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Crowdfunding and financial inclusion of SMEs in the MENA region

Massinissa Ameziane * (1)

ameziane.massinissa@univ-alger3.dz

PhD student at University of Algiers 3, Laboratory of performance and human capital- Algiers (Algeria)

Othmane Touat (2)

touat.othmane@univ-alger3.dz

Professor at University of Algiers 3, Laboratory of economic transformation strategies- Algiers (Algeria)

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Abstract

This article explores the transformative potential of crowdfunding as a catalyst for financial inclusion, with a particular focus on its impact on Small and Medium-sized Enterprises (SMEs).

Through a theoretical analysis of the state of financial inclusion of SMEs in the MENA region, this article illustrates how crowdfunding acts as a game-changer for SMEs. The study reveals that crowdfunding serves as a powerful tool in dismantling barriers that have traditionally hindered SMEs from accessing essential financing by reducing transaction costs and streamlining documentation requirements.

Keywords: Crowdfunding, SME's, Financial inclusion, economic growth, MENA region

* *Massinissa Ameziane*

1. INTRODUCTION

In recent years, the MENA region has witnessed a surge in entrepreneurial spirit, with SMEs becoming the lifeblood of economic growth. SMEs represent the backbone of economic development in the MENA region, contributing substantially to job creation, innovation, and overall economic growth. However, these enterprises often face challenges in accessing traditional forms of financing, hindering their potential for expansion and innovation.

Access to traditional financing for these enterprises has often been a challenge. This is where crowdfunding steps in as a democratizing force, reshaping the financial landscape and providing a lifeline for SMEs seeking capital. Crowdfunding represents a departure from traditional financing methods, offering a decentralized approach that connects entrepreneurs with a global network of backers.

Various related studies prove evidence on the role of financial inclusion in promoting economic growth and development, including;

(Saed Khalil et al., 2023) who explored the relationship between financial inclusion and human capital development in 12 Arab countries for the 2004-2019 period. financial inclusion was proxied by the number of bank branches. Pooled mean group (PMG) method was used for the analysis. The results reveal that financial inclusion promote the human capital development in the long-term.

(Demirguc-Kunt, Asli, & al, 2017) , a World Bank study also linked financial inclusion and a number of macroeconomic variables, including economic growth, stability and equality, and showed the positive correlation between financial inclusion and these variables, but it indicated that the relationship may depend on a number of determinants, including per capita income, quality Regulatory and supervisory environment.

(Ayyagari & others, 2016)'s study shows that the presence of credit bureaus, with what they mean by the availability of credit records for individuals and companies' data, which would increase the levels of access to finance in a sample of 70 developing economies, has contributed to an increase in the employment growth rate by about 3.5 percentage points among micro, small and medium-sized companies, compared to only 1.2 percentage points for the largest companies.

Moreover, other studies revealed the importance of crowdfunding in enhancing the financial inclusion of SME's, these studies include:

(Kim & De Moor, 2017) described crowdfunding as a potential solution to enhance financial inclusion, particularly by facilitating accessible funding for vulnerable populations and Small and Medium-sized Enterprises (SMEs), overcoming geographical constraints and minimizing transaction costs.

According to (Ivo Jenik, 2017) The primary and immediate advantage across all crowdfunding categories lies in enhancing access to financial resources for traditionally marginalized individuals and entities. According to a 2013 World Bank study, there is a potential for up to 344 million people in developing economies to engage in crowdfunding, with a particular emphasis on debt crowdfunding as a form of digital credit. Debt crowdfunding, owing to its unique scoring mechanism, holds significant relevance, especially in serving Micro, Small, and Medium-sized Enterprises (MSMEs), startups, and individuals with limited or no established credit history.

However, the role of crowdfunding in fostering financial inclusion for Small and Medium-sized Enterprises (SMEs) in the Middle East and North Africa (MENA) region is an underexplored area, given the unique economic, cultural, and regulatory context of the region. Understanding how crowdfunding can serve as a tool for financial inclusion, especially for SMEs facing challenges related to traditional financing avenues, is crucial for both academic research and practical policy implications. Therefore, this research tries to answer the following questions: How does crowdfunding contribute to the financial inclusion of SMEs in the MENA region, considering factors such as access to capital, diversification of funding sources, and inclusion of businesses with limited documentation? And what are the key challenges and opportunities associated with the implementation of crowdfunding as a means of financial inclusion for SMEs in MENA, and how do these factors differ from global trends?

By answering this questions, This article serves as a comprehensive exploration of crowdfunding, its diverse models, and the transformative impact it holds on economies, industries, and, most notably, the financial inclusion of Small and Medium-sized Enterprises (SMEs) in the Middle East and North Africa (MENA) region.

Methodology:

In this study, a robust theoretical analysis was employed to investigate the role of crowdfunding in fostering financial inclusion for Small and Medium-sized Enterprises (SMEs) in the Middle East and North Africa (MENA) region. The theoretical framework drew upon established concepts in financial inclusion, crowdfunding literature, and SME financing models. This theoretical foundation guided the examination of key factors such as access to capital, diversification of funding sources, and the inclusion of businesses with limited documentation.

The article is organized into two main sections. The initial section provides an overview of the SMEs financial inclusion landscape in the MENA region. Subsequently, the second section outlines the concept of crowdfunding and delves into an exploration of how crowdfunding serves as a facilitator for enhancing access to finance specifically for Small and Medium-sized Enterprises (SMEs).

2. Financial inclusion of small and medium-sized enterprises in the MENA region

Financial inclusion is defined as the access of individuals, including low-income people, and especially micro, small and medium-sized enterprises, to a wide range of high-quality formal financial services (payments, transfers, savings, borrowing, insurance, etc.), provided in a manner Responsible and sustainable by a diverse range of financial service providers in an appropriate legal and regulatory environment (Berneh, Abi, & Atieh, 2019, p. 2).

2.1. The Importance of Financial Inclusion in Enhancing Financing Opportunities for Small and Medium-sized Enterprises:

Financial inclusion for Small and medium-sized enterprises is at the fore in the challenges of economic diversification, growth and job creation. International experiences indicate that there are many factors that can help increase the financing available to small and medium-sized enterprises, including the following (Okasana & Evgeny, 2017, p. 11):

- Economic fundamentals and characteristics of the financial sector, such as macroeconomic stability, downsizing of the public sector (to avoid crowding out SMEs for access to credit), and the soundness of the financial sector.
- Institutional factors, such as strong governance and financial regulatory and supervisory capabilities, availability of credit information, a conducive business environment, including modern security and insolvency frameworks, and legal systems that allow respect of property rights and the enforcement of contracts.

In addition, there are alternative channels that can facilitate increased access to finance for small and medium-sized enterprises, including by supporting the supply of bank credit. Comparative experiences indicate the possibility of capital markets playing such a role in the various stages of development of small and medium-sized enterprises. Similarly, Fintech can work to reduce restrictions on bank financing (for example, credit information or credit competition) and open new channels for financing SMEs.

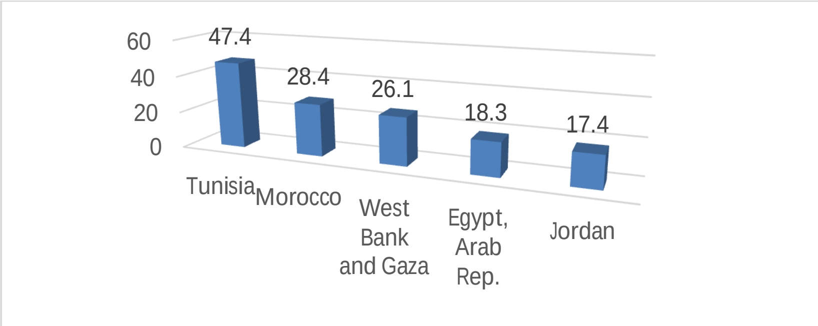
2.2. The state of financial inclusion of Small and medium-sized enterprises MENA countries:

International estimates indicate that about 70% of Small and medium-sized enterprises in emerging markets do not have access to finance, especially in Africa, Asia, Latin America and the Arab countries. In this context, the financing gap for micro, Small and medium-sized enterprises operating in the formal sector in developing countries is estimated at $5.2 trillion, as the levels of demand for financing by these enterprises are estimated at $8.9 trillion, while the current levels of supply of financing represent $3.7 trillion. (That is, the current gap is 1.4 times the current funding levels). The gap rises to about $8.1 trillion if the financing needs of micro, Small and medium-sized enterprises in the informal sector in developing countries are taken into consideration (Heba, Al-Waleed, & Tariq, 2019, p. 19).

It is not much different for small and medium-sized enterprises in the MENA countries, in terms of access to finance and financial services. Many data show that the largest part of small, medium and micro enterprises in the Arab countries do not have access to finance and other financial and banking services.

The challenges of access to finance represent one of the most important challenges facing micro, Small and medium-sized enterprises in MENA countries, which constrains their capacity to stimulate economic growth, given that approximately 79% of enterprises in the Middle East and North Africa (MENA) region, lack access to financial resources. This situation persists amid an estimated financing deficit ranging from 210 to 240 billion dollars. Within this context, the banking support allocated to this sector constitutes merely 9% of the overall banking facilities, significantly below the average observed in middle-income countries, which stands at around 18%. (Saleem, 2017). The following graph shows to what extent access to finance is considered as a major constraint in a sample of MENA countries.

Fig.1.Firms identifying access to finance as a major constraint (%) in 2019



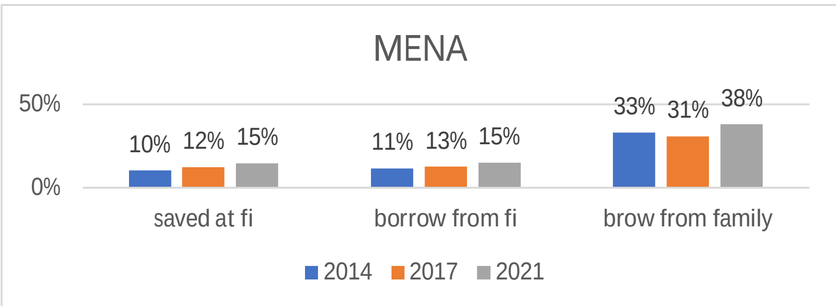
Source: *(The Global Findex Database 2021, 2022)*

In 2019 and 2020, several Middle Eastern and North African countries faced varying degrees of challenges regarding access to finance for businesses. Tunisia stood out with a significant 47.4% of firms identifying this as a major constraint, signifying substantial hurdles in securing funding, potentially hindering economic growth. Morocco followed with 28.4%, reflecting a notable concern despite its relatively more developed financial sector. The West Bank and Gaza, marked by political instability, saw 26.1% of firms struggling with financing, highlighting the impact of broader regional issues. In contrast, Egypt (18.3%) and Jordan (17.4%) had lower percentages, indicating relatively better access to capital, possibly due to supportive policies or economic conditions. This underscores the importance of addressing access to finance as a key factor for economic development in the region, with each country facing its unique challenges.

2.3. Sources of financing SMEs in MENA countries

SMEs in MENA countries rely mainly on family and national agencies to finance their projects. In addition, they can get finance from various types of financing institutions, including: Banking institutions, microfinance institutions, micro-credit associations, leasing companies, in addition to investment companies.

Fig.2.Borrowing and saving in MENA countries



Source: (The Global Findex Database 2021, 2022)

The MENA region exhibit higher rates of borrowing from family compared to borrowing from financial institutions. Strong social networks, reliance on informal financial systems, and cultural norms surrounding familial support contribute to this trend. In addition, the rate of saving at financial institutions is very low compared to the rate borrowing. This may be due to factors such as limited access to formal banking services, and religious and cultural preferences for alternative savings method.

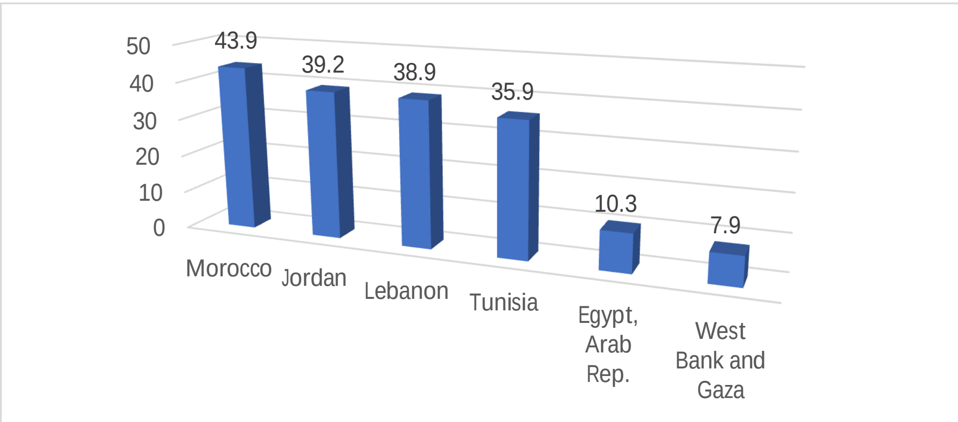
In addition, specialized agencies in some Arab countries provide guarantees for loans to small and medium-sized enterprises, such as the Small and medium-sized enterprises Loan Guarantee Fund (FGAR), the Joint Guarantee Fund for Small Loans, the Investment Loan Guarantee Fund (CGCI), the Joint Guarantee Fund for Risks / Loans for Young Entrepreneurs in Algeria. The Kafalah Program offered by the Industrial Development Fund in Saudi Arabia, the National Fund for Small and medium-sized enterprises Development in Kuwait, the Central Guarantee Fund in the Kingdom of Morocco, the Microfinance Guarantee Agency “Tayseer” in Sudan, and the “Al Dhameen” initiative in Qatar launched by the Qatar Development Bank (Table 1).

2.4. Indicators of SME’s access to finance in the MENA region

Financing indicators manifest in the measures and procedures implemented at the country level to enhance the accessibility of Small and Medium-sized Enterprises (SMEs) to financing.

In this section, we will delve into two key indicators shedding light on the diverse levels of access for SMEs across different countries. The first indicator examines the Percentage of firms using banks to finance investments, providing insights into the reliance on traditional banking channels for capital. The second indicator, the Proportion of working capital financed by banks, will be explored to understand how SMEs secure the necessary funds for their day-to-day operations. These indicators collectively illuminate the financial landscape for SMEs, offering valuable perspectives on the variations in financing approaches and accessibility from one country to another.

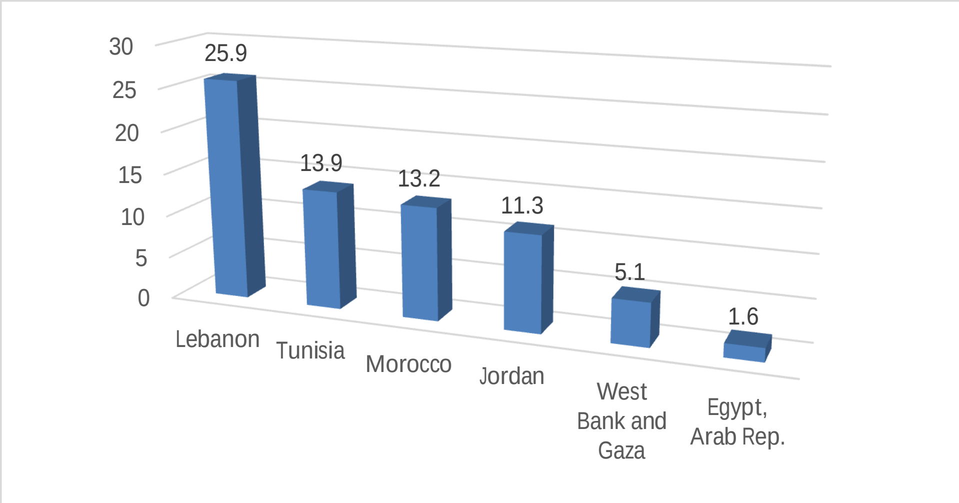
Fig.3.Percentage of firms using banks to finance investments in 2019



Source: (*The Global Findex Database 2021*, 2022)

In 2019, the data on the percentage of firms using banks to finance investments reveals varying degrees of reliance across the mentioned Middle Eastern and North African countries. Morocco exhibited a relatively high proportion at 43.9%, indicating a strong reliance on traditional banking channels for business capital. Jordan closely followed with 39.2%, reflecting a significant trust in the country's banking system. Lebanon, despite economic challenges, had 38.9% of firms using banks for investment financing. Tunisia, at 35.9%, demonstrated a noteworthy reliance on both traditional and potentially alternative funding sources. In contrast, Egypt had a lower percentage at 10.3%, possibly indicative of a more diverse set of funding sources. Palestine showed the lowest reliance on banks, with only 7.9% of firms using this avenue for investment financing, suggesting potential challenges or a preference for non-banking financial sources in the Palestinian business landscape. These variations highlight the influence of economic conditions, the strength of the banking sector, and the availability of alternative financing options in shaping the financing preferences of businesses in these countries.

Fig.4.Proportion of working capital financed by banks (%) in 2019



Source: (*The Global Findex Database 2021*, 2022)

In 2019 (with 2020 figures included for Egypt and Tunisia), the data on the proportion of working capital financed by banks in the Middle East and North Africa (MENA) region reveals relatively low percentages across the board. Lebanon stands out with the highest percentage at 25.9%, potentially indicating a stronger reliance on banks for working capital needs, possibly due to historical banking sector stability or economic conditions. On the other hand, Egypt and Palestine have the lowest proportions at 1.6% and 5.1%, respectively, suggesting a limited inclination towards bank financing for working capital in these economies. This pattern of lower reliance on banks for working capital in the MENA region may be influenced by factors such as cultural attitudes towards debt, perceived risks associated with borrowing, and potentially a preference for alternative financing methods. Additionally, regulatory environments and the accessibility of credit for businesses could play a role in shaping these patterns, highlighting the complexity of financial landscapes within the region. The moderate percentages in Morocco, Jordan, and Tunisia may reflect a balance between utilizing traditional banking channels and exploring alternative means of financing working capital needs in these countries.

3.Crowdfunding and its role in providing finance for SMEs in the MENA region

Crowdfunding emerges as a transformative force for Small and Medium-sized Enterprises (SMEs), providing a dynamic alternative to traditional financing channels.

3.1. Crowdfunding overview

Crowdfunding is part of the world of financial innovations, where crowdfunding specifically forms part of the sub-category termed as alternative funding, which refers to financing based on the electronic marketplace that depends on technology Finance.

The World Bank Group define it as: “an internet-based method that provides for the collection of funds in an organized manner, either in the form of donations or investments from multiple individuals for the purpose of financing commercial companies or other organizations, and the reason for the emergence of this new form of capital formation is due to the great difficulties faced by craftsmen projects in the early stages of raising funds in addition to the low willingness of traditional banks to lend (World Bank, 2013). While the European Commission and European Capital Markets Union defines it as follows: “Crowdfunding refers to an open invitation addressed to the public to raise funds for a specific project through crowdfunding platforms via websites that enable financial donations to be made and collected through this platform.” (European Commission 2016).

Thus, “Crowdfunding” is commonly defined as a method of financing in which small amounts of money are raised from large numbers of individuals or legal entities to finance a specific business, commercial, productive or profitable project. This activity involves the use of online platforms to connect between lenders and borrowers (individual entrepreneurs), in many cases the role of traditional financial intermediaries. Despite the difference of collective funding from an institution to another, but they are often based on three basic elements: to collect small amounts of money, from a large number of financiers and direct them to a large number of borrowers, using digital technologies (AMF, 2019).

There are four types of crowdfunding platforms according to the purpose of their establishment, including:

- **Donation-based platforms:** They collect crowdfunding with the aim of charitable or humanitarian works to support relief efforts in cases of disasters and famine, and to finance education programs. In return, the funders do not receive any reward or financial service, as the word donation explains. The JUSTGIVING and GOFUNDME platform are among the most important platforms in this field at the global level, as they managed in 2015 to collect donations estimated at 2.9 billion dollars. (Lawal Dano et Garba Benna 2018).
- **Rewards-based platforms:** These platforms collect crowdfunding for project owners in exchange for a reward that may be a gift, a word of thanks, or a sample of the final product. If the project revolves about publishing a book, the financier receives, for example, a copy signed by the author of the book. The KICKSTARTER and INDIEGOGO platforms are among the most important platforms. From 2009 to May 2019, the KICKSTARTER platform

contributed to financing 447,000 projects worth $3.9 billion, with a 37% project success rate in 2015. (Ivo, Lyman et Nava 2017).

- **Debt-based platforms:** These platforms collect crowdfunding and provide it in the form of interest-bearing or zero-interest loans to entrepreneurs. These platforms are considered competitors of traditional banks and financial companies. The KIVA platform is one of the most important platforms, as it grants loans ranging from 10 to 100 thousand dollars, and was able to finance 3.2 million borrowers in 78 countries, with a value of 1.3 billion dollars, with a loan repayment rate of 97%. (Sansri & Cheurfa , 2020, p. 352)
- **Equity-based crowdfunding platforms:** Within this type of platform, eligible projects are financed by collecting the necessary funds in the form of subscriptions for shares representing the capital of those projects. The WEFUNDER and STARENGINE platforms are among the most important platforms for this type of financing.

3.2 Developments of crowdfunding in the MENA region

Crowdfunding activity witnessed a remarkable growth from a market of 1.5 billion US dollars in 2011 worldwide to 84 billion US dollars in 2019. Crowdfunding became one of the most important sources of financing for small and medium-sized enterprises, and it comes in second place after venture capital as a source of financing for these institutions, especially in light of the expectations that the market will grow by about 196 billion dollars during the year 2021-2025 (Attia 2020).

The expansion of crowdfunding platforms activity from association financing to financing small and medium-sized enterprises has made it the second largest source of project financing after venture capital, and according to some estimates, the crowdfunding market is expected to reach 142 billion dollars in 2022. China leads the crowdfunding market size, ranging from 60 to 100 billion dollars, then India with 28 billion dollars. In the Middle East and Africa, the crowdfunding market amounted to $358.87 million in 2016 compared to $242.03 million in 2015, with a growth rate of 48.27%. Nigeria leads the crowdfunding market in Africa with $35 million and 20% market share, followed by South Africa with $33 million and 18% market share, and Kenya with 12.5% market share. In 2016, these three markets accounted for more than 50% of the crowdfunding market. Crowdfunding in Africa (IMF 2017).

The crowdfunding market generated $34 billion in 2020, of which $17 billion was raised by the United States, ranking first in countries with a large share of this market, followed by Asia and Europe with $10.54 billion and $6.48 billion, respectively.

However, although the activity of crowdfunding platforms has developed remarkably in a number of countries in the world, its growth in the MENA region is limited and below the hoped-for level, especially with regard to crowdfunding platforms that are debt-based or equity-baseed platforms. The countries of this region need to increase levels of financial inclusion and expand the establishment of micro, small and medium enterprises to reduce unemployment rates, which requires providing a supportive environment and regulatory frameworks associated with regulating the activity of these platforms in order to maximize the desired return and reduce the levels of risks associated with them.

Crowdfunding platforms in the MENA region provide their customers with many services, of which the most important are financial due diligence services, legal and advisory services, in addition to the services of designing and managing marketing campaigns through other means, advising and managing returns for the benefit of the shareholders.

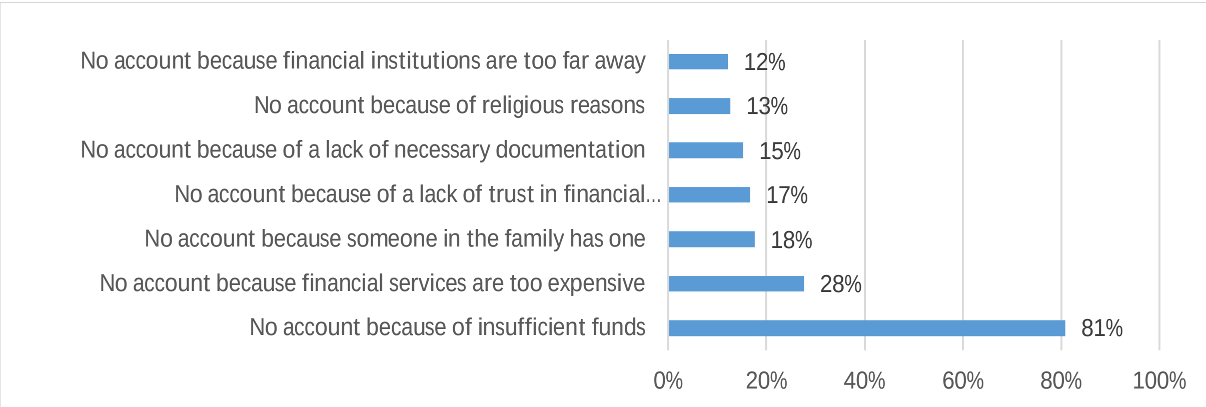
Forbes ranked the top 20 financial technology startups (FINTECH20) in the Middle East in 2019, and the list included four platforms specialized in crowdfunding in MENA region, and the 1st place is secured by **BEEHIVE platform** which is considered the first lending platform in the Middle East and Africa region. The platform is headquartered in Dubai and is registered with the Dubai Financial Services Authority. The platform uses innovative technology to link companies requesting financing and investors who can contribute to financing. Since its launch in 2014, the platform has funded more than 17,183 applicants for financing, with a value of 847.16 million dirhams, with a repayment rate of 84.4%, and a non-performing loans ratio of 1.41%, with a value of 10.90 million dirhams. The platform provides a financing service of more than 100,000 dirhams, with a repayment period of 6 to 36 months. (Fundly, 2020)

In MENA region, there are also crowdfunding platforms specialized in real estate finance, such as (DURISE), (HBR) and (ESTATEUP). And other platforms that are active outside the region, such as the ZOOMAAL platform), which is active both in Africa and the Middle East (AMF 2021).

4. The advantages of crowdfunding in enhancing financial inclusion of SME's:

Understanding the key obstacles to SME finance allows us to identify potential solutions that can be brought by crowdfunding.

Fig.5.Main obstacles to financial inclusion in MENA countries



Source: (*The Global Findex Database 2021*, 2022)

In addition to the challenges posed by religious considerations (13%) and a lack of documentation (15%), the significant concern that financial services are deemed too expensive, accounting for 28%, further compounds the difficulties faced by SMEs in the MENA region. The high cost of financial services can act as a deterrent for businesses, especially smaller enterprises with limited financial resources. This challenge may result from various factors, including high-interest rates, fees, and transaction costs associated with traditional banking services, exacerbating the financial strain on SMEs and limiting their access to essential funds for growth and sustainability.

Considering these obstacles, crowdfunding emerges as a potential alternative that could contribute to alleviating the financial challenges faced by SMEs in the MENA region. Crowdfunding provides an open forum for anyone who has an idea to present it to the potential investors around the world, and crowdfunding has provided the opportunity for entrepreneurs to collect funding from anyone who has money and wants to invest it, and there are many companies that have succeeded resoundingly through crowdfunding platforms , for example, the American company (ACULUS VR) specialized in virtual reality products was funded through a campaign on the (KICKSTARTER) website, and the company was able to raise $2.4 million, inspite the target was $250 thousand, and in 2014 FACEBOOK acquired ACULUS VR for $2.3 billion (Okasana & Plaksenkov, Analysis of Factors Affecting Financial Inclusion: Ecosystem view, 2017).

Crowdfunding platforms offer a decentralized approach to financing, allowing businesses to raise capital directly from a diverse pool of individual investors, both locally and globally. In addressing religious concerns, crowdfunding models can be designed to comply with Islamic finance principles, providing Sharia-compliant options. Moreover, the documentation requirements in crowdfunding campaigns are often more flexible compared to traditional banking, potentially reducing barriers for SMEs with limited formal documentation. Additionally, crowdfunding may offer cost-effective solutions, as it eliminates some of the intermediary costs associated with traditional financial services. By fostering a collaborative and inclusive approach to financing, crowdfunding has the potential to empower SMEs in the MENA region, offering them an alternative avenue to access capital, navigate religious considerations, and overcome challenges related to documentation and high costs associated with traditional financial services.

5. Conclusion

In conclusion, the examination of crowdfunding and its pivotal role in financing (SMEs) within the Middle East and North Africa (MENA) region underscores its transformative potential. The significance of SMEs as engines of economic growth is undeniable, and crowdfunding emerges as a critical instrument in addressing their unique financial challenges.

Crowdfunding, with its decentralized nature and ability to connect entrepreneurs directly with a diverse pool of investors, offers a compelling solution to the financing gap faced by SMEs. By fostering innovation, job creation, and entrepreneurial spirit, crowdfunding has the capacity to fuel sustainable economic development in the MENA region.

This study concludes with the following results elucidating the diverse implications of crowdfunding on financial inclusion in the MENA region:

- Small and Medium-sized Enterprises (SMEs) play a pivotal role in fostering economic growth within the MENA region. Their contribution to job creation, innovation, and overall economic vibrancy makes them a cornerstone of sustainable development.
- Despite the vital role SMEs play, they encounter significant challenges in securing financial support. A mere fraction has access to traditional financing from financial institutions, leaving the majority reliant on informal sources such as family and friends for funding.

- Recognizing the financial constraints faced by SMEs, crowdfunding emerges as a promising solution. This alternative financing method not only reduces transaction costs but also addresses hurdles related to religious considerations, specifically within Islam, and streamlines documentation requirements.
- While crowdfunding has experienced substantial growth worldwide, its adoption and expansion within the MENA region have been comparatively slower.

Building upon these insights, the study offers practical recommendations for leveraging crowdfunding to its fullest potential in supporting SMEs and advancing financial inclusion:

- Regulatory Framework: Policymakers should consider crafting clear and supportive regulatory frameworks tailored to the unique dynamics of crowdfunding. Striking a balance between investor protection and providing a conducive environment for crowdfunding platforms can foster responsible growth in the sector.
- Financial Literacy Initiatives: Launching targeted financial literacy initiatives can empower both entrepreneurs and investors participating in crowdfunding campaigns. Educated stakeholders are better equipped to navigate the crowdfunding landscape, mitigating risks and enhancing the overall effectiveness of the crowdfunding ecosystem.
- Incentivizing Crowdfunding Platforms: Policymakers should explore mechanisms to incentivize the establishment and growth of crowdfunding platforms. Offering tax incentives, grants, or other forms of support can stimulate the creation of platforms that cater specifically to the needs of SMEs in the region.
- Collaboration with Financial Institutions: Encouraging collaboration between crowdfunding platforms and traditional financial institutions can provide a hybrid financing approach for SMEs. Policymakers can facilitate partnerships that leverage the strengths of both crowdfunding and traditional banking systems.
- Monitoring and Evaluation: Establishing mechanisms for continuous monitoring and evaluation of crowdfunding activities ensures that policymakers can adapt regulations and support mechanisms in response to the evolving dynamics of the sector. Regular assessments will contribute to the long-term sustainability and effectiveness of crowdfunding in supporting SMEs.

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