CGAP

FOCUS NOTE

Financing Small Enterprises: What Role for Microfinance Institutions?

In the current political and economic environment, jobs are at the center of political debates in both developed and developing economies. There are many expectations that small enterprises[1] can create new jobs, although recent studies suggest that small enterprises contribute more to the employment share in low-income economies than in high-income countries (Ayyagari, Demirgüç-Kunt, and Maksimovic 2012). International development agencies want to promote and finance small enterprises (see Box 1) while the G-20 is also committed to improving access to finance for small businesses in developing countries.

Embedded in these efforts is the assumption that access to finance is a key constraint to small business expansion. In this Focus Note, we examine the experience and role of microfinance institutions (MFIs) in serving small enterprises.[2] We start with an overview of small enterprises and their financial needs, suggesting that they require more than just loans. We then analyze the current and potential role of MFIs in serving this market. Annex 2 provides a synthesis of a literature review on the contribution of small businesses to job creation and economic growth.

Box 1. Funder Support for Small and Medium Enterprises

At the end of 2010 total commitments of public funders were around $24.5 billion in support of small and medium enterprises (SMEs). The largest funders, each providing more than $500 million, include European Investment Bank (EIB), International Finance Corporation (IFC), World Bank, the Netherlands Development Finance Company (FMO), European Bank for Reconstruction and Development (EBRD), German development bank Kreditanstalt für Wiederaufbau (KfW), and the Asian Development Bank. The primary channel for public and private funding is wholesale investment facilities. A CGAP scan identified more than 300 investment funds for SMEs in emerging markets. Total commitments of these wholesale vehicles were more than $21 billion at the end of 2010, including both public and private funding, with almost half of investment in sub-Saharan Africa and South Asia.

Source: http://www.cgap.org/gm/document-1.9.57219/Estimating_Funder_Support_SMEs.pdf

Methodology

In December 2011 we surveyed more than 300 MFIs in 69 countries and interviewed some MFIs and networks (see Annex 1). We asked about their small business products, their risk assessment methodologies, and their internal capacity (staff resources, management information systems [MIS], etc.). We also examined their motivations, obstacles, and success factors for serving small enterprises.

In addition, we reviewed recent studies on small businesses, economic growth, and job creation (see bibliography). Finally, this paper benefited from discussions with CGAP's Micro and Small Enterprise (MSE) Working Group, which includes about 20 funders who are particularly interested among other topics, in the role MFIs can play in serving small businesses.

Understanding the Financial Needs of Small Enterprises

Defining small enterprises is challenging. Most definitions use criteria such as the number of employees, net assets, or sales.[3] However, countries have adopted widely varying criteria, making comparisons difficult.

Although there is no universal agreement about the definition, in this paper we focus on the small enterprises MFIs typically serve. Their main characteristics include the following: 5–20 employees, typically family-owned, and mostly family labor (and

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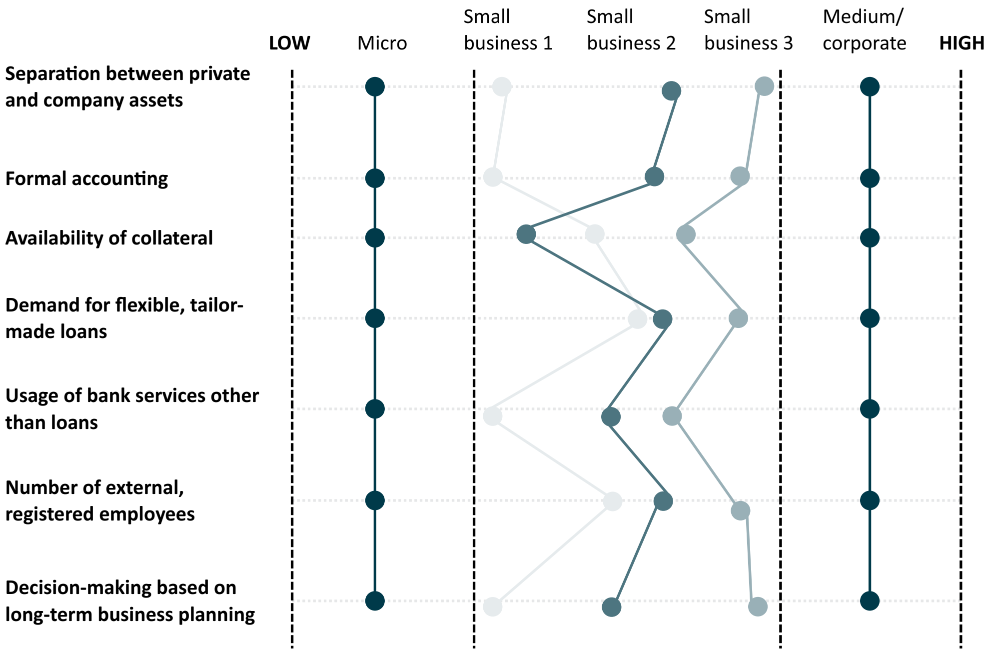
1 The terms "small business," "enterprise," and "firm" are used interchangeably in this paper.

2 For the purpose of this paper, we define an MFI as an organization that focuses on financial services for poor and low-income clients. This broad definition includes a wide range of providers that vary in their legal structure, mission, and methodology.

3 One classification often used in developing countries defines microenterprises as having up to five employees, small as having fewer than 50 employees, and medium as having fewer than 250 employees (IFC 2010).

Figure 1. Characteristics of small enterprises



Source: Illustrative examples, based on IPC (2011).

in some cases, workers outside the household). They often have fixed assets and a fixed place of business, in contrast to many microenterprises (e.g., informal vendors). Ownership and management are mostly the same with simple financial recordkeeping, often separate for the business and household.[4] Finally, their capital base is often small; while starting capital is generally provided from their own savings and borrowings from relatives and friends (CGAP 2011, Sia and Nails 2008).

The underlying challenge many MFIs face when attempting to establish small business lending operations is that this segment consists of an extremely heterogeneous group (see Figure 1). While it is fairly easy to identify common features in both microenterprises and medium-size or corporate businesses, it is far more difficult to classify small businesses (IPC 2011). Hence, a more sophisticated approach to customer service and risk assessment is often needed to serve these businesses adequately and to control credit risk.

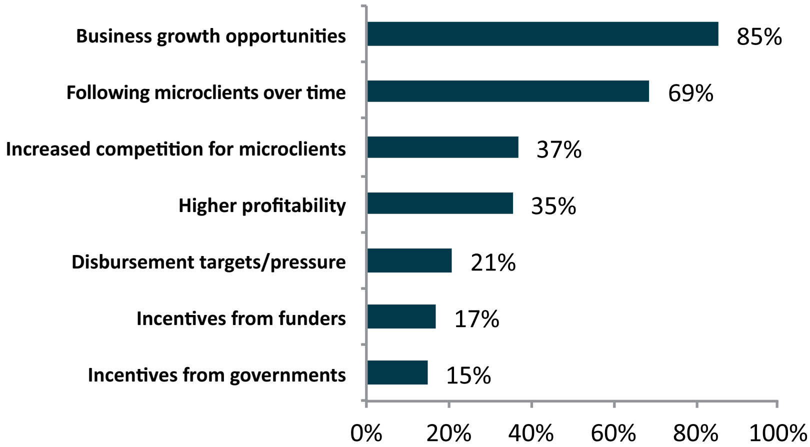
Needs of small businesses are diverse

Financial needs of small businesses are diverse and context specific. Thus, generalizing the results of the few market studies available is risky, but some patterns seem to be emerging regarding small business needs.

In the early stages of the business life cycle, small firms in developing countries often depend on informal sources of funding and have basic needs, such as managing cash flow through short-term loans and basic savings accounts. A FinScope pilot study in South Africa showed that most very small businesses need a short-term line of credit to weather brief (sometimes overnight) cash flow gaps (Bankable Frontier Associates 2009). The need for a savings buffer can be even more acute, because income is often irregular while business partners can be unreliable. As very small businesses grow, their needs extend beyond short-term lending and savings into other financial products, such as

4 The majority of the MFIs surveyed noted that this separation is often not fully clear and that financial statements of small businesses are rarely accurate.

Figure 2. MFI reasons to serve small businesses



Source: CGAP MSE Industry Survey 2011. Multiple answers allowed.

long-term debt, current accounts, transfers, and payments. For example, long-term debt finance is one of the most commonly cited needs of small enterprises (CGAP 2011, IFC 2010), but evidence from banks lending to small businesses suggests that long-term lending is often offered as a way to cross-sell other fee-based products and services, including payments and savings (de la Torre, Martínez Pería, and Schmukler 2010).

Small businesses also have many nonfinancial needs that are often unmet. For example, in the 2006–2009 World Bank enterprise survey, small enterprises in developing countries cited the lack of electricity as a bigger obstacle than lack of finance.[5] Other key barriers include inappropriate regulations, taxes, and corruption.

How Do MFIs Meet the Needs of Small Enterprises?

MFIs are increasingly serving small businesses

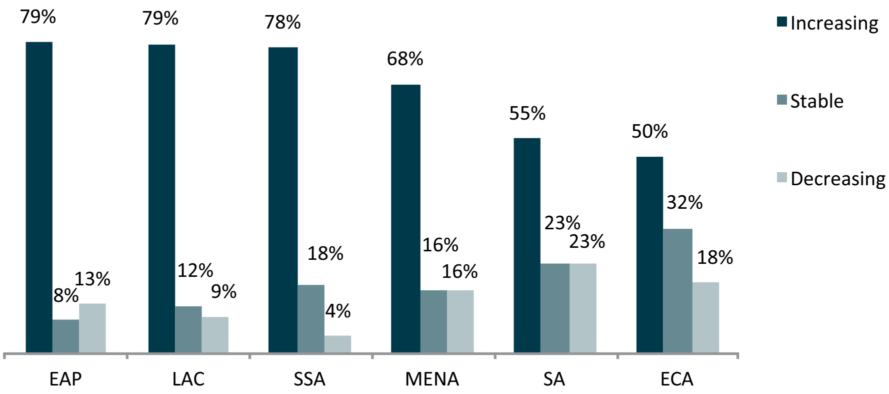
Many financial service providers serve small enterprises in developing countries, including commercial banks, cooperatives, MFIs, and others. These providers have different capacities and motivations, and target different specific subsegments within the small business landscape. Larger financial service providers, including commercial banks that want to serve small businesses, tend to focus on firms that are larger and formal. On the other hand, MFIs usually focus on enterprises that are smaller and often informal. Of the 300 MFIs surveyed, 78 percent reported that small enterprise is already part of their strategy, and almost 70 percent expect to increase their small business portfolio. Most MFIs are looking at small enterprise segments because they offer additional business growth opportunities (see Figure 2). Another motivation is the MFIs' desire to continue serving a small number of growing microclients (often their best clients).[6]

By region, East Asia and Pacific (EAP), Latin America and the Caribbean (LAC), and sub-Saharan Africa (SSA) have the most MFIs whose small business portfolios are increasing (see Figure 3). By contrast, the small business portfolios of MFIs in Europe and Central Asia (ECA) and South Asia (SA) seem to be more stable (CGAP 2011). The extent to

5 The World Bank enterprise surveys are the most comprehensive company-level data in emerging markets and developing economies. Firm size levels are 5–19 (small), 20–99 (medium), and 100+ employees (large-sized firms).

6 Forty percent of MFIs surveyed said that a very small number of their microenterprise clients (less than 10 percent) grow to become small; 28 percent of the MFIs said that this number was between 10 and 20 percent; while 18 percent reported a higher percentage (between 20 and 50 percent) (CGAP 2011).

Figure 3. Growth trend of MFIs' small enterprise portfolio, by region (percentage of MFIs surveyed)



Source: CGAP MSE Industry Survey 2011.

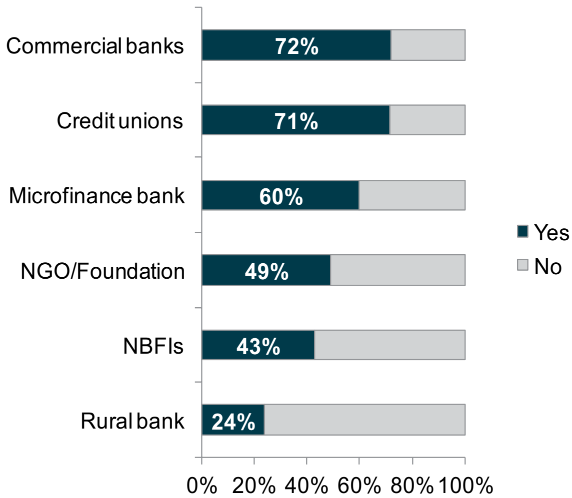
which the portfolio increase in MFI small business is due to attracting new clients, as opposed to accompanying current clients over time, needs further exploration.

MFIs' challenges in serving small business

Moving from the micromarket into the small business market requires different staff capacities, management systems, and risk assessment tools.

Lack of appropriate risk assessment methodologies. Most of the surveyed MFIs report the lack of adequate risk assessment methods as the main challenge to serving small businesses. Many institutions (51 percent) do not have separate methodologies for micro and small enterprise risk assessment. Most of these institutions use their existing microfinance risk assessment tools for small business clients despite the fact that a different level of client analysis, including financial analysis, might be required.[7] The lack of appropriate mechanisms to manage risks seems to have important implications for MFIs that are trying to expand to small business markets. Several MFIs noted that their portfolio at risk (PAR) greater than 30 days tends to be higher for small business than for microenterprises.[8] Within the MFI spectrum, those MFIs that are set up as banks seem to be better equipped in terms of risk methodologies as compared to nongovernment organization (NGO) MFIs, for example (see Figure 4).[9]

Figure 4. Separate risk methodology, by institutional type



Source: CGAP MSE Industry Survey 2011.

7 Small business banking also requires a more structured approach to loan recovery, including at times legal steps that MFIs might not be ready to undertake (based on the information provided by IFC's A2F Risk Management Department).

8 Recent research by MIX shows that MFIs that rely more on consumer or small-business lending were more exposed to financial crises than MFIs that based their lending on the traditional microfinance lending methodologies, such as village banking, solidarity groups, or individual microenterprise loans (Gonzalez 2012).

9 For more information on different types of institutions see Annex 1.

Recent research on banks that have a small business portfolio shows that those that are high performers in terms of returns on assets (ROA) conduct additional "validation" checks for small businesses with weak financial records. They underwrite on average seven times faster than low performers and allocate more time to monitoring the small business portfolio (Small Business Banking Network forthcoming).[10]

Inadequate MFI products. Most MFIs offer standard short-term credit to their core microclientele. However, small businesses often need other products that many MFIs do not currently offer (Figure 5). For example, less than half of the MFIs surveyed can offer overdraft facilities, transfers, or payment services.

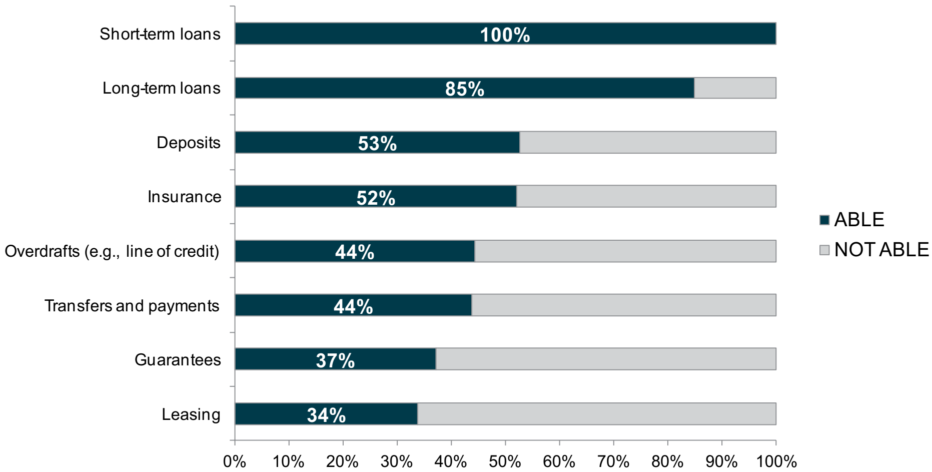
Hence, institutions that wish to retain their business clients in the long term will have to find solutions (including institutional transformation) that will enable them to cater to the changing needs of these clients over time. Alternatively, MFIs may make the strategic decision to focus on a specific small business segment or to target only small businesses up to a certain size and with limited needs in terms of financial services (IPC 2011).

MFIs have recently started diversifying their product mix. For example, during 2006–2008 a sample of 600 MFIs that report to MIX more than doubled their number of deposit accounts.[11]

Lack of a specialized department and staff. Specialized staff or a dedicated department would seem essential to serving small businesses successfully. This is a common feature among mainstream commercial banks that are leaders in the small business market. In a recent World Bank survey, 91 percent of interviewed banks in developing countries had a separate structure or department that deals with small business clients and decentralized the sale of products to the branches (de la Torre, Martínez Pería, and Schmukler 2010). Yet many surveyed MFIs (59 percent) have neither dedicated staff nor a dedicated department to serve small enterprises.

Weak portfolio management and data analysis. Sustainable services to small businesses require good MIS, but many MFIs are still lagging behind in this aspect. A large number of MFIs (44 percent) do not monitor their small business portfolio separately from their microfinance portfolio, which limits their ability

Figure 5. Ability to provide services required by small firms



Source: CGAP MSE Industry Survey 2011.

10 The SBBN survey was conducted during the summer and autumn of 2011, with 29 financial institutions in nine countries. These ranged from regional/multinational institutions to small, specialized lenders.

11 For more information see mixmarket.org.

Box 2. Three Key Lessons for MFIs Interested in Serving Small Businesses

These lessons emerge from the IPC Advisory Services experience with ProCredit Banks and other financial institutions around the world as well as IFC's experience with banks downscaling to the small business market and the work of the Small Business Banking Network (SBBN).

Understand the market. Small businesses have unique needs, typically different from larger companies, but often different from one another. MFIs need to invest in getting to know this new target group well and employ specific tailored approaches. MFIs will need to conduct market studies, mine available data to learn from their current portfolio or conduct primary research, and use direct observation. A deep understanding of customer needs and market demands is critical to the segmentation process.

Engage in an institution-building process. Opting to provide financial services to small businesses is a strategic decision that should be made at the highest level of management. Hence, it requires managerial commitment to the process of introducing a new business line (not just offering a new product) and careful planning. It can entail creating a dedicated small business unit separate from the microfinance department. However, smaller institutions or those that do not cover the wider spectrum of enterprises can have simpler structures that do not include separate units exclusively for small business lending. In any case, the MFI needs to ensure that microfinance officers who are to become small business officers are trained with a thorough understanding of the differences between the two market segments and products offered.

Develop tailored risk assessment methods. Small business loans involve larger amounts and greater complexity, so risk assessment requires thorough analysis, due diligence, and number crunching. Credit rating and scoring tools can help MFIs manage the risk better, though they face a challenge where large samples are not available to construct a model. Therefore, financial institutions that are new to the small business lending market may not have the data needed to develop a sound credit scoring system. More often, financial institutions tend to apply modified scoring systems where they use the experience gained on the ground to develop a quick set of loan assessment parameters for different groups of loans.

The MFI will also need to develop specific training for loan officers, moving from a "character only" lending judgment, as used for many microfinance lending decisions, to one that highlights first cash flow and second collateral or guarantor forms of repayment when making a small business lending decision.

Sources: IPC (2011), IFC (2009), and Sia and Nails (2008).

to manage these portfolios. The percentage is even higher in some regions, such as SSA (CGAP 2011).

Even when MFIs upgrade their MIS, there are often repeated changes in scope, budget overruns, and delays, all of which result in big gaps between the MFIs' needs and the new system's capabilities (Braniff and Faz 2012).

Another challenge is that MFIs often have to create or reconstruct the basic financial records of small business loan applicants, increasing the cost of small business lending. Many small business clients have inadequate and inaccurate financial records, and loan officers may be forced to take additional steps and improvise on the evaluation modalities, and sometimes even develop the financial statements to strengthen their analysis (Sia and Nails 2008). For example, a recent study in the Democratic Republic of the Congo showed that most small companies had a double bookkeeping system: one informal and another one formal in which they declare a small

12 Based on information provided by CHF International.

13 For LAC, this trend is confirmed in a regional survey conducted by the Inter-American Development Bank in 2011. The survey revealed that 62 percent of the small banks interviewed expect their SME portfolio to increase. http://www.iadb.org/en/news/news-releases/2011-11-14/2011-survey-latin-american-bank-sme-lending,9676.html

14 "Opaqueness" refers to the difficulty of ascertaining whether firms have the capacity to pay (project viability) and the willingness to pay (moral hazard). Opaqueness particularly undermines lending from institutions that engage in more impersonal or arms-length financing that requires hard, objective, and transparent information (de la Torre, Martínez Pería, and Schmukler 2010).

15 BRAC Bank has revised its approach, and it now sets deposit targets for all its SME clients with an objective to increase this above 30–40 percent of deposits.

Box 3. Key to Serving Small Business Well: What MFIs Say

"KYC (know your customer) approach is not enough, to successfully serve small enterprises you need to have a BWYC (be with your clients) attitude." **NGO/MFI Manager, the Philippines**

"Deep insights and strong relationship with the client." **NGO/MFI Executive Director, Dominican Republic**

"Having separate, dedicated units for serving micro and small enterprises." **Commercial Bank Manager, Kenya**

portion of their revenues for tax purposes (KfW 2011). Some MFIs are dealing with this challenge by streamlining the underwriting processes and forms, focusing only on important elements of evaluating a small business, such as form of repayment (cash flow), form of guarantee (collateral or guarantor), character analysis, and the site visit (Sia and Nails 2008).

Serving Small Enterprises: What's Next for MFIs?

The track record of MFIs serving small businesses is mixed, and providers should not add this new segment to their microbusiness without acquiring new data, capacity, and tools. MFIs are increasingly interested and aware of the need to improve their capacity to serve the small business market. Also, many networks and funders, private and public, are interested in helping MFIs improve their readiness to serve small enterprises. For example, CHF International, a commercial holding and network of MFIs is now developing a risk management system that will monitor MSE portfolio separately; it also plans to standardize small business appraisal over the next two years among its affiliates.[12] The Dutch development finance company (FMO) and a few other funders are funding pilot projects that help analyze and improve MFIs' capacity needs as they scale up into the small business market.

The role of MFIs will also depend on the context, including the availability of other service providers. Analyzing the competitive environment is another important step that will help identify the MFI's competitive advantages and priority market segments. While competition is minimal in some markets (e.g., Jordan, Colombia), other markets (e.g., Bosnia, Ghana) are highly competitive. In markets where mainstream commercial banks are active,[13] MFIs find it difficult to compete on price or other services (CHF 2012).

Despite many challenges, MFIs might bring important advantages to the small business market. Compared to commercial mainstream banks, for example, MFIs may have closer relationships with their customers, making it easier for them to overcome the "opaqueness" of small business clients.[14] Another advantage is that MFIs often have faster lending procedures and require less collateral than their competitors. Finally, MFIs can reach customers who do not have access to banks or who face serious obstacles, such as their own informality or high bank fees. There are some examples of particularly successful lending to the small business segment. For example, SME loans are now 53 percent of BRAC Bank's portfolio, with more than US$500 million outstanding at the end of 2011 (Rahman 2012).[15]

Conclusion

To adequately support small enterprises, MFIs will need to better understand their unique needs and to tailor financial services and build appropriate infrastructure to meet them. Successfully serving small enterprises is a process, not a one-time event—so careful planning is crucial. This will require a commitment from top management to create a client-centric approach, hire dedicated and knowledgeable staff, and invest in appropriate technologies.

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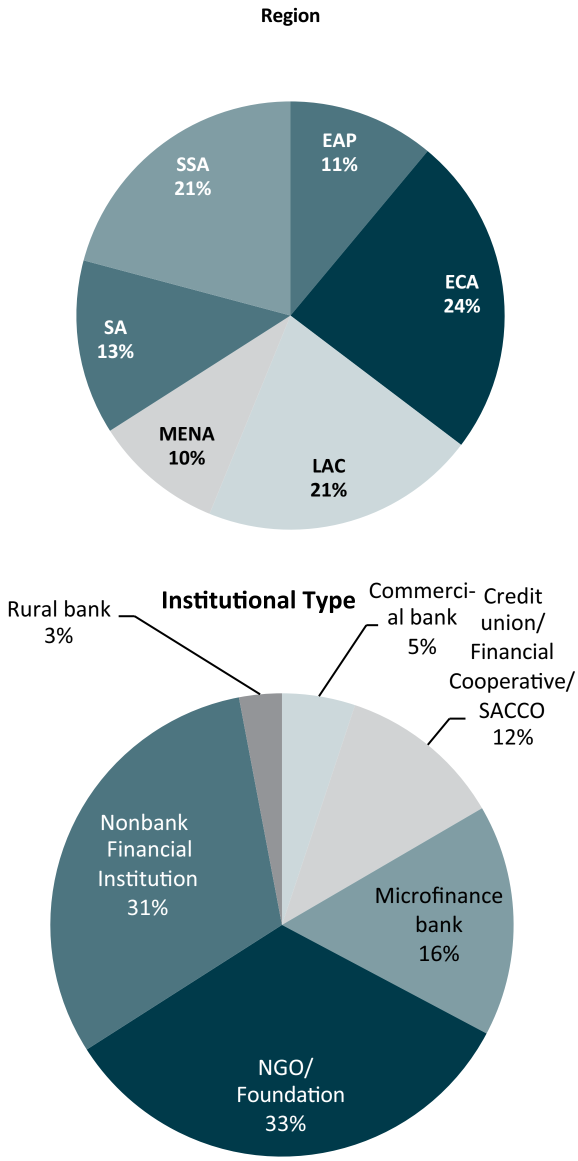
Annex 1: Sample and Research Methodology

In December 2011, CGAP conducted a survey to understand the role of MFIs in serving micro and small businesses. Around 300 MFIs responded to the survey sent to a larger number of institutions (including those in the MIX Market database), mostly from SSA, ECA, and LAC. Some countries predominantly represented in the survey include Azerbaijan, India, the Philippines, and Tajikistan. By institutional type, most participating MFIs were nonbank financial institutions and NGOs/ foundations.

Additional information was gathered from ASA Philippines, Women World Banking Colombia, Cooperative Housing Foundation (CHF), Cresol Brazil, Access Tanzania, ACEP Senegal, Internationale Projekt Consult (IPC), IFC's A2F Risk Management Department, and the Small Business Banking Network (SBBN).

Figure A1-1. Sample distribution, by region and institutional type



NOTE: **ECA**: Eastern Europe and Central Asia; **EAP**: East Asia and Pacific; **LAC**: Latin America and the Caribbean; **MENA**: Middle East and North Africa; **SA:** South Asia; **SSA**: Sub-Saharan Africa.

Annex 2: Are Small Enterprises Drivers of Job Creation and Economic Growth in Developing Countries?

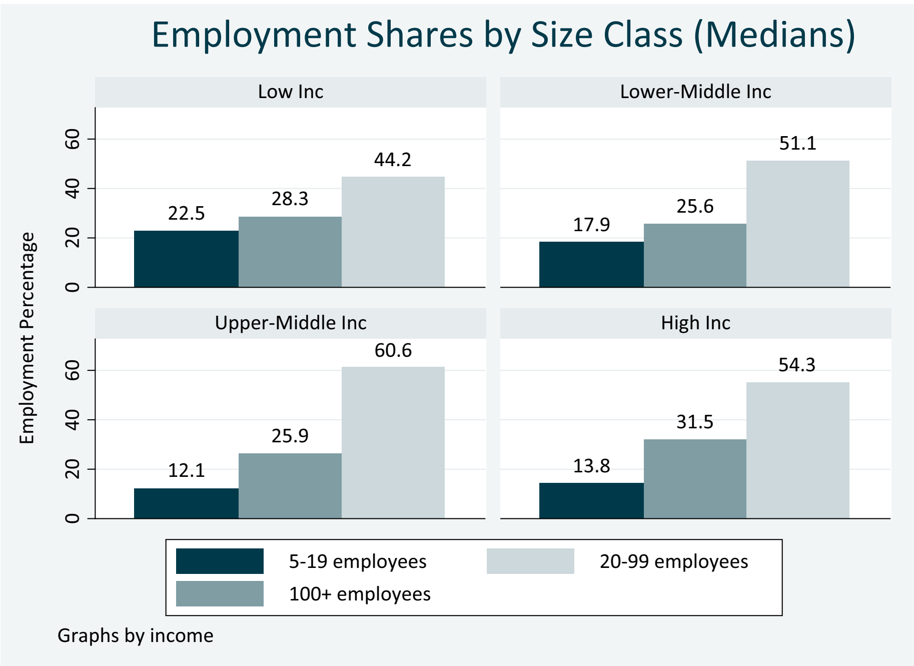
The role of small businesses as job generators has been most studied in the United States. At the beginning of the 1980s, the first research revealed that 8 of 10 jobs in the United States had been generated by small firms. This initial work was later criticized for not considering the high failure rates of small business and their net versus gross contribution to job creation, among other pitfalls (Biggs 2002). Recent work in the United States finds that large firms have the largest share of employment (Haltiwanger, Jarmin, and Miranda 2010).

In developing countries, a recent World Bank study (Ayyagari, Demirgüç-Kunt, and Maksimovic 2012) in 104 economies found that firms with 5–19 employees generate the most new jobs. Small firms also have the highest employment growth and sales growth rates, but they account for a relatively small share of total employment (see figures A2-1 and A2-2). However, in relative terms, small firms in developing countries employ more people than those in developed economies. Also, the employment contribution of the combined SME sector (5–99 employees) is more or less comparable to that of large firms.

The available research on job creation emphasizes the importance of not only quantity, but quality of jobs as well. There is a large body of empirical evidence from developed and developing countries showing that large firms offer higher wages than small firms, even when differences in worker education and experience and the nature of the industry are considered (Biggs 2002). The challenge is hence not only to create more jobs, but also to create better quality jobs to promote growth (Ayyagari, Demirgüç-Kunt, and Maksimovic 2012).

As regards small businesses' contribution to growth, researchers appear more skeptical of this claim. World Bank research finds a strong association between the small and medium firm sector as a whole[16] and gross domestic product/capita growth

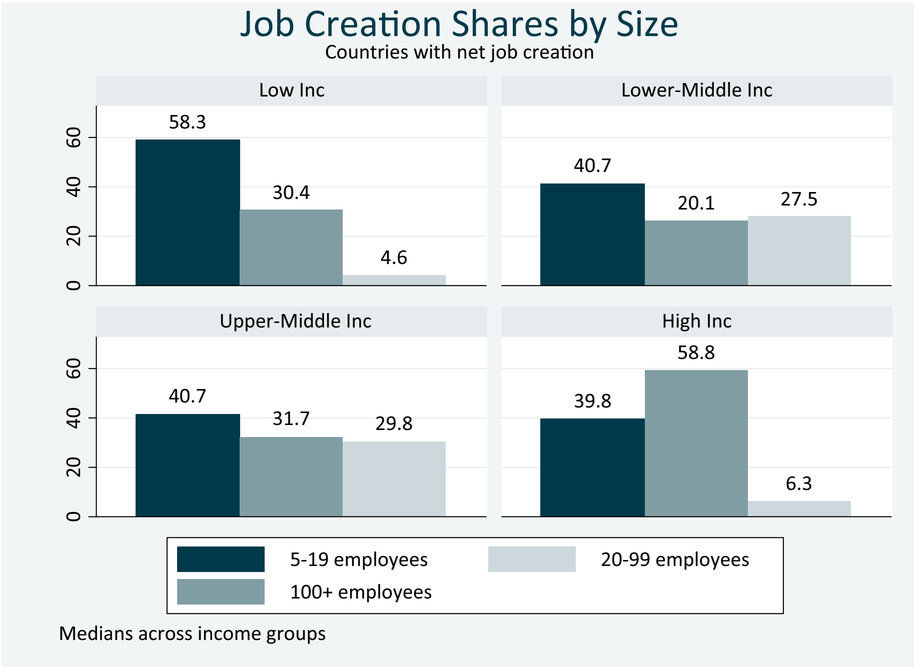
Figure A2-1. Employment shares by size class (Medians)



Source: Ayyagari, Demirgüç-Kunt, and Maksimovic (2012).

16 Firms with fewer than 250 employees.

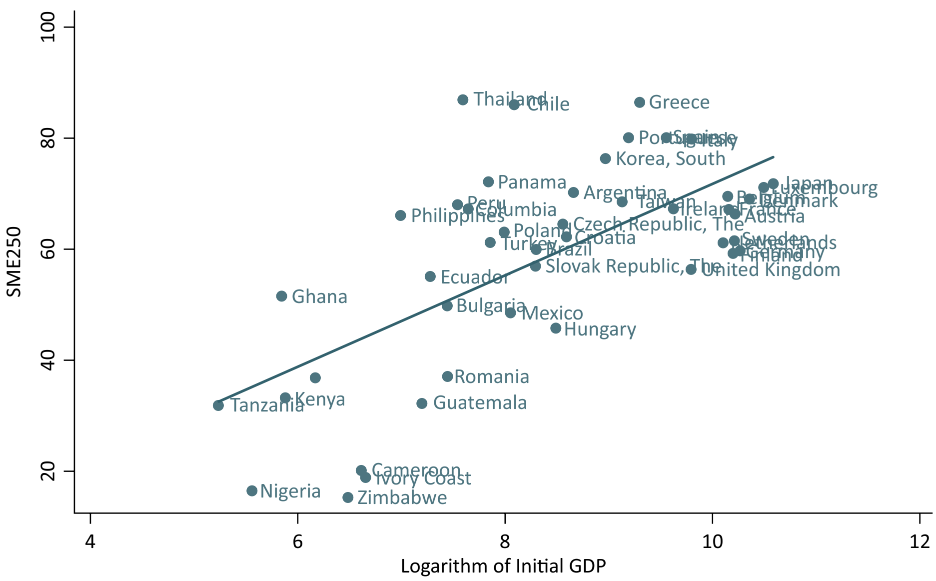
Figure A2-2. Job creation shares by size (medians)



Source: Ayyagari, Demirgüç-Kunt, and Maksimovic (2012). Graph shows countries with net job creation.

(see Figure A2-3), but no evidence of causality is found using a panel of 45 countries. Furthermore, the authors find no evidence that small and medium firms alleviate poverty or decrease income inequality (Beck, Demirgüç-Kunt, and Levine 2005). Research on how ***specifically*** small firms (fewer than 20 employees) contribute to economic growth is scarce or does not exist.

Figure A2-3. Positive correlation between SME as the percentage share of total employment (SME250) and GDP per capita in 1990 (Logarithm)



Source: Beck, Demirguc, and Levine (2005).

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July 2012

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The authors of this Focus Note are Jasmina Glisovic and Meritxell Martinez, both from CGAP. The authors would like to thank Alexia Latortue, Rich Rosenberg, and Ousa Sananikone from CGAP for their thoughtful review and suggestions. Greg Chen (CGAP), Hama Makino (IFC), Jorn Olesen (DANIDA), Lynn Pikholz (Small Business Banking Network), Eileen Miamidian (CHF), Kazuto Tsuji (JICA), and Dörte Weidig (IPC GmbH) provided generous contributions. We are also grateful to the institutions (listed in Annex 1) that the authors consulted in the research process.

The suggested citation for this Focus Note is as follows:
Glisovic, Jasmina, and Meritxell Martinez. 2012. "Financing Small Enterprises: What Role for Microfinance Institutions?" Focus Note 81. Washington, D.C.: CGAP, July.