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## IMPACT OF FINANCING SMALL AND MEDIUM SCALE ENTERPRISES ON ECONOMIC GROWTH IN NIGERIA (1980-2016)

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### Abstract

Finance is the backbone of any business enterprises whether micro, small or big. The growth of any nation depends largely on the level of investment in the real and other sub-sectors of its economy. The objectives of this study is to examine the impact of financing small and medium scale enterprises on economic growth in Nigeria for the period 1980 to 2016. The finance led growth theory; the bank capital channel theory and the big push theory of economic development were adopted as theoretical framework for the study. Time series data collected from secondary sources was employed using Vector Auto-regression (VAR) modeling techniques to achieve the stated objectives. Unit root tests and co-integration test were conducted to examine the stationarity and long-run relationship among the variables. The regression results from VAR estimation and findings based on the impulse response function and forecast error variance decomposition revealed that financing SMEs by commercial banks had contributed significantly to real gross domestic product, Development finance institutions and foreign direct investment also significantly contributed to real gross domestic product within the study period. However, commercial banks loans impacted more on economic growth in Nigeria than development finance institutions and foreign direct investments as its contribution was well over sixty percent of real gross domestic product. We, thus, recommended that government and the monetary authorities should facilitate more loans to SMEs through risk sharing arrangements that will help mitigate risks and allow more financing by commercial banks. In addition, greater openness to foreign investments can provide long term capital that can mitigate shocks to the economy.

**Keywords:** Commercial Banks, Development Finance Institutions, FDI, Co-integration, Economic Growth

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### Introduction

Small and medium scale enterprises have been widely acknowledged to be the drivers of growth and development. Numerous studies have been conducted on small and medium scale enterprises in Nigerian and elsewhere. The few studies that emphasized on the relationship between SMEs financing and economic growth in Nigeria like that of Afolabi (2013), Imoughele and Ismaila (2014), Egbeonu (2016), Alimi and Yinusa (2016) were discovered to focus on the endogenous macroeconomic variables as finance options to SMEs while exogenous variables like Foreign Direct Investment (FDI) as another financing option to SMEs was left unenclosed. It is this backdrop that motivates this study to investigate impact of SMEs financing on economic growth in Nigeria for the

period 1980 to 2016. The research addresses the following questions: 1) what is the impact of commercial banks loans to on economic growth?, 2) to what extent does development finance institutions funding to small and medium enterprises affects economic growth?, and 3) how does foreign direct investment in small and medium enterprises affect economic growth?

The structure of the paper is as follows. After the introduction, section two deals with review of related literature, section three examines the methodology of the study, section four focuses on results and discussion and, finally, section five concludes the paper.

## Literature Review

The Keynesian theory focuses its attention on the role of economic policy in the achievement of macroeconomic objectives. The emphasize on demand management policies can and should be used to improve macroeconomic performance. Keynesian economic growth models have been elaborated to show that financing small and medium enterprises should form part of macroeconomic policies (Abata, 2016). Rosenstein (1964), argued that stages of development requires gestation period and every stage requires capital investment by the state to overcome the obstacles of development and to launch it in the path of progress. Such investment involves investment in social and economic overhead such as health, power supply, communication, roads, education and so on (Egbeonu, 2016). Although issues concerning small and medium enterprises can only be situated within the context of broad economic theory such as the Keynesian theory stated above, there are, however, several empirical studies that attempt to assess the impact of financing small and medium enterprises on economic growth.

King and Levine (1993) believed that finance led growth theory that supported the activities of the financial institutions serve as a useful tool for increasing the productive capacity of the economy. They argue that countries with better-developed financial system tend to grow faster. Onyewi (2012) says that an expansive open market operations (OMO) by the Central Bank, increases stock of money, which also leads to an increase in Commercial Bank reserves and ability to create credit and hence, increase money supply through the multiplier effect. In order to reduce the quantity of money in their portfolios, the bank and non-bank organizations purchase securities with characteristics of the type sold by the Central Bank, thus stimulating activities in the real sector such as SMEs.

Chinonye (2013) in her work discovered that, in the USA, the total number of enterprises registered as SMEs amount to 22 million generating more than half of the country's GDP, and employing over 53% of the total private work force. This shows small and medium enterprises contribute significantly to economic growth and provision of employment opportunities in the United States. Abata (2012) also revealed that Latin America has an estimated 50 million micro and small scale enterprises employing 120 million people.

Kannebley (2010)'s study on manufacturing firms in Brazil using panel data found that small and medium enterprises that engaged in technological innovation experienced higher growth in employment, net revenue, labour productivity, and market share.

In Malawi, Richard (2015) conducted a study aimed at determining whether financing micro, small and medium enterprises through the commercial banking system has resulted in any corresponding impact on economic growth between 1981 and 2014. The study also aimed to establish whether interest rate levels, which have a bearing on the access to finance have impacted on economic growth in Malawi over the same period. Ordinary Least Squares (OLS) method was used to analyze the relationships. The results show that both the levels of financing and interest rates have had a significant negative impact on growth.

In Ghana, Quaye (2011) conducted a study on the effect of microfinance institutions on the growth of small and medium enterprises in the Kumasi metropolis. The study shows that most small and medium enterprises are at their micro stages since they employ less than six people and the sector is largely dominated by the retail sub-sector.

Afolabi (2013) evaluates the effect of financing small and medium enterprises on economic growth in Nigeria between 1980 and 2010. The study employed Ordinary Least Square (OLS) method to estimate multiple regression models. The estimated models results revealed that the output of small and medium enterprises proxy by wholesale and retail trade output and commercial banks' credits to small and medium enterprises significantly and positively impact economic growth while lending rate was found to have negative effect on economic growth.

Onakoya, Fasanya and Abdulrahman (2013) examine the impact of financing small scale enterprises on economic growth using quarterly time series data from 1992 to 2009. The study adopts the econometrics techniques of ordinary least squares (OLS). The study reveals that loan to small scale entrepreneurs have a positive impact on their economic performance and conclude that access to capital or finance is necessary but not a sufficient condition for successful entrepreneurial development.

Yaqub, Adam and Jimoh (2013) examine the impact of foreign direct investment on economic growth in Nigeria using Vector Auto-regression (VAR) modeling to capture the structure of inter-relationships among relevant variables. The study shows that, over the years, the inflow of foreign capital to Nigeria has increased tremendously. It rose from N542.3million in 1981 to N2.01 billion in 2005, with the average growth rate of FDI inflows being 10.8% between 1981 and 2006. Despite the phenomenal inflow of foreign capital to Nigeria over the years, the performance of the

economy has been epileptic. The economy has remained mono-cultural, with oil contributing over 60% to GDP on average since 1990 and over 90% of export earnings. Shaw (1973),

**Methodology**

$$Y_t = C + \sum_{i=1}^p A_i Y_{t-1} + \varepsilon_t \dots \dots \dots (1)$$

Where:  
 Vector  $Y_t = f(CBL_t, DFIF_t, FDIF_t, RGDP_t)$

The study adopted Vector Autoregressive (VAR) framework of Alimi and Yinusa (2016) which formulated a relationship between real GDP and financing of small and medium enterprises through commercial bank lending, development finance institutions funding and foreign direct investment. The VAR equation is as follows:

$L$  = the lag operator,  $\bar{\alpha}(L)$  = the matrix of estimated parameters,  $t$  = years and  $\varepsilon_t$  = the error term assumed to be serially uncorrelated. Expressing the model in a functional form by taking the log of each variable:

$$\begin{aligned} \text{LogRGDP} &= \alpha + \beta_1 \text{logCBL}_{t-1} + \beta_2 \text{logDFIF}_{t-1} + \beta_3 \text{logFDIF}_{t-1} + \varepsilon_{t1} \dots (2) \\ \text{LogCBL} &= \alpha + \beta_2 \text{logRGDP}_{t-1} + \beta_2 \text{logDFIF}_{t-1} + \beta_1 \text{logFDIF}_{t-1} + \varepsilon_{t2} \dots (3) \\ \text{LogDFIF} &= \alpha + \beta_3 \text{logCBL}_{t-1} + \beta_3 \text{logRGDP}_{t-1} + \beta_3 \text{logFDIF}_{t-1} + \varepsilon_t \dots (4) \\ \text{LogFDIF} &= \alpha + \beta_4 \text{logCBL}_{t-1} + \beta_4 \text{logDFIF}_{t-1} + \beta_4 \text{logRGDP}_{t-1} + \varepsilon_t \dots (5) \end{aligned}$$

Where:  
 $\alpha$  = constant  
 $\beta$  = intercept  
 $\varepsilon_t$  = error term

To achieve the stated objectives data on all variables for the period (1980-2016) was extracted from Central Bank of Nigeria (CBN) statistical bulletin and annual abstract of statistics from National Bureau of Statistics (NBS). The basic identification scheme uses a recursive VAR model that follows the following ordering as  $(RGDP = CBL + DFIF + FDIF)$  where the contemporaneously exogenous variables are ordered first. The variable in the VAR is thus, ordered from the most exogenous to the least exogenous one. The Real GDP was ordered first so that a shock in the economic growth may have an instantaneous effect on all other variables not vice versa. However, RGDP do not respond contemporaneously to any structural disturbances to the remaining variables.

**Model Evaluation Techniques**

Prior to the estimation of the vector autoregressive, the time series property of the incorporated variables in the model was examined using the conventional unit root test. We, then, proceed to conduct co-

integration test to examine the long-run relationship between the variables. Post-estimation tests mainly; Stability and Normality tests were also conducted to ensure that the model is stable and multivariate normal. However, the study’s analysis was based on Impulse Response Function (IRF) and Forecasted Error Variance Decomposition (FEVD) to examine whether the results of the model estimation are theoretically meaningful and statistically satisfactory.

**Results and Discussion**

This section discusses the econometric regression results of the impact of small and medium scale enterprises (SMEs) financing on economic growth in Nigeria for the period of 37 years (1980 – 2016). The econometric VAR model was used in the multiple regression analysis to explain the response of the dependent variable in relation to the shocks in the independent variables of the model.

**Table 1: Summary Results of Unit Root Test at First Difference Augmented Dickey-Fuller Test**

Variables	ADF Calculated Value at Level	ADF Calculated Value at 1 <sup>st</sup> Difference	Mackinnon 5% Critical Value	P-Value	Order of Integration
CBL	-0.8164	-4.7413	-2.9484	0.0005	I(1)
DFIF	-1.7308	-5.6375	-2.9677	0.0001	I(1)
FDIF	-2.0613	-7.0548	-2.9511	0.0000	I(1)
RGDP	-1.0395	-7.3489	-2.9484	0.0000	I(1)

Source: E-Views Software Computations (2018)

**Phillips-Perron Test**

Variables	PP Calculated Value at Level	PP Calculated Value at 1 <sup>st</sup> Difference	Mackinnon 5% Critical Value	P-Value	Order of Integration
CBL	-0.8164	-4.7413	-2.9484	0.0000	I(1)
DFIF	-1.3051	-7.0613	-2.9604	0.0000	I(1)
FDIF	-1.5120	-9.8769	-2.9484	0.0000	I(1)
RGDP	-1.5284	-7.5284	-2.9484	0.0000	I(1)

Source: E-Views Software Computations (2018)

The result of the unit root test using both the ADF and PP test is presented in the table 2 above. It indicated that at 5% level of significance all the P-Values are significant indicating rejection of the null, that the series are stationary. Hence, we concluded that the series is not stationary at first difference. However, the time series indicates that all the series are integrated of order one i.e I(1) process.

**Table 2: Johansen Co-Integration Test Summary Results**

Date: 04/17/18 Time:14:09 Sample (adjusted): 5 37 Included Observations: 29 after adjustments Trend assumption: Linear deterministic trend Series: LGDP LFDIF LDFIF LCBL Lags interval(in first difference): 1 to 2						
Hypothesized No: CE(s)	Eigen values	Trace Statistic	0.05 Critical Value	Max-Eigen Statistic	0.05 Critical Value	P-Values
None	0.467892	33.07896	47.85613	18.29637	27.58434	0.4706
At most 1	0.269008	14.78259	29.79707	9.087234	21.13162	0.8253
At most 2	0.171468	5.695354	15.49471	5.454895	14.26460	0.6837
At most 3	0.008257	0.240459	3.841466	0.240459	3.841466	0.6239

Source: Extracted by the Authors using E-view

The table 3 presents the result of Johansen (1988) Co-Integration Test. The result shows that all the P-Values are insignificant at 5% level of significant which indicates acceptance of the null that there is no co-integration among the variables in the model. However, absence of stationary and long-run relationship in the series necessitates adoption of Vector Autoregressive (VAR) analysis to estimate the variables at their first difference.

**Table 3: VAR Estimation Result**

Vector Autoregression Estimates Date: 04/17/18 Time: 13:51 Sample (adjusted): 4 37 Included observations: 31 after adjustment Standard error in ( ) & t-statistics in [ ]				
	LGDP	LFDIF	LDFIF	LCBL
LGDP(-1)	0.732339 (0.20788) [ 3.52292]	-0.436542 (0.23505) [-1.85720]	-0.244009 (0.37043) [-0.65872]	-0.169427 (0.25124) [-0.67436]
LFDIF(-1)	-0.140240 (0.19912) [-0.70429]	0.200100 (0.22515) [1.01654]	0.955868 (0.35483) [2.69389]	-0.059580 (0.24066) [-0.24757]
LDFIF(-1)	0.029696 (0.11605) [ 0.25589]	0.107742 (0.13122) [ 0.82107]	0.483406 (0.20680) [2.33760]	0.032530 (0.14026) [0.23193]
LCBL(-1)	-0.170515 (0.18220) [-0.93588]	-0.127388 (0.20602) [-0.61833]	0.110270 (0.32467) [0.33963]	0.863422 (0.22021) [3.92098]
C	2.549748 (0.93822)	0.712009 (1.06088)	-1.506358 (1.67188)	2.393779 (1.13393)

	[2.71763]	[0.67115]	[-0.90100]	[2.11104]
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Source: E-Views Computations 2018

The regression result shown in table 4, shows that at lag order 1 all the variables; gross domestic product (GDP), foreign direct investment funding (FDIF), development finance institutions funding (DFIF) and commercial bank loans (CBL) to SMEs are significant in their own equations with T-statistics [3.52292], [1.01654], [2.3376] and [3.92098] respectively. This shows that each variable can be used to explain variations in today’s changes in the long rate of other variables in the model.

This is consistent with the apriori expectation. The result support the fact that increasing foreign direct investment funding, development finance institutions funding and commercial bank loans to SMEs has significant spillover effect on the SMEs output hence, economic growth in Nigeria.

**Table 4: Lag Length Selection**

VAR Lag Order Selection Criteria  
 Endogenous variables: LGDP LFDIF LDFIF LCBL  
 Exogenous variables: C  
 Date: 04/17/18 Time: 13:58  
 Sample: 1 37  
 Included observations: 31

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-89.50610	NA	0.004899	6.032652	6.217682	6.092967
1	6.018654	160.2351*	2.93e-05*	0.902022*	1.827175*	1.203599*
2	18.84313	18.20248	3.81e-05	1.106895	2.772170	1.649733

\* indicates lag order selected by the criterion  
 LR: sequential modified LR test statistic (each test at 5% level)  
 FPE: Final prediction error  
 AIC: Akaike information criterion  
 SC: Schwarz information criterion  
 HQ: Hannan-Quinn information criterion

In Table 5 the lag length selection result shows that all the three (3) lag order selection criteria namely; the Akaike Information criterion (AIC), Schwarz Information criterion (SC) and Hnnan-Quinn Information criterion (HQ) selected lag order 1 base on the sequential modified LR test statistic (each test at 5% level) as indicated by the (\*) in all the criteria at lag 1.

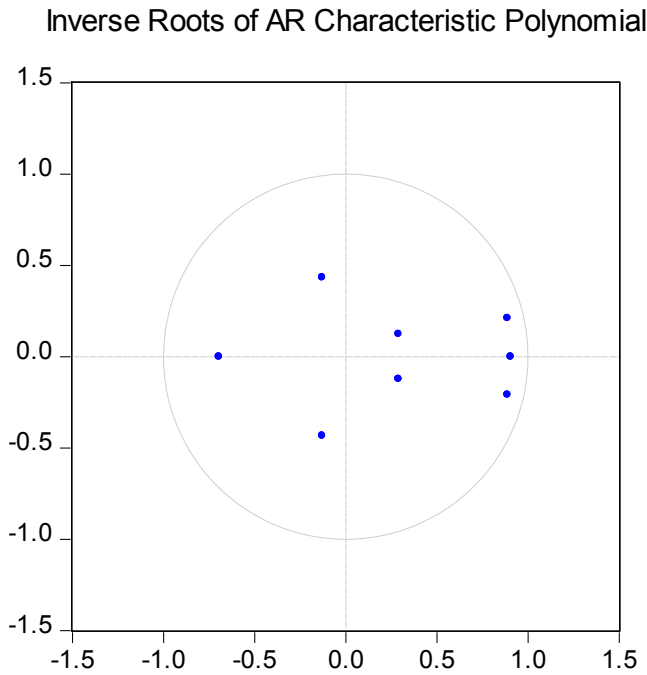
**Table 5: Stability Test Result**

Roots of Characteristic Polynomial	
Date: 04/17/18 Time: 14:00	
Sample: 1 37	
Included observations: 31	
Root	Modulus
0.887457 - 0.209871i	0.911935
0.887457 + 0.209871i	0.911935
0.905382	0.905382
-0.695317	0.695317
-0.128121 - 0.433312i	0.451857
-0.128121 + 0.433312i	0.451857
0.289653 - 0.124154i	0.315140
0.289653 + 0.124154i	0.315140

Source: E-Views Computations 2018

No root lies outside the unit circle.  
 VAR satisfies the stability condition.

**Graph**



**Fig. 1: Result of Stability Test**

The result of stability test is presented in the table 6 above. The roots of AR characteristic polynomial from both the table and graph shows that all the modulus lie within the unit circle. This shows that the VAR satisfy the stability condition.

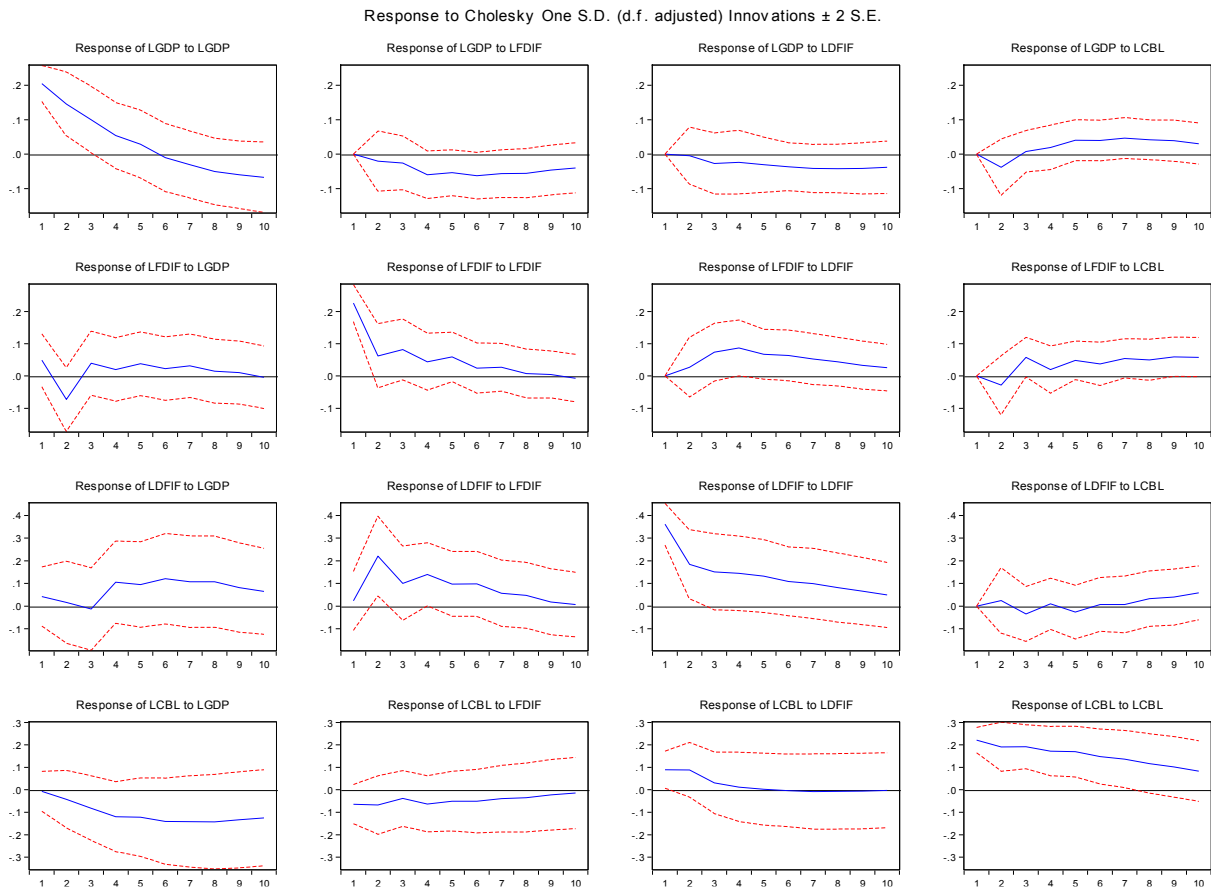
**Table 6: Normality Test Result**

VAR Residual Normality Tests			
Orthogonalization: Cholesky (Lutkepohl)			
Null Hypothesis: residuals are multivariate normal			
Date: 05/08/18 Time: 08:07			
Sample: 1 37			
Included observations: 31			
Component	Jarque-Bera	Df	Prob.
1	1.109415	2	0.5742
2	27.87453	2	0.0000
3	3.057314	2	0.2168
4	2.397751	2	0.3015
Joint	34.43901	8	0.0000

Source: E-Views Computations 2018

Table 9 above presents VAR Residual Normality Test Result. Using the Jarque-Bera table, the Joint Probability Value is less than 0.05 (0.0000). This shows that we do not reject the null. Hence, we conclude that the residual of the model are multivariate normal.

**Impulse Response Function Plot of Economic Growth**



**Fig. 2: Contemporaneous Response Of SME’S Financing**

The figure above presents contemporaneous response of SMEs financing from foreign direct investment, development finance institutions and commercial banks to Cholesky one squares variances shocks on gross domestic product. The columns present responses to GDP shocks, FDIF shocks, DFIF Shocks and CBL Shocks while the rows present their equations respectively.

The first row indicates responses of the change in GDP long rate to first shocks in the change of GDP long rate, then to the shocks in the change in the FDIF long rate then to the shocks in the change in the DFIF long rate then to shocks in the change in the CBL long rate. This implies that, we can ruled out that changes in the GDP rate is contemporaneously be affected by shocks to the FDIF, DFIF and CBL long rates and that is why the graph was forced to start at zero.

We can also see in the first column that, responses of all the four variables to shocks in the GDP rate was positive except commercial bank loan which responded instantaneously negative. This implies that except commercial bank loan, shocks in the gross domestic product have immediate positive effect to the GDP rate then to FDIF rate then to DFIF rate.

As for FDIF equation, the response of GDP to foreign direct investment funding shocks begins positively at first period, declined to negative at second period and rose up to positive at the third period and maintained slight parallel fluctuations to the last period.

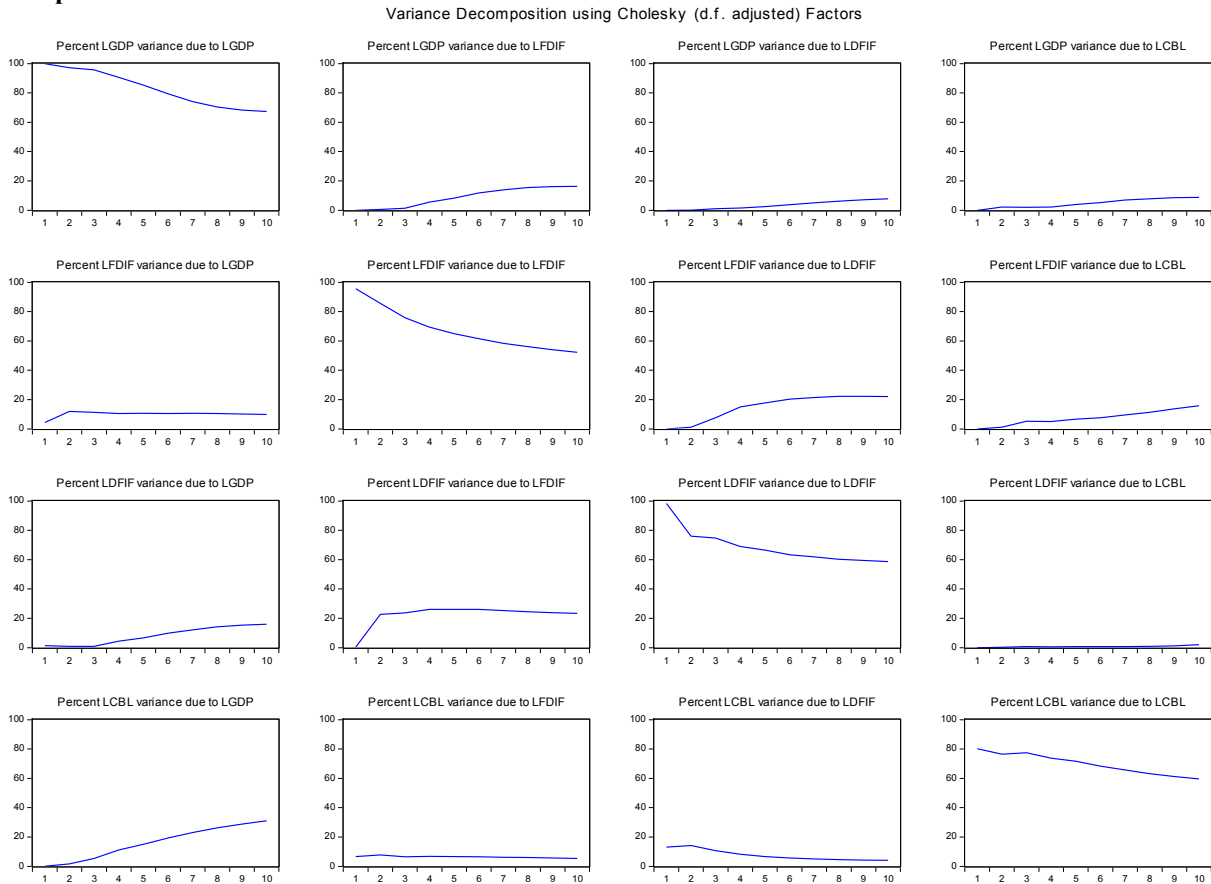
As for DFIF equation, it indicated slight positive contemporaneous response of GDP to shocks in the development finance institutions funding to SMEs from first period which declined to zero at second period but picked up highly positive at the third period which maintained horizontally up to the tenth period.

As for CBL equation, GDP shows immediate negative contemporaneous response to the shocks in the commercial bank loan to SMEs which keep widening up to the end of the period.

The result therefore, indicates that, development finance institutions funding (DFIF) to SMEs has more positive impact on the economic growth (GDP) followed by the foreign direct investment funding (FDIF). The result however, indicated that the commercial bank loan to SMEs has negative impact on the economic growth in Nigeria.

**Table 11: Variance Decomposition**

**Graph**



**Fig. 3: Variance Decomposition**

The variance decomposition separates the variation in an endogenous variable into the component shocks of the VAR model. The table 11 above presents the variance decomposition of gross domestic product from commercial bank loan to SMEs, development finance institutions funding and foreign direct investment funding to small and medium scale enterprises in Nigeria for the period 1980 to 2016. We used Cholesky Ordering of the variance decomposition assuming that all the variables are endogenous and we select 10 periods. The second column labeled “S.E” contains the forecast error of the variable at a given forecast horizon. The source of this forecast error is the variation in the current and future values of the innovations to each endogenous variable in the VAR. The other columns for each of the macroeconomic variables give percentage of the forecast variance due to each innovation, with each row adding up to 100.

The result indicates that, in the short run, that is period 3, impulse or innovation or shock to commercial bank loan (CBL) to SMEs account for 94.04% variation of the fluctuation in the commercial bank loan (own shock), while development finance institutions funding (DFIF), foreign direct investment funding (FDIF) and real gross domestic product (RGDP) contribute 1.60%, 0.26% and 4.08%, respectively. In the long run, that is period 10 own shock contributes 65.66% variation of the fluctuation in CBL, while DFIF, FDIF and RGDP can contribute 8.44%, 0.87% and 25.01% respectively.

This therefore means that, own shock can contribute more variation of the fluctuation in the CBL in the short run (94.04%) than in the long run (65.66%) while all other variables can contribute more in the long run than in the short run.

The second variable, that is development finance institutions funding (DFIF), in the short run, the result indicates that shock in the DFIF can contribute 73.81% forecast error variance of the fluctuation in the DFIF (own shock) while commercial bank loan (CBL), foreign direct investment funding (FDIF) and real GDP can contribute 6.44%, 17.83% and 1.91% respectively. In the long run, own shock can contribute 63.11% while CBL, FDIF and RGDP can



contribute 6.00%, 21.56% and 9.31% respectively. This categorically shows that contribution of own shock to fluctuation in the DFIF falls in the long run, that of commercial bank loan remained unchanged, but FDIF and RGDP increased.

The third variable, that is foreign direct investment funding (FDIF), in the short run, the result indicates that, shock in the foreign direct investment funding (FDIF) can cause 71.68% forecast error variance of the fluctuation in foreign direct investment funding (own shock), while CBL, DFIF and RGDP can contribute 9.37%, 9.42% and 9.50% respectively. In the long run, own shock can contribute 52.87%, while CBL, DFIF and RGDP can contribute 22.25%, 18.20% and 6.66% respectively. This shows that own shock can contribute more to the variation of FDIF fluctuation in the short run than the long run, while all other variables can contribute more in the long run than the short run.

The fourth variable, that is Real Gross Domestic Product (RGDP), in the short run, the result indicates that, shock in the Real Gross Domestic Product (RGDP) can cause 94.26% forecast error variance of the fluctuation in Real Gross Domestic Product (own shock), while CBL, DFIF and FDIF can contribute 1.57%, 2.17% and 1.98% respectively. In the long run, own shock can contribute 64.20%, while CBL, DFIF and FDIF can contribute 7.36%, 19.06% and 9.36% variation of the fluctuation in the Real Gross Domestic Product (RGDP) respectively. This however, shows that own shock can contribute more (94.26%) in the fluctuation of RGDP in the short run than the long run (64.26%), while shock in all other variables; CBL, DFIF and FDIF can contribute more to the variance fluctuation in RGDP in the long run than it does in the short run.

This study examined the impact of small and medium scale enterprises financing on economic growth in Nigeria from 1980 to 2016. The study focused on the shocks from the commercial banks loan, development finance institutions funding and foreign direct investment to SMEs on the economic growth in Nigeria within the period. The study was conducted under the Framework of big push theory of economic development and employed Vector Auto-regression (VAR) modeling to examine the long run relationship between financing of SMEs and economic growth in Nigeria.

The major findings based on the results indicated that all the variables in the model are significant This shows that financing SMEs has positive impact on economic growth in Nigeria. The results from the impulse response function and forecasted error variance decomposition discovered that shocks to commercial bank loans to small and medium scale enterprises have more impact on economic growth as it contributes over 65 percent to the variation in real gross domestic product. Shocks to development finance institutions funding also contribute up to 63.11 percent to the variation in real GDP. Shocks to foreign direct investment contributes a little over 52 percent variation to fluctuations in the real gross domestic product, This indicates a positive trend in financing SMEs in Nigeria. Finally, the results from co-integration test suggest that there is a long run relationship between financing SMEs and economic growth in Nigeria. These findings are in line with the findings of several studies such as Quaye (2011), Akingunola (2011), Afolabi (2013) and a host of others.

### **Conclusion and Recommendations**

Given the fact that commercial banks loans and financial institutions lending to small and medium scale enterprises have been found to have significant impact on economic growth in Nigeria in the long run, this implies that loans directed mainly to small and medium productive economic enterprises might have a multiplier effect in creating jobs and reducing unemployment in Nigeria. The fact that foreign direct investment directed to the small and medium scale businesses in Nigeria has long run impact on economic growth in Nigeria suggests a need to scale up this type of investment by a further strengthening of the foreign investment led industrialization strategy of the past decade.

Given the positive impacts of these sources of financing small and medium enterprises, we recommend that commercial banks should be allowed to play more roles by altering economic incentives that will make them direct more loans to this sector through risks sharing between the government and the banks. Development finance institutions should be strongly involved not only in financing but also in periodic coordination, monitoring and evaluation of the performance of the SMEs so as foster effective scoring that enables financing on a sustainable long term basis.

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