from the various issues of Annual Reports on MSMEs, Handbook of Statistics on the Indian

because of the high cost of small transactions, lack of traditional collateral, lack of basic requirements for financing and geographic isolation.

Rao & Ganesh (2011) found that reluctance by banks to extend credit to women, inability to provide adequate security and margin money, tight repayment schedule are the main problems being faced by the MSME sector.

Jimenez, Ongena, Peydro & Saurina (2012) found for their sample of Spanish firms that bank balance-sheet strength determines loan approval in crisis times. Firm balance-sheet strength determines loan granting in good as well as in crisis times but matters more during the latter.

Shiralashetti (2012) stressed that absence of adequate and timely supply of bank finance, limited capital and knowledge, lack of power, low quality inputs, low return, non availability of suitable technology, low production capacity, ineffective marketing strategies are the main problems of MSMEs in India.

Economy published by Ministry of MSMEs and SIDBI Annual Report.

OBJECTIVES

- To highlight the issues of Financing Gap and Credit Rationing for the Indian MSMEs
- To evaluate the Debt Demand of MSME Sector in India



Financing Gap in MSME Sector

The term “financing gap” refers to a situation where a sizeable proportion of economically significant MSMEs cannot obtain financing from banks, capital markets or other suppliers of finance. Furthermore, it is often alleged that many entrepreneurs or MSMEs that do not currently have access to funds would have the capability to use those funds productively if the funds were available but due to structural characteristics, the formal financial system does not provide finance to such entities. The broad picture that emerges from the various surveys of MSME financing “strongly suggest that business owners view access to financing as a significant problem for business activity” (Turner et al, 2008). There might be a “financing gap” despite the various public and private sector initiatives to facilitate access to financing.

The term “financial gap” is used to refer to the existence and extent of difficulty faced by MSMEs in attaining access to finance. This could arise as consequences of the implementation of credit rationing by banks, or of the extent of market failure in financial markets. It could be measured by the difference between desired access to finance and actual access to finance, and by the cost and terms of access to finance.

MSMEs face a deficiency in obtaining the finance that they require, and that this will act as major inhibitor in terms of their performance – growth, employment, and productivity etc. From a theoretical perspective it was considered for a long time that it was not meaningful to talk about a financing gap, except where the authorities deliberately kept interest rates below the

market clearing level. As risks increased financial lenders would be required to increase interest rates to bring market demand into equilibrium with market supply. However, Stiglitz and Weiss (1981) showed that under certain conditions financing gaps can exist for all firms, as banks respond in a rational fashion by imposing credit rationing. While the arguments were not specifically targeted at explaining credit rationing for MSMEs, these enterprises possess characteristics that make them more prone to credit rationing than larger enterprises. This position has been applied more generally to problems encountered in emerging market and developing economies in particular.

Causes of a Financing Gap

The issue of access to finance by firms in general, and the theoretical recognition that financing gaps can exist for firms, can be traced back to the theory of imperfect information in capital markets (Stiglitz and Weiss 1981). From the lender’s perspective (or supply side), banks have difficulty differentiating between good (high quality) and bad (low quality) loan applicants. As a result banks are likely to adopt more stringent lending policies favouring those who are able to provide more collateral assets, or who have a more established credit record. In other words banks have to adopt credit rationing measures to minimize problems from adverse selection and moral hazard. The potential for credit rationing is thought to be greater for small firms.

On the demand side, as argued by Petersen and Rajan (1994), the amount of information that banks could acquire is usually much less in the case of small firms, because banks have



little information about these firms' managerial capabilities and investment opportunities. The extent of credit rationing to small firms may also occur simply because they are not usually well-collateralized (Gertler and Gilchrist 1994). The most recent paper by Torre *et al.* (2010) also attributes hindrances to MSMEs' access to finance to "opaqueness", meaning that it is difficult to ascertain if firms have the capacity to pay (have viable projects) and/or the willingness to pay (due to moral hazard). This opaqueness particularly undermines lending from institutions that engage in more impersonal or arms-length financing, requiring hard, objective, and transparent information (Hyytinen and Pajarinen, 2008).

The problem of a mismatch between the supply of funds (loans) and the demand for funds (loans) leads to the notion of "financial gaps" (Industry Canada, 2002), which can be defined as an imperfection (of geography, laws, transaction costs, and regulations) that impedes supply of and demand for financial products from clearing, with the result that markets do not function efficiently. The gaps exist if particular categories of firms that ought to receive financing are systematically unable to obtain it, despite a willingness to pay higher interest rates, indicating market failure particularly if such lending opportunities are profitable. A mismatch between demand for finance and supply of finance can arise due to asymmetry in information and consequent difficulty in distinguishing between good and bad loans, leading to the application of credit rationing. This is potentially more severe for MSMEs than for large enterprises. In emerging market economies there is also greater likelihood of

Demand > Supply for loans as a result of the implementation of credit rationing.

Credit Rationing

Credit rationing refers to the situation where lenders limit the supply of additional credit to borrowers who demand funds, even if the latter are willing to pay higher interest rates. It is an example of market imperfection, or market failure, as the price mechanism fails to bring about equilibrium in the market. It should not be confused with cases where credit is simply "too expensive" for some borrowers, that is, situations where the interest rate is deemed too high. On the contrary, the borrower would like to acquire the funds at the current rates, and the imperfection refers to the absence of equilibrium in spite of willing borrowers. In other words, at the prevailing market interest rate, demand exceeds supply, but lenders are not willing to either loan more funds, or raise the interest rate charged, as they are already maximising profits.

Credit rationing is not the same phenomenon as the better-known case of food rationing, common in times of war. In that case, shortages lead governments to control the food portions allocated to individuals, who would be willing to pay higher prices for more portions. However, credit rationing is not necessarily the result of credit shortages but rather of asymmetric information. More importantly, food rationing is a result of direct government action, while credit rationing is a market outcome.

The conventional wisdom argues that the inadequate financing of MSMEs is to a significant extent rooted in supply-side



features. The manner in which the financial institutions and banks operate in the developing countries is biased when compare MSMEs with large enterprises. MSMEs find it relatively harder to get access to finance from these financial institutions. Banks generally show lack of interest when it comes to getting involved with MSMEs.

There are several factors which constrain financial institutions to get involved with the MSMEs. One of the major reasons, why banks shy away from granting loans to MSME sector is because they are opaque. Opacity basically means that it is relatively difficult to know about the pay back capability of the firm. Whether the firm has feasible and profitable projects with them and whether they have the interest to pay back the money to banks.

Debt Demand of MSME Sector

Financial Institutions have traditionally limited their exposure to the sector due to the perception that these businesses carry high risk and high cost of delivery, and have limited access to immovable collateral.

Banks generally require transparent information regarding the financial position of the firm and viable projects the firm wishes to undertake in future for granting loan to this sector. When we compare MSMEs to the large enterprises then we find that the MSMEs are much more opaque than the large enterprises and this tendency increases in developing countries. These things make the situation even worse for the MSMEs as opacity increases the risk perception of banks towards MSMEs.

If a firm is unable to disclose its financial statements clearly then banks cannot lend them with ease and confidence. Informality basically means the firm has got contingent liabilities to the government and other creditors. In this case, banks would be reluctant to lend to these firms or charge a higher risk premium.

Although the overall debt demand in the sector is estimated to be INR 26 trillion, not all of it can be met immediately by the formal financial sector due to several reasons. Table 1 reflects the exclusions from overall Debt Demand.

Table - 1
Exclusions from Overall Debt Demand

Type of Enterprises	Share of Debt Demand (In Percentage)
Sick Enterprises in Default	13%
New Enterprises with less than one year of operations	23%
Portion of enterprises rejected by formal financial institutions	1%
Voluntary exclusions of micro services sector enterprise segment	25%
Total	62%

Source: MSME Annual Report (2011-12)



Based on the exclusions in Table 1, it is estimated that of the total debt demand of INR 26 trillion, at least 38% or INR 9.9 trillion is the size of the viable demand that

can be addressed by the formal sector in the near term. Table – 2 highlights the viable and addressable debt demand in MSME Sector.

Table - 2

Viable and Addressable Debt Demand in MSME Sector (In INR Trillion)

Total Debt Demand	26
Excluded Demand	16.1
Immediately Addressable Demand	9.9

Source: MSME Annual Report (2011-12)

Nearly 90 percent of the total viable and addressable debt demand is from unregistered enterprises, and the balance demand of INR 1 trillion is from registered MSMEs. What is interesting though is that registration of enterprises in no way impacts the access to finance from formal financial institutions.

Of the total viable and addressable debt demand of the MSMEs, the working capital requirement is the biggest, estimated to account for approximately 61

percent of the total need. Analysis of a typical MSME's balance sheet and available financial data corroborates the fact. Current assets account for 74 percent balance sheet growth year-on-year, while capital expenditure accounts for only 26 percent of the growth, clearly indicating the critical role of working capital finance in the functioning and growth of MSMEs. Table – 3 displays the viable and addressable working capital and Capital expenditure Demand.

Table – 3

Viable and Addressable Working Capital and Capital Expenditure Demand (In INR Trillion)

Total Debt Demand	9.9
Short Term Demand (<1 Year)	6
Long Term Demand (2-5 Years)	3.9

Source: Reserve Bank of India Annual Report (2011-12)

Of the total INR 9.9 trillion of viable debt demand that can be addressed by financial institutions in the near term, the micro,

small and medium enterprise segments respectively account for INR 4.4 trillion, INR 2.9 trillion and INR 2.6 trillion. The



micro and small enterprises sub-segments together account for 74 percent of this debt demand and hence form the focus of the priority sector lending norms. Table – 4

highlights the viable and addressable debt demand in Micro, Small and Medium Enterprise segments.

Table – 4

Viable and Addressable Debt Demand in Micro, Small and Medium Enterprise Segments (In INR Trillion)

Type of Enterprise	Share of Demand
Micro	44%
Small	30%
Medium	26%

Source: MSME Annual Report (2012-13)

CONCLUSION

Although a significant number of MSMEs still rely on their internal resources for start-up and business expansion, external finance is very important for aspiring smaller domestically owned companies in less developed economies which make lower profits and which have insufficient access to funds. Moreover, the size of the MSMEs and stage of the country's development (reflecting the financial market conditions) also affect the diversity of choices of financial institutions and financial products that MSMEs can access.

There is potential for credit rationing, or risk premiums exercised by the financial institutions on MSMEs. The size and stage of country development (financial market development) do affect the conditions of external finance offered to MSMEs, i.e., larger MSMEs in more developed economies tend to get bigger loans, with longer terms, and at a lower interest rate than otherwise. The owners' net worth, collateral, business plan, financial statement, and cash flow are critical for

financial institutions in devising the financial conditions they extend to MSMEs. In other words, financial intuitions seem to put higher risk premiums on opaque MSMEs by offering less favourable financial conditions to less well-established and transparent MSMEs.

The financial institution behaviour is strongly linked to the legal, institutional and regulatory environment in which they operate. In an economy where the legal system does not adequately protect property rights and a bankruptcy law is lacking or non-existent, where there are inefficiencies in the operation of institutions themselves and the regulatory environment is lacking in terms of disclosure and transparency requirements relating to firm operations, it would be perfectly rational for financial institutions to restrict credit or impose a risk premium on opaquely operating enterprises. Consequently, problems in accessing finance for MSMEs may not be due solely to distortions or inefficiencies in the financial sector itself, but also by weaknesses



in the legal, institutional and regulatory environment in which these institutions operate. Financial access has a significant impact on MSMEs' innovation capability and participation in the export market. The bigger MSMEs with access to larger loans with

longer terms and at a lower interest rate are more capable of innovation and exporting activity, since these external finances with favourable conditions would provide MSMEs enough time and resources to innovate and enter foreign markets.

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