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ENTREPRENEURIAL VENTURES UNDER INFORMATION ASYMMETRY IN TRANSITION COUNTRIES

Gazmend Qorraj
University of Prishtina, Republic of Kosovo
gazmendqorraj@yahoo.com

Abstract

The firm activities that drive economic growth cannot be sustained without financial support of credit institutions. Financial support to firms has been one of the most crucial challenges especially for banks in transition economies due to information asymmetry and transition deficiencies. Similarly, large firms and SMEs in Kosovo face liquidity constraints due to these inefficiencies. This paper explores credit activities under information asymmetry in functions of enterprise development. A survey conducted with 200 firms, including 100 large firms and 100 SMEs in Kosovo responds to the above dilemmas. The empirical results of this paper suggest that large firms that possess their own capital in Kosovo are more dependent on bank funding to grow, compared to small firms that survive with their own funds but do not grow much.

Keywords: *firms, ventures, adverse selection, moral hazard, information asymmetry*

1. INTRODUCTION

Agency problems are represented in all economic activities mainly as adverse selection and moral hazard. This paper considers the agency problem of information asymmetry in lending, which has a direct impact on entrepreneurship development due to limited financial sources. In transition economies there is a massive information deficiency that cannot be properly filled because of the lack of transparency in the enterprise and financial sectors, which are necessary to support prudent lending activity. In general, uncertainties in the business environment impose high interest rates, lower-term maturity loans, and credit constraints.

There are many theoretical contributions with regard to credit constraints, which impose obstacles to enterprise development due to agency problems. Kiyotaki and More (1997) developed a model with Stiglitz and Weiss–type credit constraints, which arise because lenders cannot force borrowers to repay their debts. Therefore, the lenders lack the necessary information to distinguish between good and bad borrowers due to adverse selection and moral hazard in the credit market. Rajan and Zingales (1998) presented industry-level evidence from a large sample of countries showing that firms that need external finance tend to develop slower in countries with less-developed financial markets. A large review of theoretical literature by Levine (1997) indicated the importance of financial issues through better identification of investment projects, lower costs of financing, and rational entrepreneur behaviour.

Furthermore, Evans and Jovanovich (1989) tried to explain entrepreneurial choice by taking liquidity constraints into consideration. They were inspired by the Schumpeter and Knight theories, suggesting that wealth does not impact entrepreneurial ventures. On the other hand, Knight recognised that entrepreneurs should finance themselves because capital markets provide little capital to entrepreneurs due to adverse selection and moral hazard problems (LeRoy & Singel, 1987).

Evans and Jovanovich tried to clarify the dilemma of whether the entrepreneur should be wealthy in order to undertake entrepreneurial venture. They analysed the importance of liquidity constraints as a parameter by employing a model of entrepreneurial choice. Jovanovich (1989) assumed that, in case of financial constraints, personal wealth will be the main source of support for entrepreneurship activities. In addition, Ando (1985) reported that two main conclusions should be drawn regarding liquidity constraints and new ventures. First, there is the critical role of savings and loans from relatives and friends, especially when it comes to business formation. Second, once the firm is established the role of personal savings diminishes because the investor assumes less risk and consequently will be able to provide more capital.

This paper explores how the entrepreneurship development in transition is effected by financial intermediaries taking into consideration the agency problems, adverse selection and moral hazard respectively. Based on the Jovanovich and Ando models, the following hypotheses are tested:

Hypothesis 1: Large entrepreneurs, despite possessing their own capital, use more external financial sources to expand their activities, compare with small firms, who barely survive.

Hypothesis 2: There is no significant development of small ventures and start-ups in Kosovo due to agency problems and difficult access to credit markets.

This paper analyses and compares data created through a survey specifically designed for this study, with theory introduced by Evans and Jovanovich (1989), which supposes that the main source of finance is personal wealth under the condition of credit constraints.

2. METHODOLOGY

In order to ensure and incorporate the best practices, the analysis is based on theoretical approaches but also supported by empirical experiences in transition economies. The first section is a literature review that introduces entrepreneurial approaches by exploring the recent literature.

The second section discusses a survey which identifies financial constraints faced by SMEs. The survey data were collected by interviewing owners and managers of randomly selected firms. The subject of the survey was the current situation and development of the SME sector in Kosovo. This survey enables identification of the role of finance in the firm development. The surveys were conducted with 200 firms, including 100 large firms and 100 small firms in Kosovo, and descriptive statistics analyses were performed in order to obtain empirical evidence regarding the comparison between large and small enterprises regarding their ability to obtain financial support.

The distinction between large and small firms is based on the number of employees. This distinction in large and small entrepreneurs is made in order to explore whether the access to financial sources is similar for the two categories. Analysis of entrepreneur behaviour is based on the entrepreneur behaviour model by Evans and Jovanovich (1989), which links limited financial sources with enhancement of the entrepreneurship ventures. Policy conclusions are derived from the research results.

3. THEORETICAL BACKGROUND

Information asymmetry problems are found to be especially relevant to transition economies because the subject originated with the description by Kornai (1979) of financing in centrally planned economies. Kornai and Roland (2003) broadly applied information asymmetry to the relationship between lenders and borrowers in transition economies.

Adverse selection is at the core of a vast literature dealing with overcoming this problem in lender–borrower relations. The most widely used class of these models is based on Besanko and Thakor (1987), who addressed the screening of the agents through the use of credit rationing and collateral. The model introduced by Townsend (1979) explained the moral hazard problem; the essence of the model is that the agent, who has no wealth of his own, borrows money from the principal to run an investment project. The outcome of the project is freely observed only by the agent. Furthermore, the present paper addresses other theories such as the theories of credit constraints of Kiyotaki and More (1997) and Leland and Pyle (1997) and adverse selection followed by credit rationing model of Stiglitz and Weiss (1981).

3.1 The impact of information asymmetry on lending

Agency problems are represented in all economic activities, but this paper considers agency problems specifically in lending relationships between banking industry and firms. All less-developed countries, in which bank activities are at a lower stage of development, are characterized by these problems. In addition, financial intermediaries are able to transform the risk characteristics of assets, because they can overcome a market failure and resolve information asymmetry problems. Moreover, banks are a critical source of liquidity even for large firms during economic crises (Seidenberg & Strahan, 1999). A reduction in the supply of bank loans increases the financing costs of firms that are dependent on banks for credit.

Bank-dependent firms are typically smaller in size (Gertler & Gilchrist, 1994). These firms tend to be bank dependent because their access to non-bank capital markets is poor because of reduced economies of scale with respect to intermediaries acquiring information about small firms. The bank-lending channel is likely to be more important in small, open economies than in large, closed economies because the proportion of small bank-dependent firms tend to be higher in smaller economies than in larger economies. A reduction of the supply of the bank credit reduces real activity. During the Asian crises in the second half of the 1990s, for example, the disruption in the supply of credit was the major factor in the recessions experienced by the affected countries. Banks in these countries were unable or unwilling to establish the credit facilities required for importers to provide overseas suppliers assurance of payment. Information asymmetries and the inability of lenders to monitor borrowers causelessly lead to agency costs, which creates a wedge between the cost of internal and external financing for the firm.

Kiyotaki and More (1997) developed a model with Stiglitz and Weiss–type credit constraints, which arise because lenders cannot force borrowers to repay their debts unless the debts are secured. Assets such as land, buildings, and machinery serve as collateral for loans, and borrowers' credit limits are affected by the value of the collateralised assets. When lenders lack the necessary information to distinguish between good and bad borrowers, it is said that adverse selection and moral hazard problems exist in the market for credit.

3.2 Adverse Selection and Moral Hazard

The common assumption for all the models is that entrepreneurs are better informed than investors, including banks, about the quality of the projects they want to develop. Leland and Pyle (1997) considered that entrepreneurs can signal the quality of their projects by investing more or less of their own wealth into these projects. In this way they can partially overcome the adverse selection problem, because good projects can be separated from bad projects by their level of self-financing. This signalling through self-financing is crucial in order to avoid adverse selection problems.

Entrepreneurs who are endowed with good-quality projects prefer to self-finance rather to sell the entirety of their projects at a low price; they can limit themselves to partial self-financing if they can convince investors that other entrepreneurs who are endowed with low-quality projects have no interest in self-financing. In other words, the decision to self-finance a project will signal to outside investors, including banks, that the project is good. In this way the bank has strong arguments to approve the project and to finance it. The main methods for solving adverse selection problems are to restrict the opportunistic behaviour and to equalize information (Perloff, 2004, p. 660).

The companies as borrowers send signals to banks about their activities and projects. This signalling, which is an action taken by an informed person or institution—in this case, the company as a borrower—is done to send the information to the less-informed institution—in this case, the bank as a lender. Screening is an action taken by uninformed persons or institutions, in this case to determine the information possessed by informed people or informed institutions. The banks try to use screening as a means to gather information on hidden characteristics in order to reduce the adverse selection. If the banks obtain better information, they could approve the loan to the company or sign the contract. A moral hazard problem between banks and borrowers arises from a contract form of a bank loan, under which the interest rate paid by a borrower is fixed when the loan is made. A borrower may increase the risk of its investments to obtain higher returns. In order to mitigate moral hazard problems, banks monitor and impose collateral requirements on borrowers.

Some firms require external financing, and there is a moral hazard problem between the entrepreneurs and their financiers—in this case, between the bank and the company—because the entrepreneurs can divert project resources towards private uses. That increases their private benefits but reduces the expected return of their projects. When a company is more indebted, a larger part of its return goes to the lender; from this point of view the entrepreneur has an incentive to increase his/her private benefits. Thus the greater the reliance on external financing, the more severe the moral hazard problem becomes (Repullo & Suarez, 2000).

3.3 Credit Rationing

Credit rationing has been the subject of a vast amount of literature. An example is the availability doctrine developed in the early 1950, followed by contributions of the Baltensperger (1978) and Stiglitz and Weiss (1981).

Usually, banks use financial ratios in order to assess the repayment capacity of companies, but in some examples Kosovo banks also have used character-based lending, which is characteristic for this region because of the lack of background of many companies, specifically credit history.

Information accumulated by banks through monitoring and screening can be shared among banks or credit providers in order to create a credit market environment with lower information asymmetry, and this leads to more-efficient allocation of credit. A credit information system is a very useful instrument in order to avoid adverse selection problems in lending. Unlike standard markets, in which delivery of a commodity by a seller and payment for the commodity by a buyer occurs simultaneously, in the credit market a loan received today is exchanged for a promise of repayment of the loan along with accrued interest in the future. One borrower's promise may not be as good as another borrower's promise, and there may not be an objective way to determine the probability that the promise will be kept (Meza &Webb, 1992). In general, banks are interested not only in the interest rate they receive on a certain loan, but also in the risk associated with it. The risk can be represented as the probability that a loan is paid back. This probability differs from one firm to another, but cannot be observed by the bank. The result is that the level of the interest rate reflects a hidden characteristics problem, because anyone willing to pay a high interest rate usually is a bad risk. A firm which agrees to pay a high interest rate could have a high probability of not repaying the loan.

The other issue with regard to credit rationing is the case when a bank offers two types of contracts: one contract that contains a low level of collateral and a low reduction in the interest rate, and a second contract that contains high level of collateral and high reduction in the interest rate. Self-selection occurs because firms with a small probability of repaying the money will choose the first type of contract.

4. INFORMATION ASSYMETRY PROBLEMS IN KOSOVO

Massive reconstruction activities in Kosovo during the early 2000s' led to a high demand for bank loans. Therefore the banks in Kosovo applied higher interest rates because of higher demand as well as higher risk associated with the lending activities. This risk could not have been observed by the banks because they faced massive information deficiencies due to the lack of transparency in the enterprise sector. The result was that the level of the interest rates reflected a hidden characteristics problem. There was evidence that some companies were willing to pay higher interest rates because the probability of repaying the loans was small.

Banks and other lending institutions in Kosovo could not use the mechanism of credit history as a screening device, because in the beginning of their lending activities there was no credit information bureau and it was impossible to check the credit history of the customers. Therefore banks mostly used the other solution: requiring a high level of collateral in addition to an inflated interest rate. This offered the opportunity to design contracts in such a way that the various risk was selected over the various contracts and that no rationing occurs in equilibrium (Bester, 1985). The high level of the collateral required by the banks affect the demand of companies for credit. This caused withdrawal of some companies, and other companies tried to offer collateral that could not be properly evaluated.

The other challenge was that in Kosovo, banks could not rely upon courts enabling the enforcement of creditor's rights and contracts within a reasonable time and at a reasonable cost. An additional deficiency that characterised the Kosovo lending market was that companies did not have clear projects for their future prospects but in some cases imitated the actual businesses, which caused deficiencies in some economic branches, such as the service sector. Moral hazard or post-contractual problems occurred after the loans were approved when the companies changed their initial projects and used loans for riskier purposes. Banks have limited tools for controlling the way in which the money will be spent, which may have negative effects on the probability that the loan will be paid back as agreed.

In the case of Kosovo, most banks transferred money to company suppliers directly and not to company accounts in order to avoid the misuse of the funds. In the case of international suppliers this approach was successful, but with local suppliers this approach did not work. Firms used the credit line for trading activities instead of production, or they used money for current assets instead of fixed assets or machinery, equipment, etc. The other specific characteristic for Kosovo was that companies had hidden debts to other companies or creditors, which the banks could not observe, because most of the companies used cash operations. This is information that banks cannot observe during site visits, and therefore the banks cannot investigate the hidden debt. One way to reduce moral hazard problems is to approve credit lines only to companies that have additional sources of income or that have other project running; this means not extending credit to start-up companies, because in case of default of one project they cannot cover losses from other successful projects.

5. LARGE vs. SMALL FIRMS, WEALTH, AND FINANCIAL SOURCES WITHIN INFORMATION ASSYMETRY

Based on the Evans and Jovanovich model (1989), the borrowing constraints imply that personal wealth is positively related to the probability that the person will engage in entrepreneurship activity. The study of entrepreneurship in Bosnia and Herzegovina (BiH) (Demirgüç-Kunt, Klapper, & Panos, 2007) found that non-governmental organizations and government-supported programs that provide grants and transfers to promote entrepreneurship had a positive effect on the probability of becoming entrepreneurs. They also found that a wealthier person can start a venture with more efficient capital and thereby realise a greater return from investments than can a poorer person.

Survey evidence from Thai households (Paulson & Townsend, 2004) and BiH households (Demirgüç-Kunt, Klapper, & Panos, 2007) confirms this. Hence, wealthier households are more likely to produce the self-employed. Fazzari, Hubbard, and Petersen (1987) reported evidence of capital market imperfections, including for public manufacturing industries, in which case loans from friends and relatives could be a way to reduce liquidity constraints. There is evidence that the entrepreneurial success of some groups is due to their access to family capital and other financing networks. Ando (1985) also reported that loans from friends and relatives constituted approximately 10% of the start-up capital, whereas bank loans constituted approximately 41%. In transition countries, studies use household consumption as a wealth proxy instead of income, because income usually is under-reported.

Finally, it is important to discuss start-up or new firms which are connected with external as well as internal sources of finance. Start-up capital for an entrepreneurship activity can be acquired through financial institutions—banks, non-government institutions, or government grants—considered as external finance, whereas inheritance as a form of wealth is considered an internal source of finance. Different authors have reported that the propensity to start a business relates to inheritances received in the past (Holtz-Eakin, Joulfaian, & Rosen, 1994; Blanchflower & Oswald, 1998). Hurst (2003) reported that high-wealth households have a high propensity to undertake risk. This group of households is much more likely to switch to specific businesses, such as professional businesses such as law firms, medical practices, etc.

6. RESULTS

It is important to analyse limited financial resources and lending default as an obstacle to enterprise development in Kosovo, due to insufficient experience of Kosovo enterprises dealing with the credit market as well as due to agency problems. Despite the difficult access to financial sources, most entrepreneurs in Kosovo stated that borrowing from banks is not very useful due to short-term loan maturity and high interest rates. This paper reports data obtained by surveys with regard to financial sources for the enterprises.

From the empirical evidence, approximately 48% of the large firms surveyed used bank credit as a financial source, whereas approximately 18% of the firms used personal savings only. Other sources of finance are less important and therefore not significant. In contrast, the situation with small businesses is different. According to the surveys, the most important financial source for these firms is personal savings, approximately 36%, and only approximately 14% depended on banks, implying that small businesses have less access to bank financing.

In addition, non-entrepreneur's behaviour was analysed by surveying approximately 100 non-entrepreneurs in order to identify why they do not undertake the entrepreneurship ventures. According to the results, approximately 45% of them did not try entrepreneurship due to limited access to financial sources.

An additional survey was conducted by COSME (Europe's programme for small and medium-sized enterprises, 2014) with regard to financial support for firms in Kosovo. The results support the analysis in this paper: approximately 47% of small firms used their own savings, whereas only 29% of large firms used savings.

The other important issue is that only 3% of small firms refinance their ventures from their business turnover, whereas approximately 25% of large firms refinance their business ventures from their business turnover. With regard to banking loans, approximately 38% of small businesses are supported by banking loans whereas approximately 50% of large businesses are supported by the banking industry.

With regards to hypothesis testing, this analysis confirms the hypothesis that large entrepreneurs use more external financial sources, although their own capital is larger compared to small firms. This could be explained by the fact that large entrepreneurs have better access to credit markets than do SMEs, and therefore large firms own more capital which could be used as a screening device, namely collateral, by the financial institutions.

The second hypothesis, that development of small ventures and start-ups in Kosovo is hampered by limited financial sources, is also confirmed because these small companies cannot create sustainable development by basing their business plans only on their own capital, relatives, and other sources, especially taking into consideration the low level of welfare and personal wealth of people in Kosovo.

7. DISCUSSION

The entrepreneurship climate in Kosovo is fragile, and the most critical issues are growth of firms and creation of new jobs, optimisation of resource allocation, transfer of technology, and boosting entrepreneurship ventures. Despite important steps forward, entrepreneurs in Kosovo still face many obstacles during the process of starting a business and doing business in general, such as the lack of institutional and legislative transparency and unfair competition. Apart from the above-mentioned challenges, credit constraint due to information asymmetry is an obstacle for financial institutions, which therefore limits credit potential and increases the costs, and consequently it is an obstacle for entrepreneurship development. Banks usually use credit analyses such as financial ratios and cash flow analysis to assess the repayment capacity of the borrowers. However, in Kosovo, due to the lack of the appropriate financial data and audited reports offered by companies, banks combine financial ratios and character-based lending to evaluate the business.

7.1 Theoretical Contributions

The main contribution of this paper is in extending the limited literature on the financing of entrepreneurship ventures under information asymmetry in transition economies, focusing on the Kosovo case. Because of its recent past, Kosovo is characterized not only by economic and institutional challenges, but also by political challenges, all of which play an important role in developing entrepreneurship. Another practical contribution is to inform the stakeholders in Kosovo, such as banks, financial institutions, and firms, about the impact of information asymmetry in financing and firm growth. Compared to other theories and authors, such as the theory of Evans and Jovanovich (1989) stating that "the borrowing constraints imply that personal wealth is positively correlated to the probability that the person will engage in entrepreneurship activity", this paper finds that in the case of Kosovo, personal wealth of an entrepreneur is positively correlated with bank financing and lower information asymmetry. In contrast, less-wealthy small firms are financed with personal resources, including resources from close relatives, and do not make a strong case for bank financing, suggesting negative effects of information asymmetry.

7.2 Practical Implications and Limitations

Because of existing information asymmetry, banks limited credit lines to firms in Kosovo in the last decade. With the recent legal reform that introduced private bailiffs, the lending interest rates of commercial banks decreased, but the share of financing to small firms remains limited. The main limitation of this paper is a lack of availability of detailed firm-level data that would enable analysis of all the reasons behind the low level of bank financing of small firms; instead, this paper depends on a limited number of variables used in a survey.

7.3 Further Research Directions

Further research could be extended by analyzing the obstacles of the business environment in Kosovo, as well as technical capabilities of the small firms, such as their capabilities to represent to financial institutions the appropriate information, business plans, and other useful documents. Furthermore, analysing this improvement of small firms could facilitate their approach to financial sources, because most of the small firms surveyed indicated their difficulties in obtaining financial resources, whereas large firms have better access to financial resources from the banks. The main questions to be raised are: Can small firms meet the banking requirements given their limited capacities? Do banks still apply higher requirements for small firms, including more collateral, due to information asymmetry, so that small firms cannot easily meet these demands?

EXTENDED SUMMARY / IZVLEČEK

Aktivnosti združb, ki predstavljajo gonilo gospodarske rasti, ni moč ohranjati brez finančne podpore kreditnih institucij. Finančna podpora združbam predstavlja enega ključnih izzivov, predvsem vezano na aktivnosti bank v tranzicijskih gospodarstvih, predvsem zaradi informacijske asimetrije in pomanjkljivosti, ki izhajajo iz tranzicije. Tako se srednje velika in velika podjetja na Kosovem soočajo z omejitvami, povezanimi z likvidnostjo, ki izhaja iz prej omenjenih izzivov. Članek se osredotoča na kreditno aktivnost v luči informacijske asimetrije v funkciji razvoja združb in gospodarstva. Raziskava dvestotih združb (100 velikih in 100 srednje velikih in malih) na Kosovem odgovarja na izpostavljene dileme. Empirični rezultati nakazujejo, da so večja podjetja, ki posedujejo večji delež lastnega kapitala, bolj odvisna od bančnega kreditiranja v primerjavi z manjšimi, ki lažje preživijo z lastnimi sredstvi, a hkrati ne rastejo.

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