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TRADE FINANCE AND THE GROWTH OF SMALL AND MEDIUM ENTERPRISES (SMES) IN NIGERIA

Adekunle, Gideon Adesunkanmi[1] & Mojekwu, Ogechukwu Rita[2]
[1]The Institute of International Trade and Development, Faculty of Social Sciences, University of Port Harcourt, Rivers State Nigeria.
[2]Department of Finance and Banking, Faculty of Management Sciences, University of Port Harcourt, Rivers State Nigeria.
Corresponding Author: rita.mojekwu@uniport.edu.ng

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Abstract:
This study examined trade finance and the growth of Small and Medium Enterprises (SMEs) in Nigeria. The Pecking Order Theory which was proposed by Stewart Myers and Nicolas Majluf in 1984 anchored this current study. The study adopted a qualitative methodology and secondary data sources. The findings of the study showed that trade finance instruments enable SMEs to access working capital and manage cash flow more effectively which helps them to enter new markets, expand their operations, and increase their production capacity. Also, trade finance reduces barriers to international trade for SMEs by providing them with the capital required to participate in profitable cross-border transactions, by facilitating exports and imports, which are crucial for SMEs seeking to diversify their markets and increase their revenue streams. Lastly, the availability of trade finance improves SMEs' relationships with suppliers by enabling them to secure better credit terms and negotiate favorable conditions for improving their performance. Based on the findings, this study concluded that trade finance plays a vital role in promoting and sustaining the growth of small and medium enterprises (SMEs) in Nigeria. It was recommended among others that policymakers and financial institutions should continue to support and develop trade finance mechanisms to empower SMEs, promote economic development, and strengthen Nigeria's position in the global market.

Keywords: Trade Finance, Small and Medium Enterprises (SMEs), Growth

INTRODUCTION

Small and Medium Scale Enterprises (SMEs) play significant role in the economic growth in developed countries, developing and emerging economies. Consequently, the contributions of SMEs to economic growth and development have been recognized globally, Nigeria inclusive (Cabbar, 2018). Governments all over the globe are paying deliberate and great attention to SMEs with special emphasis on their sustainability. This is because efforts expended on the establishment and development of large scale industries tends to contradict expectations and predictions as they have not succeeded in improving the socio-economic wellbeing of the people. Consequently, SMEs are now viewed and treated as agents of equitable economic development (Memba, Gakure & Karanja, 2020). It is based on the contributions of SMEs to the economic development of Nigeria, that various political and military administrations have promoted several initiatives aimed at stimulating the growth and development of the SME sector in the country. Emphasis in this regard revolves around the provision of financial incentives to SMEs because, it is empirically proven that finance remains the main bane of SMEs. Access to finance by SMEs provides them with the requisite resources to build competences such as acquisition of technologies for enhanced production capabilities and achieving competitive advantage (Olawuni & Oyeladun, 2021).

Consequently, trade finance is one major means of promoting the growth of SMEs. According to Giddy (2015), trade finance refers to the range of financial products and services used to support and facilitate international trade transactions through instruments such as letters of credit, factoring, and trade credit insurance, which mitigate risks and provide liquidity to businesses engaged in cross-border trade. Trade finance plays a crucial role in supporting the growth SMEs by providing the necessary funding and financial tools to manage and expand trade activities. In Nigeria, where SMEs are pivotal to economic development, trade finance has significant implications for their growth and sustainability (Nwokoro & Chukwuma, 2023). In addition, trade finance is a critical component of global

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commerce, providing the necessary financial support to facilitate the international trade of goods and services. For Small and Medium Enterprises (SMEs), which are often constrained by limited access to capital, trade finance can be a vital tool for growth and expansion (Eze & Okonkwo, 2022). One advantage of trade finance is the improvement of cash flow and liquidity. SMEs often face cash flow issues due to delayed payments from customers or the need to pay suppliers upfront. Trade finance instruments like factoring and forfaiting provide immediate cash flow by converting receivables into cash. This enables SMEs to manage their working capital more effectively, invest in growth opportunities, and reduce reliance on expensive short-term borrowing (Iweala & Akpan, 2022).

According to Bello and Kolo (2023), access to trade finance enables SMEs to engage in international trade and explore new markets. With the financial backing provided by trade finance instruments, SMEs can take on larger orders, manage cross-border transactions, and compete with larger firms. This market expansion can lead to increased revenue, diversification of income sources, and long-term growth. Furthermore, Akinyemi and Akinola (2022) noted that trade finance instruments help mitigate various financial risks, including currency fluctuations, credit risk, and trade-related disputes. For instance, hedging instruments can protect SMEs from adverse movements in exchange rates, while trade credit insurance covers potential losses from non-payment by buyers. SMEs can focus on their core business activities and pursue growth opportunities with greater confidence by managing these risks effectively.

Despite the benefits, SMEs in Nigeria face several challenges in the quest to access trade finance. These challenges include high interest rates, stringent collateral requirements, and limited awareness of available trade finance products. These constraints hinder SMEs' ability to fully leverage trade finance for growth and limit their potential to capitalize on market opportunities. Specifically, trade finance often involves high costs, including fees for letters of credit, trade credit insurance, and other financial instruments. These costs can be particularly burdensome for SMEs in Nigeria, which usually operate with limited financial resources and face higher relative expenses compared to larger firms. These high costs can erode SMEs' profit margins, making their products less competitive in both domestic and international markets. This financial strain can hinder their ability to invest in growth opportunities, such as expanding operations or entering new markets. Also, many SMEs in Nigeria face difficulties accessing trade finance due to stringent requirements set by financial institutions, such as collateral demands and rigorous credit assessments. Additionally, smaller financial institutions might lack the capacity to provide comprehensive trade finance services. Limited access to trade finance restricts SMEs' ability to engage in international trade and secure necessary working capital. This constraint can prevent them from seizing growth opportunities, impacting their competitiveness and ability to scale their operations. Drawing from the foregoing, this study sought to examine the link between trade finance and the growth of small and medium enterprises (SMEs) in Nigeria.

LITERATURE REVIEW

Conceptual Literature

Concept of Trade Finance

Trade finance is the financial mechanisms and services that support the global trading of goods and services. It encompasses both short-term and long-term credit products that help businesses manage the financial risks and liquidity needs associated with international transactions (Petersen & Rajan, 2002). The EBRD (2019) explained trade finance as a set of financial solutions that support trade activities, including export and import transactions. These solutions help businesses by providing working capital, managing payment risks, and ensuring the availability of funds throughout the trade cycle. The World Bank (2020) defined trade finance as a suite of financial products that facilitate trade transactions by bridging the gap between importers and exporters. This includes various types of credit and insurance instruments that provide the necessary funding and risk management tools to ensure the smooth flow of goods and services across borders. Biersteker and Weber (2016) viewed trade finance as the financial tools and services used to facilitate international trade by providing credit, insurance, and risk management solutions. This framework assists firms to tactically overcome the problems associated with cross-border transactions, including payment delays and credit risks. Miller and Packer (2021) described trade finance as the financial services and products that help businesses manage the complexities of international trade. These include short-term and long-term financing options, trade credit insurance, and other tools designed to mitigate risks and ensure the flow of goods and services between international buyers and sellers.

Types and Instrument of Trade Finance in Nigeria

Trade finance in Nigeria plays a pivotal role in facilitating both domestic and international trade by offering financial products and services that mitigate risks, improve cash flow, and ensure smooth transactions.

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Nigeria's dynamic economic environment and burgeoning trade activities have led to the development and adoption of various trade finance instruments. However, the major types and instrument of trade finance in Nigeria include:

a. **Letters of Credit (LCs):** LCs are fundamental in international trade finance. The letters are issued by banks to guarantee payment that will be made to the seller provided that the terms and conditions stipulated in the credit are met. There are several types of LCs: In Nigeria, LCs are widely used to minimize risk in cross-border transactions and provide assurance to sellers that they will be paid once they fulfil their contractual obligations.

b. Trade Credit Insurance: Trade credit insurance is designed to assist firms protect themselves against the risk of payment defaults by buyers, particularly in cases of insolvency or default. This insurance covers the financial risk associated with extending credit to buyers. In Nigeria, trade credit insurance is essential for exporters and suppliers who wish to manage credit risk and secure financing by demonstrating reduced risk to lenders.

c. **Factoring:** Factoring describes a situation whereby accounts receivable (invoices) are sold to a third party, known as a factor, at a discount in exchange for immediate cash. There are two main types: Factoring helps Nigerian businesses, especially small and medium enterprises (SMEs), improve their cash flow by converting outstanding invoices into immediate working capital.

d. **Forfaiting:** Forfaiting describes a technique where exporters sell their medium- to long-term receivables to a forfaiter at a discount. This process allows exporters to receive immediate payment and transfer the risk of non-payment to the forfaiter. Forfaiting is particularly beneficial for Nigerian exporters dealing with large international transactions and longer payment terms.

e. **Trade Loans and Financing:** Trade loans provide short-term financing for businesses to purchase goods or raw materials. They include: These loans are crucial for Nigerian businesses to manage cash flow and bridge the gap between purchasing goods and receiving payment from buyers.

f. **Supplier Credit:** Supplier credit is a financing arrangement where the supplier extends credit to the buyer, allowing for deferred payment. Types of supplier credit include: This arrangement helps Nigerian buyers manage their cash flow and allows suppliers to maintain competitive payment terms.

g. **Documentary Collections:** Documentary collections involve the seller's bank collecting payment from the buyer's bank against the shipping documents. There are two main types: Documents Against Payment (D/P) which in which payment must be made before the documents are released to the buyer, as well as Documents Against Acceptance (D/A) in which payment is made after the buyer accepts a draft or bill of exchange. Documentary collections offer a less costly alternative to LCs but carry higher risk for the seller.

h. **Bank Guarantees:** Bank guarantees are promises made by banks to cover a loss if a party defaults on their contractual obligations. They include: performance guarantees that ensures that contractual obligations are met, and bid bonds which guarantee that a bidder will enter into a contract if selected. In Nigeria, bank guarantees provide security for both buyers and sellers, reducing the risk of non-performance.

i. **Export Credit Agencies (ECAs):** Export credit agencies are government or quasi-government institutions that support domestic companies in exporting goods and services. Export credit agencies are vital for Nigerian exporters, offering favorable financing terms and risk protection.

j. **Trade Finance Hedging Products:** Hedging products help businesses manage risks that are related to exchange rates, interest rates, and commodity prices. Types include: forward contracts which **involve a**greements to buy or sell a currency or commodity at a future date at a predetermined rate as well as options where **c**ontracts giving the right but not the obligation to buy or sell at a specified rate. These products are used by Nigerian businesses to protect against adverse market conditions and stabilize their financial performance.

Concept of Small and Medium Enterprises (SMEs)

Small and Medium Enterprises (SMEs) describes a set of firms with fewer than 100 employees. They emphasize the role of SMEs in economic development, noting their importance in creating jobs, fostering innovation, and contributing to economic dynamism. Their definition focuses on employee numbers as a primary metric (Beck, Demirguc-Kunt & Levine, 2005). In their

research, Ayyagari, Beck, and Demirguc-Kunt (2007) defined SMEs on the basis of number of employees: microenterprises (up to 10 employees); small enterprises (between 11 and 50 employees); and medium-sized enterprises (having 51 to 250 employees). They emphasize that the SME sector is critical for economic development and job creation. World Bank (2019) defined SMEs as firms with fewer than 300 employees. This broad definition allows for variations in national contexts and helps to standardize SME data collection across different countries. The World Bank focuses on the economic impact of SMEs and their role in poverty alleviation and employment. European Commission (2020) defined SMEs based on the perspective of employee numbers and annual turnover or balance sheet total. The Organisation for Economic Co-operation and Development (OECD) (2020) defined SMEs as businesses with fewer than 250 employees. It categorizes SMEs into microenterprises (1-9 employees), small enterprises (10-49 employees), and medium-sized enterprises (50-249 employees). This definition is used for statistical and policy purposes, highlighting the scale of operations and the number of employees as key factors.

Measures or Indicators of the Growth of Small and Medium Enterprises (SMEs)

Measuring the growth of Small and Medium Enterprises (SMEs) involves several key indicators that reflect various dimensions of business performance and development. These include:

i. **Revenue Growth:** This indicator measures the increase in sales or revenue over a specified period. It reflects the business's ability to expand its market reach and attract more customers. Revenue growth indicates overall business health and is often used to assess the effectiveness of business strategies and market performance.
ii. **Profitability:** Profitability indicators include net profit margins, gross profit margins, and return on assets (ROA). These metrics assess the efficiency of the business in generating profit relative to its revenue and assets. High profitability indicates effective cost management and revenue generation, which are crucial for long-term sustainability.
iii. **Market Share:** Market share describes the percentage of total sales in an industry gained by a particular company. It reflects the company's competitive position within its market. Increasing market share suggests business growth relative to competitors and improved market presence.
iv. **Customer Base Expansion:** This measures the increase in the number of customers or clients served by the business. A growing customer base indicates effective market penetration and customer acquisition. Expanding the customer base is critical for sustained revenue growth and business viability.
v. **Product or Service Diversification:** This indicator assesses the extent to which a business introduces new products or services. Diversification can lead to increased revenue streams and reduced risk. Diversification indicates the company's ability to innovate and adapt to changing market demands.
vi. **Operational Efficiency:** Measures such as inventory turnover, production efficiency, and cost of goods sold (COGS) relative to sales. These indicators assess how well the business manages its operations. High operational efficiency can lead to cost savings and improved profitability.
vii. **Customer Satisfaction and Retention:** Measures the level of satisfaction among customers and the rate at which customers return for repeat business. High customer satisfaction can lead to increased loyalty and referrals. Satisfied and loyal customers contribute to stable revenue and positive brand reputation.
viii. **Innovation and Technology Adoption:** This measures the extent to which a business adopts new technologies and innovative practices. Innovation can lead to improved efficiency, new product development, and competitive advantage. Staying at the forefront of technology and innovation is essential for maintaining competitiveness and fostering growth.
ix. **Export Growth:** For SMEs engaged in international trade, export growth measures the increase in the volume or value of goods and services sold to foreign markets. Export growth indicates the company's ability to compete internationally and access new markets.
x. **Market Penetration:** This measures the extent to which a company has entered new markets or regions. It reflects the company's ability to expand its geographical reach. Market penetration can lead to increased sales and brand recognition in new areas.

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Role of Trade Finance in the Growth of Small and Medium Enterprises (SMEs)

Trade finance plays a pivotal role in the growth and sustainability of small and medium enterprises (SMEs) in the following ways:

i. **Access to Funds:** Trade finance solutions, such as letters of credit and trade credit, provide SMEs with the necessary working capital to fund their operations. By securing financing to cover production and procurement costs, SMEs can fulfill large orders and expand their market reach without the immediate need for extensive personal or business savings.

ii. **Enhanced Liquidity:** Trade finance instruments help improve liquidity by providing short-term loans and lines of credit that enable SMEs to manage their cash flow effectively. This is particularly important for SMEs that may not have substantial reserves or access to traditional bank loans.

iii. **Mitigating Risks:** Trade finance instruments such as export credit insurance and factoring help SMEs mitigate the risks that are associated with international trade, including payment defaults, political instability and currency fluctuations. By transferring these risks to financial institutions, SMEs can operate more confidently in foreign markets.

iv. **Market Expansion:** Trade finance enables SMEs to explore and enter new markets by providing the financial backing required for international trade. With access to funding and risk management tools, SMEs can compete globally and tap into new customer bases, which drives growth.

v. **Improved Negotiating Power:** By leveraging trade finance, SMEs can negotiate better terms with suppliers and buyers. For instance, letters of credit can reassure suppliers of timely payment, leading to more favorable trade terms and improved supplier relationships.

vi. **Building Trust:** Trade finance solutions, such as letters of credit, help build trust between SMEs and their international partners by ensuring that transactions are secure and payments are guaranteed. This trust strengthens business relationships and encourages long-term partnerships.

vii. **Supporting Sustainable Growth:** Trade finance provides SMEs with the financial resources to scale their operations. By securing funding for larger orders and investing in production capabilities, SMEs can increase their output and grow their businesses sustainably.

viii. **Innovation and Investment:** With access to trade finance, SMEs can invest in new technologies, expand their product offerings, and explore innovative business models. This investment in growth and innovation contributes to their long-term success.

ix. **Improving Financial Health:** Utilizing trade finance solutions helps SMEs build a positive financial track record. SMEs enhance their creditworthiness and improve their chances of securing additional financing from other sources through By demonstration of their ability to manage trade credit and repay loans.

x. **Financial Stability:** Trade finance helps SMEs maintain financial stability by providing a cushion against unexpected expenses or delays in payment. This stability is crucial for sustaining operations and achieving long-term growth.

Theoretical Underpinning

This study is anchored on Pecking Order Theory. Pecking Order Theory, proposed by Stewart Myers and Nicolas Majluf in 1984, addresses corporate financing decisions and deals with small business operations. It sheds light on the benefits or incentives that influences small and medium scale enterprises (SMEs) capital structure decisions. This theory assumes that firms prefer the use of their internal sources of capital first before resorting to external sources (such as deposit money banks) in the event that the internal sources are inadequate. In other words, Pecking Order Theory states that firms prefer to finance their operations using internal funds first, followed by debt, and resort to issuing equity only as a last option. The theory emphasizes that firms prioritize their sources of financing based on the costs and risks associated with each.

Assumptions of Pecking Order Theory

i. Firms prioritize their financing sources according to a specific hierarchy. They prefer using internal funds first, followed by debt, and only issue equity as a last resort. This hierarchy is based on minimizing the costs and risks associated with each financing source.

ii. The theory assumes that there is asymmetric information between firm managers and investors. Managers are assumed to have better information about the financial health of the firm and future prospects than external investors. This information imbalance affects the firm's financing decisions.

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iii. The Pecking Order Theory assumes that the cost of external financing (debt and equity) is higher than the cost of internal financing. This is due to the potential dilution of ownership and increased scrutiny associated with issuing new equity, and the risk premium associated with debt.
iv. It is assumed that external markets react negatively to new equity issuance, which is often perceived as a signal of financial distress or undervaluation. This negative perception affects the firm's decision to avoid issuing new equity unless absolutely necessary.
v. The theory posits that firms do not aim for an optimal capital structure. Instead, they focus on maintaining financial flexibility by following the hierarchy of financing sources based on available internal resources and the costs of external financing.

Criticisms/Drawbacks of Pecking Order Theory

i. The Pecking Order Theory heavily relies on the notion of asymmetric information. However, this assumption might not always hold true, as firms may have mechanisms in place to reduce information asymmetry, such as transparent financial reporting and investor relations.
ii. The theory undervalues the potential benefits of equity financing, such as reducing financial risk and providing capital for growth without incurring debt obligations. Equity financing can be beneficial in certain situations, but the theory tends to focus more on its costs.
iii. The theory assumes a one-size-fits-all approach to financing decisions, ignoring the influence of firm-specific factors such as industry characteristics, firm size, and growth opportunities. Different firms might have unique preferences and strategies for financing.
iv. Pecking Order Theory assumes that the costs associated with debt and equity are constant over time. In reality, these costs can fluctuate based on market conditions, interest rates, and changes in firm risk profiles.
v. The theory does not fully explain why some firms might pursue significant changes in their capital structure, such as moving towards a high level of debt or equity, which could be influenced by strategic goals, market conditions, or regulatory requirements.

Application of Pecking Order Theory to the Study

In the context of SMEs and trade finance, the Pecking Order Theory provides theoretical explanation of how SMEs manage their financing needs and the impact of trade finance on their growth. SMEs often prefer to use internal funds to finance their trade activities whenever possible. However, due to limited internal resources, they frequently rely on trade finance products to bridge the gap between their financing needs and available capital. This reliance on external finance is consistent with the pecking order, where SMEs opt for debt financing through trade finance rather than issuing equity. Also, trade finance instruments, such as trade loans and factoring, represent debt financing options that SMEs use to support their trade activities. According to the Pecking Order Theory, SMEs might choose these debt options over equity because they are less costly and do not dilute ownership. This debt financing allows SMEs to take advantage of growth opportunities without giving up control of their business. Hence, SMEs can overcome the limitations of internal financing and access the necessary capital to expand their operations by utilizing trade finance. This access supports their growth by enabling them to enter new markets, increase production capacity, and fulfill larger orders.

METHODOLOGY

This study adopted a qualitative research method to provide a comprehensive analysis of the link between trade finance and the growth of small and medium enterprises (SMEs) in Nigeria. A thorough review of existing literature on trade finance, and the growth of small and medium enterprises (SMEs) was conducted to identify key concepts, theories, and findings. As a result, secondary data were used and these data were sourced from Academic Journals, Central Bank of Nigeria (CBN), National Bureau of Statistics (NBS) reports, World Bank reports as well as Organisation for Economic Co-operation and Development (OECD) reports

FINDINGS

The major findings of this study are summarized below:

i. Trade finance instruments such as letters of credit, trade credit, and export financing enable SMEs to access working capital and manage cash flow more effectively. This access helps SMEs to enter new markets, expand their firm operations, and increase their production capacity.
ii. Trade finance reduces barriers to international trade for SMEs by providing them with the necessary financial resources required to engage in cross-border transactions. This includes facilitating exports and imports, which are crucial for SMEs seeking to diversify their markets and increase their revenue streams. Effective trade finance solutions can mitigate

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the risks that are linked with international trade and improve SMEs' competitiveness.

iii. The availability of trade finance improves SMEs' relationships with suppliers by enabling them to secure better credit terms and negotiate favourable conditions.

iv. Trade finance has been linked to increased employment opportunities within SMEs. As trade finance enables SMEs to expand their operations and production capacity, they often require additional labor to meet increased demand. This results in job creation and contributes to reducing unemployment rates, which has a positive effect on the overall economy.

CONCLUDING REMARK AND RECOMMENDATIONS

Trade finance has been identified to play a pivotal role in the growth and development of SMEs in Nigeria. By enhancing access to international markets, improving cash flow, facilitating supply chain financing, mitigating financial risks, boosting competitive advantage, supporting business expansion, and encouraging investment, trade finance contributes significantly to the success and sustainability of SMEs. For Nigerian SMEs, leveraging trade finance solutions can overcome financial barriers, optimize operations, and drive growth. Based on the findings, this study concludes that trade finance plays a vital role in promoting and sustaining the growth of small and medium enterprises (SMEs) in Nigeria Based on these findings, the following recommendations are proffered:

i. Policymakers and financial institutions should continue to support and develop trade finance mechanisms to empower SMEs, promote economic development, and strengthen Nigeria's position in the global market.

ii. Develop and implement policies that increase the accessibility of trade finance instruments to SMEs, especially those in underserved regions. This can include establishing more accessible trade finance facilities, simplifying application processes, and providing targeted financial products designed for SMEs.

iii. Government should introduce financial incentives, such as subsidies or tax breaks, for banks and financial institutions that provide trade finance to SMEs. This could help reduce the cost of trade finance for SMEs and encourage more financial institutions to offer these services.

iv. Lastly, Government should strengthen institutional frameworks and capacity-building initiatives to support SMEs in accessing trade finance. This includes improving the efficiency of trade finance institutions and increasing the capacity of SMEs to utilize available financial resources effectively.

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