INTEREST RATE AND THE PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NIGERIA. A REVIEW PAPER

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Abstract

Small and Medium enterprises (SMEs) remain central to Nigeria's economic growth, contributing substantially to employment generation and gross domestic product (GDP). However, their sustainability is increasingly undermined by macroeconomic instability, particularly interest rate. This study explores the impact of interest rate on the performance of SMEs in Nigeria, drawing on loan pricing theory, supply lending theory and credit market theory. Using a qualitative approach, the study reviews empirical studies, Central Bank of Nigeria (CBN) statistical bulletins, and relevant literature to examine how interest rate dynamics influence SMEs output, capital access and competitiveness. The findings reveal that monetary policy rate (MPR) had a significant and positive impact to the total asset and total liabilities for deposit money banks in Nigeria economy but has a negative and insignificant impact to total deposit. It further reveals that interest rate has a negative impact on SME contribution to the Gross Domestic product (GDP). The study recommends that monetary policy rate (MPR) and interest rate be reduced in order to reduce lending rate to SMEs which will improve SMEs' financial capacity.

Introduction

Small and medium enterprises drive growth and development in any economy. Most economies, especially emerging ones depend on then since they make up most companies, providing jobs and boost global economic growth (world bank, 2022). They are vital to global economic development architecture and processes (Manasseh et al, 2019) and are garnering more attention as the drivers of economic growth and development especially in poor nations, SMEs in developing economics account for 90% of enterprises globally, 40% of GDP, and more than 50% of employment, according to the World Bank (2022).

SMEs make up the majority of enterprises in Nigeria, producing over 70% of jobs and contributing over 45% to the GDP. Over 80% of Nigerian employment and 49.78% of GDP come from SMEs, according to the SMEDAN/NBS MSME Survey (2017) (PWC, 2020).

Eniola (2014) stated that SMEs employs 70% of the country's work force; not withstanding crude oil extraction. Any economy's growth depends on the SMEs. It drives industrialization, modernization, rural-

urban development, and gainful employment, increasing per capital income, promoting equitable income distribution and improving citizens' welfare and quality of life. various government, national and international organisations' are increasingly concerned about engaging the survival of SMEs to guarantee economic growth and development.

Despite their significance, SME in Nigeria face numerous challenges, many of which are linked to the country volatile macroeconomic environment. Nigeria economy is heavily dependent on oil exports making it susceptible to fluctuation in global oil prices. The dependency has led to macroeconomic instability characterized by high inflation rates, interest rates, exchanges volatility etc. These factors among others have a profound impact on the performance of SMEs which often lack the resources and resilience to navigate such uncertainties.

Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) in 2021 reports that most small and medium enterprises businesses in Nigeria die before their fifth anniversary. Certain factors in Nigeria business environment have been identified to affect the performance of the SMEs and contribute to the high failure rate.

Interest rate also plays a crucial role in shaping the operational landscape for SMEs. When borrowing gets more expensive, high interest rates have the potential to discourage investment and restrict access to credit. The strict lending policies of banks, which frequently do not favour SMEs' owing to perceived risks, exacerbate this situation. High interest rates have been shown to have a negative correlation with the growth of SMEs' because they make it more difficult for these companies to obtain the capital, they need for the expansion of an ongoing operations.

Objectives of the study

The main objectives of this study are to examine the effect of interest rate on the performance of SMEs in Nigeria, while the specific objectives include;

i. Examine how interest rate affect Nigerian SMEs performance.

ii. To ascertains the impact of interest rates on SMEs output in Nigeria.

Methodology

This study adopts a qualitative research approach were contemporary literature such as books, journals, online publications, CBN statistical bulletin and quarterly reports, Newspaper and empirical studies of previous researchers were reviewed in an attempt in gauging the efforts of government through its agencies like the central bank of Nigeria and Small and Medium Enterprises Development Agency of Nigeria in addressing the various challenges hindering the SMEs' in achieving its potential.

Literature Review and Conceptual Frame Work

There is no universally acceptable definition of SMEs in the literature, perhaps due to the fact that different countries utilize different criteria and definitions. A number of criteria are used to identify small and medium sized enterprises (SMEs), including the number of employees, total capital invested, plant capacity, sales turnover, and profits margin (Dababneh & Taken in Manasseh et al, 2019). Similarly, defining SMEs on a global scale is a challenge for the World Bank. The World Bank Research Group (2019) notes that national standard differs significantly. Micro, small or medium sized businesses are defined using the same standard criteria by the International Finance Cooperation (IFC) and the Multilateral Investment Guarantee Agency (MIGA),

according to the World Bank Research Group (2019), A proper definition of SMEs is important to distinguish between the different categories of the production units in terms of factors like, number of employees, the value of fixed assets, production capacity, basic characteristics of the inputs, level of technology used, capital employed, management characteristics etc.

In Nigeria, the CBN puts the employment level of the small-scale business at less than 50 and medium scale business at less than 100. In terms of asset based, small scale has less than ₦1 Million, while medium scale has less than ₦150 million naira (IFC, 2002). Classification in USA, Britain and Canada defined SMEs in terms of annual turnover and the number of paid employees whereas it is conceptualized in Japan as an industry paid up capital and the numbers of employees.

The Federal Ministry of Industries defines a medium scale enterprise as any company with operating assets less than ₦200 million and employing less than 300 persons. A small-scale enterprise, on the other hand, is one that has total assets of less than ₦50 million, with less than 100 employees. Annual turnover will not be given consideration in the definition of an SME. The National Economic Reconstruction Fund (NERFUND) defines a Small-Scale Enterprises as one whose total assets are less than ₦10 million, but makes no reference either to its annual turnover or the number of employees. The Small and Medium Industry Equity Investment Scheme (SMIEIS), defined an SME as any enterprise with a maximum asset base of N50 million, excluding land and working capital and with the number of employees not less than 10 and not more than 300. This definition did not distinguish between a medium scale enterprise (Sanusi, 2003).

SMEDAN (2007) adopted a classification and definition for National Policy of MSMES.

S/N	Size Category	Employment	ASSETS ('N' million Excluding Land and Building)
1	Micro Enterprises	Less than 10	Less than 5
2	Small Enterprises	10 – 49	5 - less than 50
3	Medium Enterprises	50 -199	50- less than 500

Source: SMEDAN, 2007.

- Micro are those enterprises whose total assets (excluding land and Building) are above ₦1 million but not exceeding ₦10 million with a total work force of not exceeding 10 employees.
- Small are those enterprises whose total assets (excluding land and building) are above ₦10 million but not exceeding N100 million with a total workforce of above 10, but not exceeding 49 employees.
- Medium are those enterprises with total assets (excluding land and building) above N100 million but not exceeding N1 Billion with a total workforce of between 50 – 199 employees.

Ibimodo (2015) define interest rates as the rental payment for the use of credit by borrowers and return for parting with liquidity by lenders. Like other prices, interest rates perform a rationing function by allocating

limited supply of credit among the many competing demands.

Bernhardsen (2018) defined the interest rate as the real interest rate, at which inflation is stable and the production gap equals zero. The interest rate very often appears in monetary policy deliberations. However, Anyanwoncha (2013) states that interest rates are charged for a number of reasons, but one is to ensure that the creditors lowers his or her exposure to inflation. Inflation causes a nominal amount of money in the present to have less purchasing power in the future.

Interest Rate Volatility and the Performance of Small and Medium Enterprises

In Nigeria, lending to SMEs has been a vital concern of not only the government, but other corporate bodies, such as the World Bank and the International Monetary Fund (IMF), and stakeholders in the country as well. The interest rate regime became effective in 1960, when the Nigerian Government had the sole authority to determine the interest via the monetary policies geared towards the development of and supporting the vital SME sectors of the economy (Ene, Agoke & Ene, 2015). This concern came as the Government's methodical policy intended to expand the economy. However, there was a sharp twist when the trade liberalization policy that culminated in the introduction of the Structural Adjustment Program (SAP) in 1986 was embraced.

According to Ifeanyi and Chukwu (2004) and Tajudeen et al. (2017), the SAP gave rise to the liberalization of the financial sector, leaving the interest rate to the dictates of demand and supply, the risk appetite of financial institutions, and consumers' negotiating dominance. This no doubt affected SMEs (Udoh et al, 2018). Suleyman (2014) opines that the performance of SMEs deteriorates as they become susceptible to the interest rate volatility due to their weak negotiating strength.

Interest rate affects all sectors of the economy through the cost of debt and the availability of money and credit and this could affect a firms' ability to access external sources of fund. Fiscal policies affect a firms' after-tax net cash flow, its products, and survival. Prior to interest rates liberalization, interest rates were determined through administrative controls and after liberalization by market forces (Wachira, 2009). These factors that now determine interest rates include; inflationary expectations, the real rate of interest differentials, excess liquidity and domestic and foreign interest rate differentials i.e when there are no restrictions on capital movements. According to Cargill (2011), there exists two approaches used to determine interest rate, liquidity funds approach and loan able funds approach. In addition, these approaches assume that the level of income and employment determined in the real section of the economy are constant; increases in the nominal interest rate intensifies the aggregate rates of failure or default (Wadhwani, 2016; Robson, 2016), as firms' are financed with high variable rate, firm may unable to increase their debt through borrowing and therefore, unavoidably face liquidity risk as a result of cash shortage. Interest rates have been observed to have diverse impact on SMEs performance. High interest rates are likely to curb business investments and innovation. Rising interest rates could also increase loan defaults in the banking system and SMEs' business financing and affect business revenues and profits negatively. When interest rate is raised, the general effects is to lessen the amount of money in circulation, which works to keep inflation low. On the other hand, lower interest rates give companies, an opportunity to borrow money at lower rates, which allows them to expand their operations and also their cash flows. When interest rates are declining, the economy is

expanding in the long-run. Appropriate interest rates should therefore be set to maintain inflation at desired levels while encouraging economic development.

Theoretical Frame Work

Loan Pricing Theory

This is a model or theory-based approach for calculating the fair value of an option. Under the loan pricing theory, banks cannot always set high interest rates, for example, trying to earn maximum interest income. Banks should consider the problems of adverse selection and moral hazards since it is very difficult to forecast the borrower type at the start of the banking relationship (Stiglitz and Weiss,1981). If banks set interest problems because high risk borrowers are willing to accept these high risks. Once these borrowers receive the loans, they may develop moral hazard behavior or so-called borrower moral hazard since they are likely to take on highly risk projects or investments (Chodechai, 2004). From the reasoning of Stiglitz and Weiss, it is usual that in some cases we may not find the interest rate set by banks being commensurate with the risk of borrowers.

Supply Lending Theory

The supply lending theory postulates that the existence of financial institutions like deposit money bank (DMB) and the supply of their financial assts, liabilities and related financial services in advance of demand for them would provide efficient allocation of resources from the surplus unit to the deficit units, thereby lending the other economic sectors in their growth process (Patrick 1996). This theory performs two functions; first it transfers resources from traditional sectors to modern sectors and second; it promotes and stimulates an entrepreneurial response (SMEs) in the modern sectors. The proponents of this theory believe that the activities of the financial institutions serve as a useful tool for increasing the productive capacity of the SME's in the economy. They opined those countries with better developed financial institutions serve as a useful tool for increasing the productive capacity of the SME's in the economy. They opined that countries with better financial system tend to grow faster in this aspect. Early Economist like Schumpeter (1911) has strongly supported the view of finance led casual relationship between financing small-medium enterprise SME, and a country's economic growth.

Credit Market Theory

This theory ties the Interest rate required on loans with the bank's income earned from lending activities. It Postulates that there exist credit terms that clears the Market. In assuming that loans and advances remains Constant, the interest rate then becomes the price (Credit term) that clears the market- However, a rise in loan demand given a certain customer base level will spike a certain surge in interest rate, Vice-versa. Ewert, Szczesmy & Schenk (2000) Contends that a rise in the default risk by borrowers will necessitate an increase in the interest premium to cover against any occurring losses arising from default on the future. The main thrust of this theory rest on two major factors; bank's income and interest rate. A higher interest rate means more income for banks, but a rise in interest rate makes borrowers prone to default risk. Consequently, any rate above the optimal interest rate may lead to possible losses and less income for banks.

Theoretical Review

Ihegboro et al. (2022) investigated the effect of interest rate on deposit money banks performance in Nigeria for the period of 2010-2019. The interest rate was proxied by the monetary policy rate of the CBN while bank performance was proxied by row assets, total

liabilities and total of deposits money banks in Nigeria. Ordinary least square (OLS) simple regression technique was employed to analyze the data in order to determine the impact of the independent variables on the various dependent variables. Findings showed that monetary policy rate had a positive and significant impact to the total asset i.e f-statistic (20,79420) and P-value of (0.040) and total liabilities i.e, t-statistics (20,79420) and P-value (0.0402) of deposit Money banks in Nigeria economy but has a negative and insignificant impact to total deposit i.e t-statistics (-1.943590), was negatively signed and the p-value (0.3556) was insignificant. The study focused on banks in Nigeria and as such its findings cannot be used for effective decision in the SMEs Sector.

Ashogbon et al. (2022) assessed the impact of interest rates on the growth of SMEs in Nigeria. Data for the study were obtained from the World Development Indicator (WDI) and the Central Bank of Nigeria (CBN) statistical bulletin using annual time series data from 2000 to 2019. The dependent variables were Small and medium sized enterprises GDP (SMEG), while the independent variables were commercial bank total credit to the private sector, Commercial bank loans to SMEs, percentage of commercial bank loans to SMEs, Monetary policy rate (MPR), inflation, exchange rate, reserve requirement, and Commercial bank lending rates to SMEs. Descriptive and Inferential statistics were used, and the Autoregressive distribution Lag (ARDL) was used to test the long-term relationship of the Variables. The result shows that LRCM has a negative effect on SMEGDP, with a 1% Increase resulting in a 1.6% decrease in SMEGDP. In Contrast a 1% increase in RR causes a 0.005% increase in SMEGDP. The study recommends that monetary policy rate (MPR) and interest rate (INTR) be reduced in order to reduce LRCM which will Improve SMEs' financial capacity and, as a result, Increase SMEs Contribution to national GDP.

Sandra et al (2021) investigated the effect of interest rates on the performance of SMEs in Kenya. The study adopted a descriptive research design with a simple linear regression model. The Study relied heavily on Primary data since the data collection Instrument used was a structured questionnaire. Simple Random Sampling (SRS) was used to identify the number of respondents as 100. These 100 respondents included financial Institutions, managers and SMEs business owners within Nairobi. Linear regression was used as a tool for the data analysis, the study revealed a direct relationship between Interest rates and the performance of SMEs. The study was conducted in Kenya and the findings may not be useful in the Nigerian Context due to regulatory and Legal Framework for SMEs in the Nigerian Context.

Adegbite and Alli (2021) investigated the effect of interest rate and small and medium scale enterprises growth in Lagos and Ogun state, Nigeria. The study adopted descriptive survey research design with a study Population of thirteen thousand four hundred and fifty-Seven (13,457) which comprises of the total registered SMEs in both Lagos and Ogun state according to SMEDAN 2013 survey. Primary and Secondary data utilized as the research Instruments to solicit responses and data while Linkert five-point rating scales measurement was used to test the degree of agreement and disagreement with the research questions. Taro Yamane's Sampling size determination was used while stratified and proportionate Sampling techniques was adopted to determine the exact Sample size that structured questionnaire will be administered to in Lagos and Ogun state Without bias and Misappropriation. Statistical Package for Social Sciences (SPSS) Version 21 and Ordinary Least Square Regression (OLS) statistical techniques are used to ascertain the relationship between the Independent and dependent variables. In the study, one

hypothesis was formulated and tested. The results from the hypothesis tested revealed that a significant negative relationship exists between interest rate and SMEs performance in Nigeria. The study recommends that microfinance banks should charge moderate interest rate to SMEs without stringent collateral requirements to boosts SMEs growth in Nigeria.

Conclusion and Recommendations

This study investigated the impact of interest rate on the performance of small and medium enterprises (SMEs) in Nigeria. The findings reveal that interest rate has a negative impact on SME contribution to gross domestic product (GDP), it further reveals that monetary policy rate (MPR) had a significant and positive impact to the total asset and total liabilities to deposit money banks in Nigeria economy but has a negative and insignificant impact to total deposit as collaborated by Ashogbon et al (2022), Ihegboro et al (2022) and Adegbite & Alli (2022) in their empirical studies. Based on the findings the following recommendations were made; that the monetary policy rate (MPR) and interest rate be reduced in order to reduced lending rate to SMEs which will improve SMEs financial capacity. The study further recommend that micro finance institutions should charge moderate interest rate to SMEs without stringent collateral requirements to boost SMEs growth in Nigeria.

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