CREDIT DEMAND, SUPPLY AND DISCOURAGEMENT: EVIDENCE FROM UK SMALL BUSINESSES IN THE CURRENT ECONOMIC RECESSION (SUMMARY)

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Principal Topic

Not all small businesses with potentially good investment opportunities will apply for external finance even if they need it. Those discouraged from applying as they fear rejection, namely ‘discouraged borrowers’, represent an interesting but under-researched group of firms in the small business literature. In this study, we question whether these entrepreneurs were correct in their assumptions about being rejected for loans. In particular, we seek to investigate what really happens to small business lending when an economic downturn occurs, and how do such unfavourable economic events impact on the willingness of entrepreneurs to continue making loan applications even if they perceive that profitable investment opportunities are available.

Method

We use a unique set of data drawn from the Department for Business Innovation and Skills (BIS) 7 SME Business Barometer Surveys. The surveys were carried out at 2-3 monthly intervals over the course of the current recession, which officially began in September 2008, amongst small businesses in the UK. A total number of 3506 firms were asked questions to assess their performance during the latest recession, their levels of business confidence going forward, and barriers to the firms’ future growth especially in terms of access to external finance. We then estimate a sequential set of probit models with sample selection effect to compare the firm characteristics between discouraged borrowers and denied/approved applicants.

Results and Implications

Our headline findings are that levels of discouragement are quite low in general, even in tough economic times, but higher amongst experienced entrepreneurs. But failure rates for loan requests are high with between 30 and 40% of total loan requests being turned down. This suggests that more experienced entrepreneurs are making rational decisions given the prevailing economic climate. Further analysis implies that 55.6% of discouraged borrowers would have got loans had they applied. Regarding credit supply, the key finding is that the financial crisis added too much noise and uncertainty to the lending market and banks responded by placing much more emphasis on relationships when making their loan decisions.

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