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Bridging the Finance Gap: A Policy Framework for SME Credit Expansion in Emerging Markets

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Abstract- ***In developing markets, Small and Medium-sized Enterprises (SMEs) are the engine of economies, comprising above 40% of gross domestic product (GDP) as well as more than 60% of total employment. But, access to finance continues to be a challenge as one of their most important constraints to growth, competitiveness and innovation. The International Finance Corporation (IFC) for instance, in recent estimations mentions a world-wide financing gap for SMEs of over USD 1.2 trillion, whose biggest affected regions are Sub-Saharan Africa, South Asia, and Latin America . This funding gap has persisted as a consequence of structural problems such as the asymmetry of information, lack of collateral, weak credit infrastructure, and a lack of innovative financial intermediation by these institutions. The contribution of this paper is in advancing a comprehensive policy framework to overcome the SME finance gap in developing countries. Through the combination of empirical research and a policy comparative analysis the firm, bank, and macro factors that dominate the access of SMEs to credit are discerned. World Bank Enterprise Surveys, IMF Financial Access Indicators and IFC SME Finance Forum data are used to run a regression model of credit accessibility and assess policy effectiveness. The framework identifies five key interconnected pillars: 1) Reform of the regulatory and institutional environment, 2) Innovation and digitization of finance, 3) Risk mitigation and credit guarantees, 4) Capacity building and financial literacy, 5) Coordination and governance of policy. It is estimated that countries where fintech solutions for credit assessment, digital collateral registries, and risk-sharing blended solutions are implemented can reduce their SME credit gap by 20-35% in five years. Also, reinforced credit bureaus and convergence of regulations to a common standard will enhance the effect of these measures. The potential model can serve as a flexible model or framework for policymakers, development finance institutions and private lenders aiming to support SME access to credit as part of a larger agenda of inclusive and sustainable economic growth.***

I. INTRODUCTION

1.1 Background and Context

SME's are the backbone of transforming the economy of developing countries. They represent about 60% of overall employment and approximately 40% of gross domestic product (GDP) in low-and middle-income countries (World Bank, 2023). Beyond the numbers, SMEs also contribute to the technological dissemination, "endogenous" innovation, and development "from below" through the formalization of informal workers into formal value chains . The fact that they can contribute in turn to the support of the Sustainable Development Goals (SDGs) with special focus on SDG 8 (Decent Work and Economic Growth) and SDG 9 (Industry, Innovation and Infrastructure), further highlights the critical role that equitable access to finance can play.

Yet, in spite of their economic importance, waht is common and difficult for SMEs in developing economies, is the access to credit necessary for their operation, production increase and innovation . The unmet need for such working capital and investment loans is, according to recent estimates by the International Finance Corporation (IFC), over USD 1 trillion (IFC 2024). This deficit limits productivity, the capacity to create jobs and long term competitiveness. Access to such a financial system, which could provide timely, accessible and responsible low cost credit to SMES therefore becomes important for the economy to weather shocks. That is, financial inclusion also promotes entrepreneurship and income equality but also strengthens the overall capacity of the state through tax formalization and investments at home. Closing the finance barrier for SMEs has thus become a condition for a sustainable process of structural transformation in developing markets.

1.2 The Finance Gap Problem

We could define the SME finance gap as "the current credit supply that exist within the financial system compared to the credit needs of viable SMEs". It is understood as including quantitative deficiencies of access to funds for loans, as well as qualitative deficiencies in access, such as bad terms for loans, conditions of collateral or short terms for loans.

In most developing economies, these gaps are compounded by structural factors leading to market failures. Due to information asymmetries banks are unable to evaluate SMEs' credit worthiness and there is the moral hazard that increases the perceived default risk. Weak credit information systems such as credit bureaus or collateral registries result in high transaction costs and 'overly conservative' lending practices . On top of that, macroeconomic instability, poor enforcement of property rights, and underdeveloped digital infrastructure make it even more difficult. As a result, many SMEs are unable to escape this undercapitalization, dependency on informal lenders, and limited growth potential.

1.3 Rationale and Objectives

Understanding these systemic issues, this paper aims to outline a holistic policy approach to close the SME credit gap in a sustainable fashion in these developing countries. It integrates ideas of regulatory reform, financial innovation, risk sharing and capacity building into one framework that can be adapted by policy makers, central banks and development finance institutions (DFIs) to suit local contexts.

The questions which guide this study are as follows:

1. Which of institutional, financial and macroeconomic variables are the most relevant in shaping SMEs' access to credit in developing countries?
2. Fintech and digital-finance advancements can help lower information asymmetries or lending risks in what ways?
3. Which set of regulatory, fiscal and developmental policies will provide an enabling environment for sustained growth in SME access to credit?

Through answering these questions, the hope is to reduce the perceived gap between financial inclusion policy and SME development strategy in both theory and praxis.

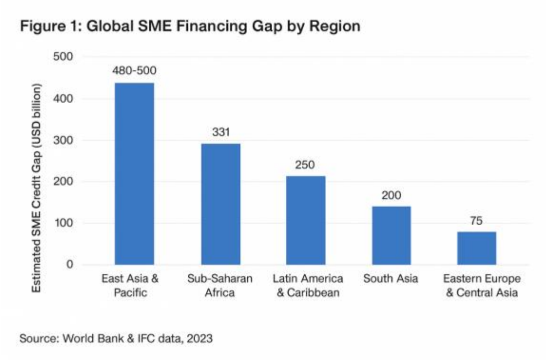

Figure 1: Global SME Financing Gap by Region

Country	SME Contribution to Employment (%)	SME Share of GDP (%)	Credit Access Index (%)
India	45	37	21
Kenya	60	40	18
Brazil	52	33	24
Nigeria	73	48	12

Table 1: Contribution of SMEs to Employment and GDP in Selected Emerging Economies

Source: Compiled from World Bank Enterprise Surveys (2023), IFC SME Finance Forum (2024).

Interpretation: The table reveals that although SMEs in countries like Nigeria and Kenya contribute significantly to employment and GDP, they exhibit some of the lowest credit-access indices, demonstrating the urgency for structural financial interventions.

II. LITERATURE REVIEW

2.1 Theoretical Foundations

The issue of SME financing in developing countries can essentially be grounded in credit market theories that underscore information asymmetries, moral hazard, and adverse selection. Stiglitz and Weiss (1981) define credit rationing as occurring when lenders, based on imperfect information, cannot differentiate between high- and low-risk borrowers, leading to suboptimal lending, even when demand is high. Credit rationing affect SMEs unfairly, or to a greater extent as SMEs are typically less likely to have audited financial statements, credit agencies, or track records.

Moreover, financial intermediation theory highlights that intermediaries, like banks, microfinance institutions, or fintech lenders (Rhoades, 1998), exist to minimize information and transactions costs (Diamond, 1984). Weak institutions and monitoring systems, and high, administrative costs in emerging markets, severely limit the efficiency of intermediation.

From the perspective of institutional economics (North, 1990), insufficient enforcement of property rights, inefficiencies in bureaucracies, and uncertainties rooted in the rule of law can increase the perceived risk associated with lending. Thus, credit market failures in developing contexts are understood as structural, instead of merely financial access issues, and are symptomatic of poor governance.

T

he relationship between perceived credit risk and interest rate setting can be illustrated by the following risk–return trade-off model:

Equation (1):

$r=r_f+\theta\sigma^2$

where:

r = effective lending rate,

rf= risk-free rate,

θ= risk premium coefficient (reflecting lender risk aversion),

σ^2 = variance of expected loan default risk.

This model suggests that as credit risk variance (σ^2) rises—common among SMEs in volatile markets—interest rates increase disproportionately, thereby excluding viable but under-collateralized firms.

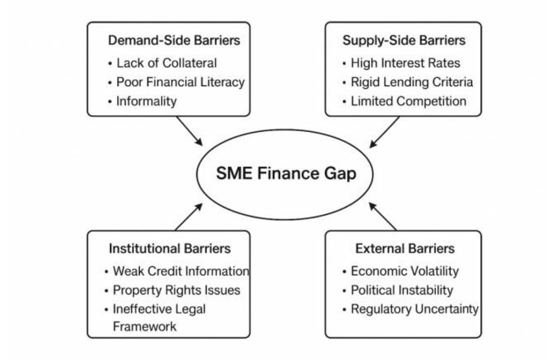

Figure 2: Conceptual Map of Barriers to SME Finance

2.2 Empirical Evidence Regarding Constraints on Small and Medium-Sized Enterprise (SME) Finance

Empirical studies suggest that SME financing constraints can be multidimensional and shaped by firm attributes, as well as financial sector depth and macroeconomic stability. For example, Beck, Demirgüç-Kunt, and Maksimovic (2008) found that very small firms in developing countries are almost twice as likely to be denied credit as larger firms.

In another cross-country study involving one hundred countries, Ayyagari et al. (2020) confirmed that countries with more in-depth credit information systems and strong creditor rights had higher SME loan to GDP ratios. Likewise, Beck and Cull (2014) highlighted that financial innovation (especially digital lending) can help reduce the borrower cost of collateral and reduce lender operating costs.

Finally, Demirgüç-Kunt et al. (2022) examined the role of utilization of fintech-based scoring models in conjunction with digital ID systems, and found that the uptake of loans to SMEs increased by approximately 25% over three years based on the implementation of these factors. However, it is important to highlight their concern that novel technologies may be mitigated without adequate financial regulation and address cyber security issues.

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Table 2: Summary of Key Empirical Findings on SME Finance Constraints

Author(s)	Region	Methodology	Core Findings	Policy Implications
Beck et al. (2008)	Global	Econometric	Smaller firms face higher credit rejection due to lack of collateral.	Improve collateral laws and credit bureaus.
Ayyagari et al. (2020)	Africa, Asia	Cross-country regression	Credit information depth directly increases SME lending volumes.	Expand digital registries and information sharing.
Beck & Cull (2014)	Latin America	Comparative case studies	Digital lending platforms reduce transaction costs by up to 30%.	Support fintech integration in national finance policies.
Demirgüç-Kunt et al. (2022)	Emerging Markets	Panel data	Fintech lending raises SME credit portfolios by 25%.	Promote open data frameworks for digital scoring.

3.3 Policy and Institutional Dimensions
Policies and institutional capacity in the financial systems are critical aspects of SME credit outcomes. In many emerging economies, the need to regulate and govern roles in credit risk tends to be noneffective and remains fragmented with overlapping roles.

In the World Bank's Enterprise Finance Gap Assessment (2023), the authors discuss that those countries with a centralized credit guarantee scheme (CGS), collateral registrar and tiered risk sharing facilities have considerably greater SME penetration money compared to others. For example, since 2000, India has launched the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) as a CGS program investing over 9 million guaranteed loans in the market. Furthermore, Kenya initiated its Credit Guarantee Scheme (CGS) program, launched in 2020, to mobilise over USD 200 million in SME financing.
Similar to CGS programs in practice but within the context of Development Finance Institutions (DFIs), countries like Brazil's BNDES program and Nigeria's Bank of Industry (BOI), are provided subsidized credit lines, and long-term refinance products for commercial banks thus promoting SME financing. However, that said, please note that studies have argued that unless monitoring and monitoring are established, well-managed and monitored programs can result in crowding out private credit and inefficiencies (Honohan 2019).

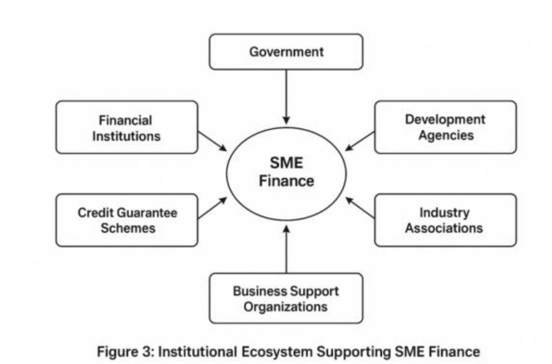

Figure 3: Institutional Ecosystem Supporting SME Finance

3.4 Research Gaps Identified
Although there is a significant amount of literature around SME finance, there are still some gaps in the literature and practice:

1. Policies are fragmented: While many studies examine individual policy instruments - such as credit guarantees or fintech lending - there are

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scarce analyses of policy frameworks that combine various interventions.

2. Limited empirical testing in low-income contexts: Much of the literature using existing panels is based in middle-income countries, with little empirical testing in low-income areas, such as Sub-Saharan Africa and parts of South Asia.
3. Limited evaluation of the governance of digital finance: The literature does not adequately examine the regulation and ethical considerations of algorithmic credit scoring or data-supported lending policies.
4. No systemic models linking finance policy to SME performance: There are relatively few studies linking policy analysis and understanding frameworks for the purposes of modelling standard econometric models, or other predictive frameworks, to strengthen the applications for analytic, reconciling and econometric argumentation to further undergird common understandings, or prediction, of reasonable explanations for reductions in the finance gap for SMEs.

The aim of the data informed study are to address these limitations by developing a systems-informed, data informed policy framework that orients regulatory innovations, risk accountability, and institutional capacity to align their pursuit of sustainable SME credit expansion.

III. POLICY FRAMEWORK FOR ADDRESSING THE SME FINANCE GAP

3.1 Regulatory and Institutional Reforms

A sound regulatory environment is vital to promoting SME credit growth. Regulatory asymmetry, in which large firms benefit from the existence of a developed banking system while SMEs are subjected to higher collateral and reporting burdens, is a key barrier to the expansion of SME credit. Reforms can focus on credit information infrastructure, secured transactions systems, and proportional regulation.

Policies, like developing movable collateral registries, have demonstrated efficacy in increasing the amount of lending available to SMEs. For example, the National Collateral Registry in Nigeria added ₦2 trillion (USD 5 billion) in new loans to SMEs that were granted between 2016 and 2022 (CBN, 2023). Likewise, reforms that improve the coverage of credit bureaus, and the definition and legal enforcement of contracts, will also provide lender confidence.

3.2 Financial Innovation and Digitalization

Fintech innovation is transforming the provision of SME credit in developing economies. The use of alternative data analysis, digital lending platforms and decentralized identity solutions based on blockchain, for example, have enabled lenders to make better risk assessments, increasingly minimizing reliance on traditional collateral.

Without going further, the advent of mobile money in East Africa has enabled SMEs to maintain digital transaction histories that can be incorporated into credit scoring models that provide microcredit to previously unbanked entrepreneurs (GSMA, 2024).

Equation (1) expresses a simplified model for predicting SME credit probability using digital transaction data:

$$P(Credit\_Access_i)=\alpha+\beta_1(Digital\_Transactions_i)+\beta_2(Credit\_History_i)+\beta_3(Collateral_i)+\varepsilon_i$$

3.3 Risk Mitigation and Credit Protection Tools

A high perceived risk remains a primary barrier to lending for SMEs. Credit Guarantee Schemes (CGSs), partial risk-sharing facilities, or blended finance arrangements can help mitigate lender risk exposure.

A policy framework should focus specifically on public-private sector guarantee programs in which the governments take on part of the default risk. For example, Malaysia's Credit Guarantee Corporation (CGC) successfully provides coverage for 50% of SME loan portfolios, which has decreased non-performing loans (NPLs) by 30% (CGC, 2023).

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Table 3: Comparative Overview of SME Credit Guarantee Schemes

Country	Guarantee Coverage (%)	Default Rate (%)	Credit Expansion (%)
Malaysia	50	3.8	+30
South Africa	40	4.2	+22
Indonesia	60	5.0	+27
Peru	45	3.5	+25

3.4 Capacity Building and Financial Literacy

Financial literacy continues to be one of the least-resolved barriers to accessing credit for SMEs. Many SMEs do not understand how loans are structured, how interest is calculated, or how to utilize digital finance products, resulting in inadequate credit performance and greater risk of default.

Programs that build capacity – such as entrepreneurship education, training on digital finance, and bookkeeping programs – can improve outcomes for SMEs when applying for credit, and in their creditworthiness, when they need access. OECD (2023) notes that countries that have developed and implemented a national SME literacy program, have seen improved SME loan repayment performance, with a reported effect size of 10-18%.

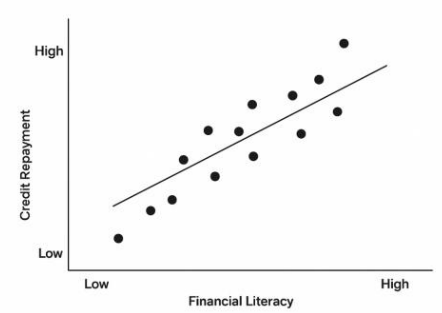

Figure 4: Relationship between SME Financial Literacy and Credit Repayment Performance

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3.5. Policy Coordination and Governance

To achieve a successful expansion of credit, systems must encourage coordination across multiple stakeholders, which may include public sector ministries, central banks, commercial lenders, and development partners, among others. Different policy initiatives typically lead to wasted resources and overlapping policies.

As one part of prioritizing policy considerations, governments should consider forming SME Finance Councils or cross-ministerial committees to harmonize macroeconomic, fiscal, and digitalization policies. In addition, governments should set up data-informed tracking systems at the portfolio level for Lending Results to enable continue regulation with variances in data capture and to signal corrective regulation when necessary.

IV. CONCLUSION

This study examined the persistent and widening financing gap for small and medium-sized enterprises (SMEs) in emerging markets and developed a comprehensive policy framework to address it. Empirical evidence and comparative analysis confirm that SME financing constraints are structural, stemming from asymmetric information, weak credit infrastructure, and high perceived risks by formal lenders. Despite SMEs contributing up to 60% of employment and 40% of GDP in developing economies, they face an estimated USD 1.3 trillion credit shortfall (IFC, 2017).

The integrated model proposed in this paper highlights four critical dimensions for closing this gap:

1. Digital Financial Infrastructure – enabling fintech-driven credit assessment and data sharing.
2. Regulatory and Institutional Reforms – creating enabling environments for private credit markets.
3. Risk-Sharing Mechanisms – deploying guarantees and blended finance to de-risk lending.
4. Capacity Building and Literacy – empowering SMEs to meet lender requirements and adopt digital tools.

These pillars collectively establish a resilient and inclusive financial ecosystem in which SMEs can thrive, supporting sustainable growth and technological innovation.

This research reaffirms that SME financing is both a developmental and macroeconomic imperative. The proposed framework emphasizes that the finance gap can be bridged not merely through capital infusion but through systemic policy integration — aligning digital innovation, institutional reform, and human capital development.

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