CEB
COUNCIL OF EUROPE DEVELOPMENT BANK
BANQUE DE DEVELOPPEMENT DU CONSEIL DE L'EUROPE

TECHNICAL BRIEF

Credit constraints, regional institutions and the economic performance of MSMEs
Lessons from empirical analysis



January 2020

ISSN: 2707-5974 (print)
ISSN 2707-5982 (online)

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The working paper is printed in this form to communicate the result of an analytical work with the objective of generating further discussions on the issue.

Acknowledgements

This technical brief was prepared by Monica Brezzi and Kristina Maslauskaite (CEB Technical Assessment & Monitoring Directorate) on the basis of the paper by Brezzi, M., Ganau, R., Maslauskaite, K. and A. Rodriguez-Pose (2019) titled "Credit Constraints, Labour Productivity and the Role of Regional Institutions: Evidence for Manufacturing Firms in Europe" (under review for publishing). The work was overseen by Anton Spierenburg (Director a.i. of TAM), coordinated by Yael Duthilleul and reviewed by Merve Akinci (Technical Advisors, TAM). Roberto Ganau and Andres Rodriguez-Pose (London School of Economics and Political Science) are kindly acknowledged for their inputs. We also thank colleagues from the Strategic Development & Special Topics Division at the Executive Office Directorate, the Office of Evaluation and the European Cooperation & Strategy Directorate for their comments.

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Executive summary

Micro, small and medium enterprises (MSMEs) are the engines of economic growth in European countries and regions. Yet, despite the favourable macroeconomic climate and abundant liquidity of recent years, many European MSMEs struggle to access sufficient capital. In Europe, where MSMEs rely primarily on bank credit for their financing, information asymmetries between banks and firms often lead to credit rationing. The ensuing capital misallocation forces some of the most innovative and productive firms to forego profitable and productivity-boosting investments. As a result, countries and regions dominated by relatively inefficient financial markets generally struggle to transform latent economic potential into economic activity and productivity growth.

Moreover, firm size, credit rationing and its negative returns on firm productivity may be related to the context in which firms are located and operate. While the literature confirms that macroeconomic, regulatory and institutional variables at national level all play an important role in firm performance, the unequal distribution of MSMEs in European regions and the persistently high territorial inequalities that exist suggest that subnational differences also matter.

This technical brief presents the main findings of an empirical analysis[1] that examines the relationship between credit constraints, firm-level economic performance in terms of labour productivity, and institutional quality measured by the perception of corruption, quality and impartiality of education, public healthcare, and law enforcement in different European regions. The key contribution of this research involves blending the literature on the economic returns of credit constraints on firm-level labour productivity with the literature covering regional institutional quality, in order to evaluate whether and to what extent subnational institutional quality represents a factor attenuating or exacerbating the negative labour productivity returns of inefficient financial markets. Our empirical analysis covers a sample of 22,380 manufacturing firms from 11 European countries during the period 2009-2016.

The empirical results of our analysis highlight the following points:

- Credit rationing is rife in Europe, which corroborates a broadly shared view concerning the existence of a significant MSME financing gap.
- Poor access to finance represents a serious barrier to improvements in firm-level labour productivity, and this effect is far greater for micro and small firms than for larger ones.
- High-quality regional institutions – defined and measured in terms of impartiality, low corruption and high quality of public service delivery – foster labour productivity and help mitigate the negative credit constraints-labour productivity relationship that limits the economic performance of European firms.
- The positive effect of high-quality regional institutions on labour productivity is greater for smaller firms than for larger ones

Dealing with the European productivity conundrum thus requires paying greater attention to the credit constraints faced by micro and small firms. International financial institutions, such as the Council of Europe Development Bank, contribute to addressing this important market failure and can make a huge difference in terms of mobilising local potential and increasing the productivity of local MSMEs. However, in many European countries, much greater economic benefits could be reaped if better access to credit were accompanied by improved institutional quality.

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[1] This technical brief was prepared by Monica Brezzi and Kristina Maslauskaite (CEB Technical Assessment & Monitoring Directorate) on the basis of the paper by Brezzi, M., Ganau, R., Maslauskaite, K. and A. Rodriguez-Pose (2019) titled "Credit Constraints, Labour Productivity and the Role of Regional Institutions: Evidence for Manufacturing Firms in Europe" (under review for publishing).

1. Introduction

Micro, small and medium enterprises (MSMEs)[2] are the engines of economic development and employment all across Europe. According to the European Commission, MSMEs provide two thirds of all private employment and have created 85% of all new jobs in the past five years. MSMEs are at the heart of inclusive growth as they create economic and social opportunities at both national and regional level. They also play a key role in fostering the spirit of entrepreneurship and productivity-boosting innovation, not only within technological start-ups, but also in other industrial and service-oriented sectors.

However, European MSMEs face a number of challenges that can limit their establishment choices and their growth, and even threaten their very survival. While large multinational companies often benefit from easier access to international markets and accumulated in-house expertise in terms of regulations, lobbying and commercial practices, smaller enterprises have to navigate business opportunities and constraints with stretched internal resources.

Among the challenges such firms face, access to capital is one that can determine the opportunities they have to start up and/or to scale up their business. Yet, even in today's environment of low interest rates, many smaller companies still face credit constraints due to two main factors. On the one hand, banks may not have complete, verifiable information about smaller companies and are constrained by financial regulations in terms of their risk-taking behaviour. On the other hand, many MSMEs lack sufficient collateral to back potential loans. As a result, MSMEs with profitable business projects may not obtain adequate financing to develop their business to its full potential. To remedy this situation, many national promotional banks and international financial institutions, including the Council of Europe Development Bank, are working towards improving MSMEs' access to finance in Europe (Box 1).

Box 1: CEB support to MSME job creation and preservation

The CEB has been providing loans to intermediary financial institutions to create and maintain jobs in MSMEs since 1968, when the first MSME intermediated loan was approved. As of the mid-1990s, CEB support to this sector became a major pillar in the Bank's activities. In 2018, the CEB approved € 1.1 billion for MSME financing, while the total CEB funding of MSME loans over the period from January 2010 to September 2019 amounts to over €8.5 billion. This funding enables MSMEs to start up new or expand existing businesses by capitalising on new technologies, innovation and process optimisation, including energy efficiency improvements.

The CEB's programme loans to local commercial banks, national and regional development (and/or promotional) banks, leasing companies and microfinance institutions aim to provide vital resources in support of job creation and preservation through the partial financing of productive investments (and in certain cases working capital) in MSMEs. For smaller companies, asset-backed financing (e.g. leasing, factoring, purchase-order and warehouse receipt finance, etc.) is often the only form of investment finance they can access and the funding the CEB provides to leasing companies is highly effective in reaching out to this particular segment. Microfinance projects supported by the CEB are particularly targeted to micro enterprises, start-ups and to vulnerable populations (such as youth, women and refugees, among others) with the aim of stimulating employment generation, promoting financial and social integration, and reducing inequalities.

[2] Micro, small and medium enterprises (MSMEs) are defined in EU recommendation 2003/361 by their staff headcount and turnover or balance-sheet total. In terms of employees, micro enterprises have fewer than 10 staff, small enterprises between 10 and 49, and medium enterprises have fewer than 250.

Many research articles explain why some firms are more credit constrained than others and how access to credit affects the real economy at national level. This technical brief summarises the main results of an empirical analysis which explores these relationships at subnational level to reflect significant regional inequalities in Europe. We also focus on the role of local institutional quality as a determinant of a firm's labour productivity in the presence of credit constraints. To what extent do smaller European firms suffer from constrained access to credit in the different European regions? Are these constraints reflected in firm labour productivity and hence the real economy? Can a favourable institutional environment attenuate these effects?

2. Related literature on MSME credit constraints and labour productivity

Inclusive regional development is one of the key objectives in Europe today because, despite economic growth and convergence at national level, regional inequalities have either stalled or widened in the past decades (Iammarino et al., 2019). Failure to ensure sufficient economic opportunities in less developed regions leads to migration of the most mobile, further exacerbating geographic inequalities and fuelling discontent in those who stay, who then frequently turn to populist parties (Dijkstra et al. 2019). MSMEs are crucial to ensuring more balanced regional development and employment generation, especially in less developed regions because of their low capital requirements. However, they often face many difficulties, including a lack of access to finance, which hinder their establishment, growth and even survival. This section provides a very short literature review of credit constraints in Europe, their potential impact on firm productivity, and the role played by local context.

2.1. Credit constrained MSMEs in Europe

Access to finance remains one of the key challenges facing European MSMEs, even in the current environment of abundant liquidity and sluggish economic growth. Smaller companies in Europe are particularly dependent on banks, which provide almost three quarters of their external financing. Yet, the demand for bank finance remains unmet: recent estimations point to a €400 billion bank-financing gap for European MSMEs (Eurler Hermes, 2019).

Why would smaller and younger firms find it particularly difficult to obtain bank loans for their projects? Firstly, banks know that young firms can be risky: in Europe only less than half of all newly established companies reach their fifth anniversary (Eurostat, 2018). Smaller firms are also less diversified and therefore more volatile than large firms (Rajan and Zingales, 1995; Fama and French, 2002). Secondly, younger and smaller firms are more informationally opaque and have fewer options to signal their performance, which results in "information asymmetries" between firm managers and the banks. In addition, younger and smaller firms may not (yet) have established long-term relationships with banks, which could provide reassurance to the banks by facilitating the accumulation of "soft" information (Berger and Udell, 2002). Thirdly, and most importantly, small companies frequently lack sufficient collateral to back their loans, while banks need to comply with strict regulatory requirements (notably Basel III), preventing them from increasing their exposure to non-collateralised debt.

These market imperfections often result in higher interest rates for MSMEs. On the one hand, as small firms are more difficult to assess and monitor than larger companies, MSME loans can be costlier for banks in relative terms whereas their loan amounts are smaller. On the other hand, banks need to price the risks associated with small companies, in general, and the risks that they cannot measure, in particular. Higher interest rates that do not clear the markets lead to the credit rationing of some profitable investments (see seminal work by Stiglitz and Weiss, 1981).

MSMEs in Europe are faced with various forms of credit rationing: for instance, in 2016, the median interest rate charged to European MSMEs was 32.7% higher than the rate charged to large enterprises (OECD, 2018). In addition, MSMEs are also rationed in terms of the quantity of financing made available to them. Many MSMEs do not even apply for a bank loan because they lack information and/or capacity, or simply get discouraged by lengthy procedures. Finally, MSMEs find it difficult to

obtain long-term credit because shorter loans allow banks to better monitor firm performance and adjust the terms of contracts (Rajan, 1992; Diamond, 1991).

2.2. Why location matters

European MSMEs operate under very different conditions depending on their location, which determines the performance of firms. Certain environments provide more fertile soil for MSME development both at national level and in different regions of the same country. It is particularly interesting to note the (persistently) unequal distribution of MSMEs throughout Europe. Within-country regional variations in MSME density are greater than across-country differences: the number of MSMEs per capita is five to six times higher in Sweden and Belgium than in Romania and Greece, while it is seven times higher in Lombardy than in Calabria (Italy) and eight times higher in the Bucharest region than in the Romanian region of Sud-Vest Oltenia (Nistotskaya et al., 2015).

The economic literature has examined a number of external factors that affect MSME performance in different geographic zones. Different macroeconomic and regulatory conditions can have a direct impact on a firm's ability to set up and/or scale up as well as indirect effects through the availability of external finance. In effect, credit constraints are unequally distributed in Europe: today MSMEs in countries where recovery from the 2008 crisis was slow, such as Hungary or Italy, have lower chances of obtaining credit than those in Germany or France (OECD, 2019). The fundamental consequence of credit rationing for firms is that they have to rely on (often limited) internally-generated resources for productivity-boosting investment projects – such as the accumulation of physical and human capital and the adoption of new technologies – or forego them altogether, thereby hindering their ability to grow or even their very survival (Beck et al., 2000; Redmond and Van Zandweghe, 2016; Love, 2003; Guariglia, 2008, Ganau, 2016).

A more recent research strand of literature emphasises the role of institutions (both formal, such as legal and tax systems, and informal, such as national culture and socially shared values) in determining firms' behaviour, in general, and their financing decisions, in particular. Impartial and efficient governments can boost firm productivity by, for example, guaranteeing market competition, a transparent and fair juridical system, the enforcement of contracts, the protection of property rights, and the fight against corruption. By contrast, a higher level of corruption within the law creation and enforcement system is associated with more financial constraints (Djankov et al,. 2003). In more corrupt environments, firms may have higher incentives to work informally and, as a result, struggle to access bank credit. In addition, weak legal protection of creditors through laws to repossess collateralised assets will result in high interest rates, especially for riskier MSMEs.

3. Data and empirical analysis

The key contribution of this paper involves blending the literature on the economic returns of credit constraints on firm-level productivity with the literature covering regional institutional quality, in order to evaluate whether and to what extent subnational institutional quality represents a factor attenuating or exacerbating the negative labour productivity returns of inefficient financial markets. We focus on the subnational level, as variations in governance and institutional quality in Europe remain large (Tomaney, 2014). Differences in regional institutional quality in Europe and beyond have attracted considerable attention in recent years and have been used to explain persistent regional differentials in economic performance (Charron and Lapuente, 2013; Rodríguez-Pose, 2013; Ketterer and Rodríguez-Pose, 2018).

Our empirical analysis employs a sample of 22,380 manufacturing firms observed over the period 2009-2016 in 11 European countries – Belgium, Bulgaria, Czech Republic, France, Germany, Hungary, Italy, Portugal, Romania, Slovak Republic and Spain (see Box 2 for more information on the dataset).

Box 2: Dataset used in the analysis

The firm-level dataset is drawn from the *Amadeus* database (Bureau van Dijk), which provides balance-sheet data and personal information for European firms. For our analysis; we used a sample of manufacturing firms in 11 European countries – Belgium, Bulgaria, Czech Republic, Germany, France, Hungary, Italy, Portugal, Romania, Slovak Republic and Spain. The firm-level dataset is constructed following a series of steps aimed at maximising the sample size and stratified to ensure cross-country and within-country representativeness. Real investments in tangible fixed assets and capital stock are estimated using the Perpetual Inventory Method (PIM) for the years 2009-2016. The sample is representative of firms active in the 11 countries, their industrial sector, sub-national location and size.

The data on region-level institutional quality are derived from the European Quality of Government Index (EQGI) dataset, developed by the Quality of Government Institute of Gothenburg University, where it is defined as "a multi-dimensional concept consisting of high impartiality and quality of public service delivery, along with low corruption". The EQGI dataset is constructed using citizen surveys conducted in 2010 (with 34,000 individuals surveyed) and 2013 (84,000 individuals surveyed), which a focus on perception and experience with respect to corruption, quality and impartiality in terms of education, public healthcare, and law enforcement. Following the approach originally proposed by Charron et al. (2014, p. 83), the survey questions are adapted to, and interpolated with, the dimensions of government effectiveness, control of corruption, rule of law, and government accountability also available at country-level in the Worldwide Governance Indicators (WGI) dataset for the period 1996-2017 (Kaufmann et al., 2010). As underlined by Charron et al. (2014), the interpolation of the region- and country-specific indicators presents some advantages: first, it makes it possible to extend the temporal dimension of the regional institutional data to the entire period of analysis (2009-2016); second, it captures country-specific dimensions – legal system, immigration, trade, security, among others – which are not accounted for by the regional data; finally, it relaxes potential biases affecting the regional data that may be induced by the limited number of respondents per region.

The EQGI has addressed an important gap in the measurement of the relevance and influence of institutions at subnational level. It has helped overcome the absence of – and frequent controversy linked to – objective institutional indicators. It has rapidly become the most widespread measure of institutional quality in recent years, with the data being used regularly in scientific research and, increasingly, as a basis for detailed analyses feeding into policies.

The aim of our empirical analysis is to evaluate, first, the extent to which firms included in the sample suffer from credit constraints and, second, the extent to which the presence of credit constraints represents an important obstacle to firm-level economic performance (defined in terms of labour productivity). Furthermore, it assesses whether the link between credit constraints and firm-level economic performance is affected by the quality of regional institutions (see Box 3 for more information on our empirical approach).

In the absence of any direct information on the credit-constrained status of individual firms (such as information on whether an individual firm was denied credit), firm-level credit constraints are proxied by the investment-to-cash flow sensitivity. The rationale is that firms affected by credit constraints have to rely on internal resources to finance new investments and, thus, additional cash flow can enable

them to optimise real investments. Although investment-to-cash flow sensitivity may not always be a perfect proxy for credit constraints (Kaplan and Zingales, 1997), it has been widely adopted in the financial empirical literature since the seminal work of Fazzari et al. (1988).[3]

Box 3: Empirical approach

The empirical approach used in our analysis consists of a system of two equations. The first-step equation estimates the extent to which firms suffer from credit constraints, proxied by the investment-to-cash flow sensitivity. The second-step equation of the model specifies firm-level labour productivity as a function of the estimated credit constraints (from the first-step equation), the region-specific variable for institutional quality, and an interaction term between the two variables, in addition to a series of firm- and region-specific control variables, and fixed effects. The explanatory variables show whether a firm's performance is held back by credit constraints, and whether a firm's labour productivity depends on institutional quality. The interaction term evaluates whether any related credit constraint-related shortcomings in firm-level labour productivity are affected by the quality of regional institutions.

The econometric approach employs a two-step System Generalised Method of Moments estimator for the first equation, and a two-way fixed-effect model estimator for the second equation. A number of robustness tests were conducted in order to deal with potential endogeneity issues and to assess the solidity of the results. These tests fully corroborate the empirical results.

4. Four main results from the empirical analysis

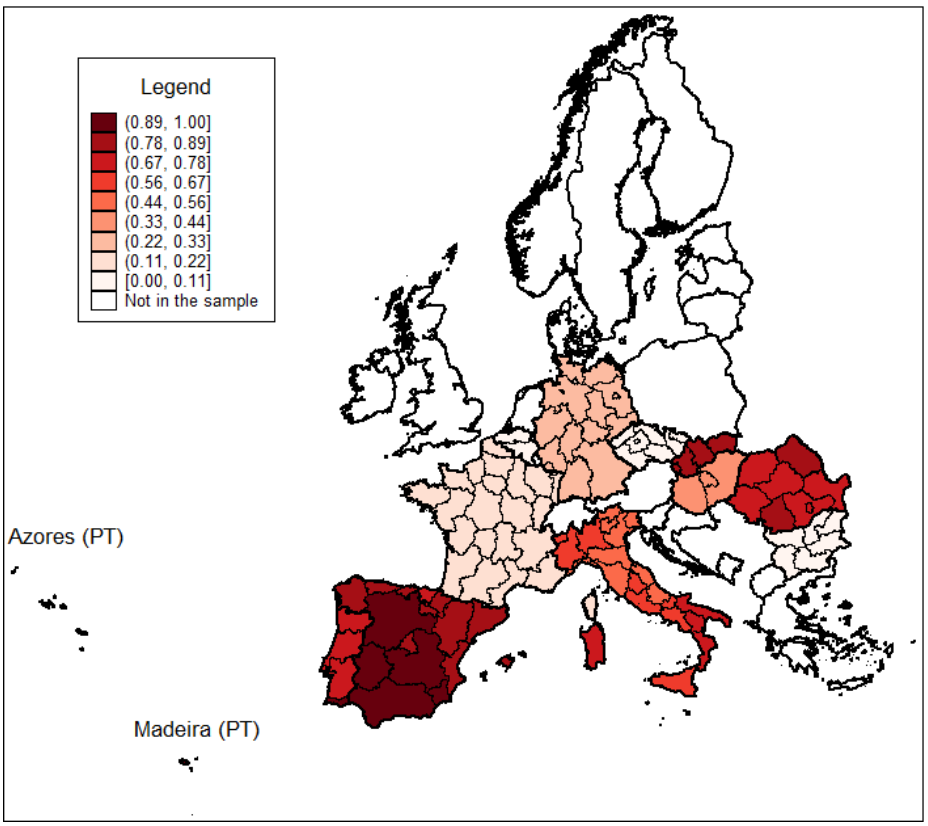
This section presents the four main findings from our empirical analysis. We corroborate the results of previous research showing that credit rationing persists in many European regions and disproportionally affects smaller firms. We also find evidence that institutional quality matters for the relationship between credit constraints and firm-level labour productivity, which is again more pronounced for smaller firms.

4.1. Credit rationing is rife in Europe

The results indicate that firms in the sample countries suffer from restrictions in the credit market, proving the existence of a significant MSME financing gap in Europe. However, not all countries are equally affected by this gap. On average, firms in Belgium, Germany and France have relatively low levels of credit constraints, while Spain, Portugal, Romania and the Slovak Republic display very high values for their average estimated investment to cash flow sensitivity. In general, credit constraints emerge more as a national rather than a regional phenomenon, but the differences in levels of credit rationing among regions are rather more marked in Italy, Portugal, Romania and Spain (Figure 1).

[3] See for example Biddle and Hilar, 2006, Cleary et al., 2007, Lyandres, 2007

Figure 1: Regional average firm-level credit constraints (estimated).



Notes: The time-averaged region-specific investment-to-cash flow sensitivity measure has been standardised between 0 and 1: the level of institutional quality in a region increases with the value of the variable. The darker the shade, the higher the value of the estimated credit constraints.

4.2. The negative effects of credit constraints on labour productivity are greater in micro and small firms

Labour productivity in manufacturing MSMEs is impaired by credit constraints. As expected, credit rationing harms the capacity of firms to innovate and compete in the market and, consequently, hinders their labour productivity. Our empirical results confirm the (statistically significant) negative relation between credit constraint and labour productivity for all sizes of firms.

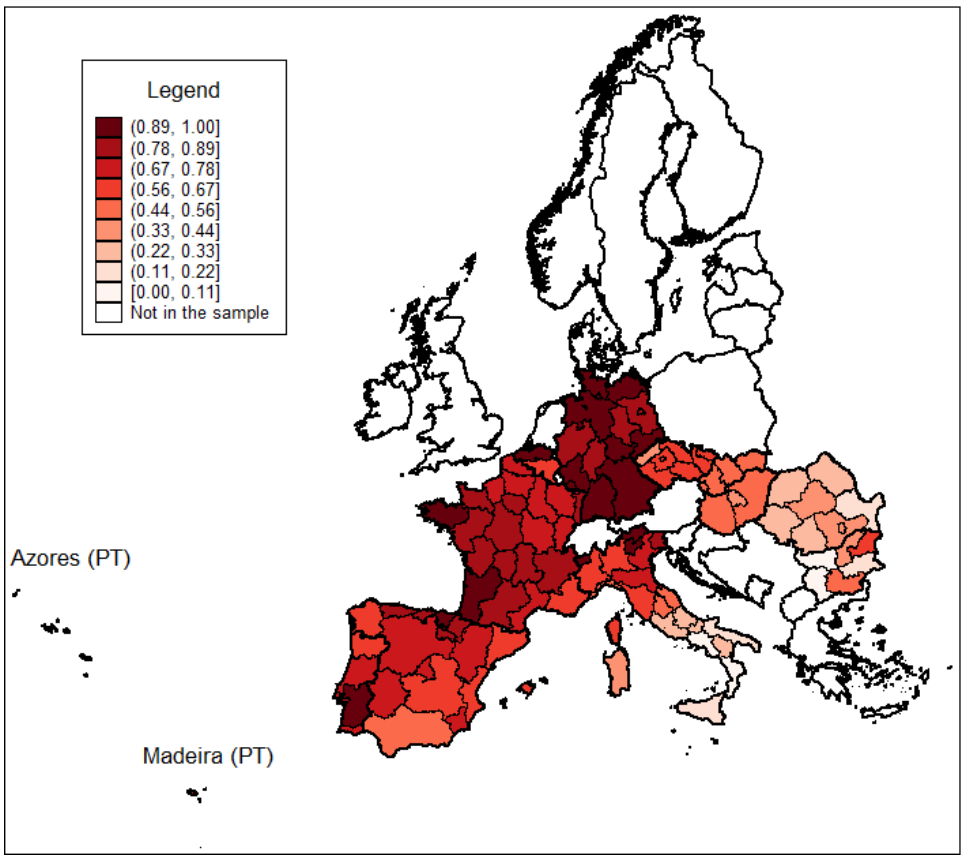
The analysis also shows that micro and small firms are particularly affected by limited access to finance. On the one hand, as predicted by economic theory, smaller enterprises experience credit rationing to a greater extent than larger firms.[4] On the other hand, the negative impact of credit constraints on labour productivity is, on average, two and a half times higher for micro firms than for large firms.

4.3 High-quality regional institutions support firm labour productivity and alleviate the negative impact of credit constraints

The data used in our empirical analysis shows remarkable differences in institutional quality both within and across countries. German regions have, on average, the best institutional quality among the 11 countries in the sample and a relatively homogeneous within-country structure. In contrast, Italy has low overall regional government quality and far more marked internal heterogeneity in institutional settings (Figure 2).

[4] The magnitude of the coefficient of the cash flow variable in the investment equation decreases from about 0.36 for micro firms, to about 0.25 for large firms.

Figure 2: Spatial distribution of the institutional quality index



Note: The institutional quality index has been averaged over the period 2009-2016, and then standardised from 0 to 1. The higher the value of the index – i.e. the better the institutional quality in a region – the darker the shade.

Our empirical analysis shows that regional institutional quality is positively and significantly associated with labour productivity: a high-quality local institutional context represents an asset for firm-level economic performance. In addition, good local institutions can, to a certain extent, attenuate the negative impact of credit constraints on firm-level labour productivity. A possible explanation for this indirect role played by high-quality regional institutions is that they increase trust and reputation among local firms, which, in turn, are more inclined to grant better contracts and deferred payments that help boost supply-chain financing opportunities, thereby alleviating the credit restrictions encountered in the financial market. Developing technology gives supply chain finance providers – who historically used to work with fewer suppliers – the possibility of reaching many other smaller suppliers that would otherwise find it difficult to access financing.

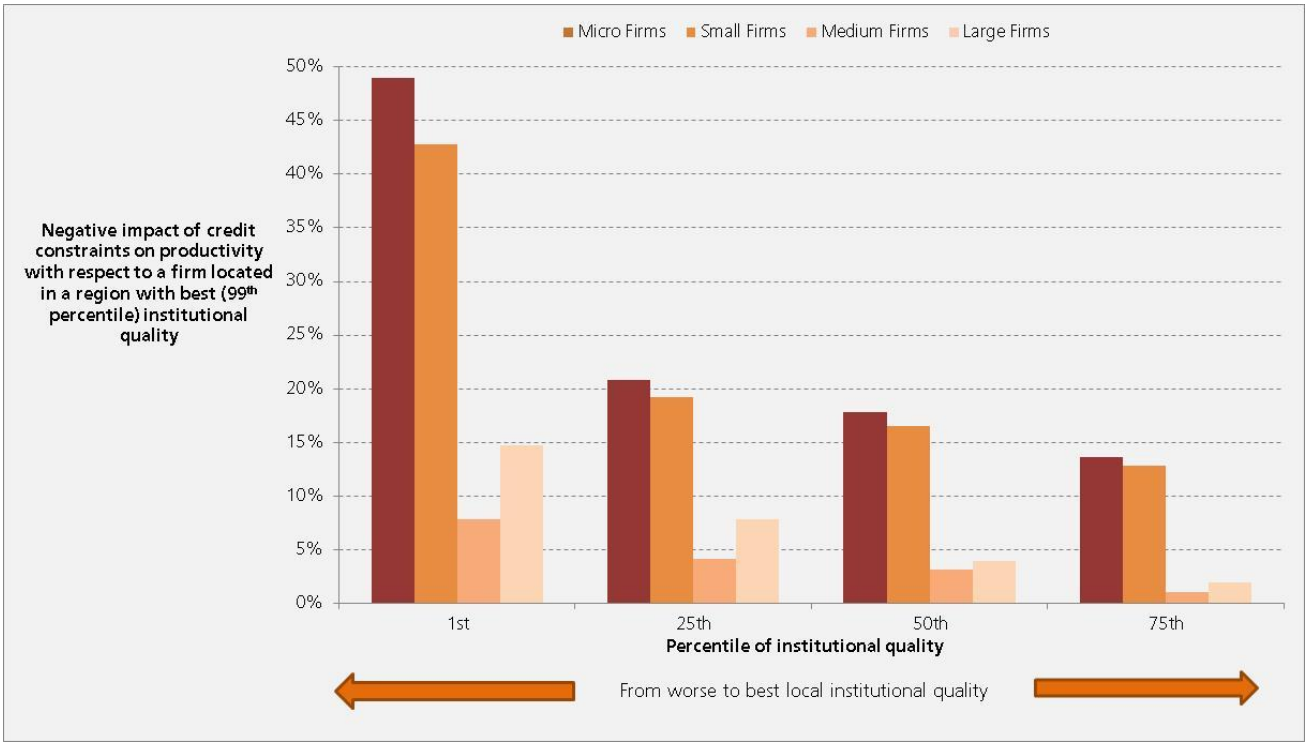
4.4 The positive effect of high-quality regional institutions is greater for smaller firms than for larger ones.

The direct impact of institutional quality on firm labour productivity and, indirectly, on the lack of credit, is significantly different across firm size categories. Poor institutional quality has a much greater effect on the impact of credit constraints on firm-level labour productivity for micro and small firms than for medium and large firms. For example, the negative impact of credit constraints on labour productivity for the average micro and small firm located in a region at the bottom of the scale in terms of government quality is almost 50% and 43% higher respectively than for the average micro and small firm in a region at the top of the scale,. By contrast, for medium and large firms this difference amounts to only 8% and 14% respectively (Figure 3).

Overall, the negative impact of credit constraints on labour productivity is almost three and a half times greater for a micro firm located in a region with the worst institutional quality than for a large firm in a region with the best institutional quality. As a result, good local institutions can attenuate the negative impact of credit constraints, meaning that micro and small firms would not only have greater access to credit if they were located in a region with good institutional quality, but would also be in a better position to transform credit into higher labour productivity.

However, it should be noted that, although good institutions mitigate the negative impact of lack of credit, they do not suffice to compensate for the fact that credit constraints remain a fundamental barrier for the economic dynamism of firms, especially the smallest ones.[5]

Figure 3: Ratio of negative impact of credit constraint on labour productivity by firm size and level of institutional quality (%)



5. Conclusions and implications

Credit constraints have long been deemed to be a major obstacle to firms thriving. Scarce credit limits the potential of firms to develop new ideas, to implement them, to grow and, finally, to acquire the capital and the labour force necessary to keep up with changes in demand. In particular, micro and small firms suffer from credit constraints because of the high fixed costs for financial institutions to evaluate and service them, frequent lack of collateral, and regulations limiting bank exposure to uncollateralised loans. However, the extent to which credit constraints affect firm-level performance, in general, and that of micro and small firms in particular, remains poorly understood. There has been only limited research into the question of how place-based credit constraints affect the capacity of individual firms to finance growth projects, and no research investigating the extent to which the institutional quality in different places affects both access to finance and, as a consequence, the labour productivity of individual firms. This paper has addressed both these issues by examining changes in labour productivity in manufacturing firms across 11 different European countries between 2009 and 2016.

[5] In the econometric model, the relationship between labour productivity and credit constraints remains negative at all levels of the regional institutional quality variable, but its magnitude diminishes as the quality of local institutions improves, for firms of all sizes.

The results of our analysis indicate that manufacturing firms in the sample countries suffer from restrictions in the credit market which remain a fundamental barrier for the economic dynamism of firms and, especially, of those at the bottom end in terms of size. Local institutional quality emerges as an important factor behind both the availability of credit and the impact of credit constraints on firm labour productivity. Good local institutions can alleviate the negative impact of credit constraints. Improving the quality of local institutions would therefore not only imply an improvement in access to credit for smaller firms, but would also limit the negative impact of credit constraints on their labour productivity.

The results highlight the fact that schemes aimed at supporting the capacity of commercial banks and other financial institutions to lend to MSMEs, including financing by multilateral development banks such as the CEB, address an important market failure and can contribute to mobilising local potential and to increasing innovation and labour productivity. Admittedly, providing affordable funding for MSME lending through financial intermediaries alone may not ensure outreach to the least developed regions, given that constraints arise from other limitations on the banks' side (such as the obligation for banks to abide by the regulatory requirements related to uncollateralised lending and limited risk appetite). International financial institutions should consider new ways, such as providing guarantees, to incentivise commercial banks to service small firms across all national territories, especially since many of the banks in Europe are currently undergoing concentration and downsizing, mostly by closing unprofitable branches in sparsely populated remote regions.

In addition, support to microfinance institutions is particularly relevant as they provide funding to the smallest firms, which, as our analysis shows, are the most credit constrained. These institutions often struggle to access affordable low-cost and long-term funding and typically require external financial support for loans and additional services for micro entrepreneurs (see Brun et al., 2019). To this end, the CEB provides guarantees to help mitigate the presumably high credit risks of microfinance institutions and, in some cases, to finance complementary activities, including "soft measures" such as entrepreneurship training for end-beneficiaries.

However, as our analysis suggests, in regions with lower institutional quality, incentivising financial institutions to lend to small firms is, on its own, far from sufficient. Weak government quality, pervasive corruption, or low levels of transparency and accountability do not only affect the capacity of firms to operate in the market, but also limit access to funding. Measures to facilitate access to credit need to be complemented with actions to improve institutional quality, as both factors together are far more effective in reducing credit constraints and improving the labour productivity and competitiveness of European firms.

The IFIs may have a limited role to play in changing the local institutional environment, but their direct involvement with local authorities can act as a catalyst for change. By developing partnerships with subnational governments across Europe, the CEB is already leveraging resources, expertise and technical assistance to strengthen institutional capacity. For example, the CEB's technical, operational and financial know-how provides valuable support to subnational authorities, in particular those who may have limited internal capacity for preparing and implementing projects, and enhances their monitoring capacity, which is a pre-condition for mobilising additional finance. Additional measures to enhance local knowledge, transparency and accountability could lead to positive outcomes in terms of MSME performance and hence regional and national growth.

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