The study addresses the theme “Building Institutions for Sustainable Development” by analysing how competition among financial institutions providing debt finance exacerbates the availability of external finance to small and medium-sized enterprises (SMEs). In particular, it is investigated whether a strong microfinance sector is associated with reduced SME finance by the formal banking sector.

Competition from microfinance institutions (MFIs) may deter conventional banks from moving down the market to smaller loan sizes due to direct effects (competition over same customers) and indirect ones: In presence of a dominant microfinance sector, banks may not find it profitable to invest in new instruments targeting at smaller and more opaque firms; thus SMEs may fail to find follow-up finance after outgrowing microfinance and requiring larger loan sizes. Furthermore, Bateman and Chang (2012) argue that banks perceive investments into microfinance more profitable than providing (risky) SME loans, which results in diversion of funds.

My study employs secondary data from the Enterprise Surveys of the World Bank in combination with the MIX microfinance database and additional World Bank data to run cross-country regression analyses. I will both test for heterogeneous effects of firm size and characteristics of the microfinance sector as well as potential mitigating effects of credit information sharing schemes. Lastly, the analysis will comprise robustness checks and look into alternative explanation approaches that may rationalize the empirical results.

This is the first study to empirically investigate the critique of Bateman and Chang (2012). Since the effect of competition between MFIs and the conventional banking sector has only been analysed from an MFI perspective, the project – for the first time – assesses the consequences for conventional banks and their SME financing activities. Analysing the factors that mitigate the adverse effect may inform decision- and policy-makers in developing countries how changes in legislation, incentive structures and/or the institutional infrastructure of the financial system may reconcile strong MFIs with functioning SME financing.

This research thus helps to understand and overcome weaknesses of formal financial institutions in developing countries in order to create a more sustainable financial system that fosters financial deepening and associated economic development.