The Effects of Interest Rate on Micro, Small and Medium Enterprises Financing Decision in Wa Municipality of Ghana

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Abstract

This study investigates the effects of interest rate on micro, small and medium enterprises' (MSMEs) access to funds and their financing decision in Wa municipality of Ghana. A multiple research method and descriptive survey were employed to permit the study to make use of bothquantitative and qualitative data collection techniques and data analysis procedures. This is because we wanted to portray an accurate profile of the enterprises, events and situations in order to obtain information which can be analysed and patterns extracted and comparisons made.In all, 200 enterprises were chosen for the research. Evidence from the analysisshows that majority of MSME businesses have resorted to the use of equity financing for their operations. This was attributed to several factors of which interest rate was the leading cause. It emerged that interest rate affects choice of financing decision of MSMEs in Wa municipality. In order to help thesemicro, small and medium enterprises, the cost of credit facilities should be reviewed downwards to enable smooth repayment and increase in the demand for loans by MSMEs to enable them grow their businesses which will in effect have ripple effect in the economy.

Keywords: Effects, interest rate, MSMEs, financing decision, Wa municipality

1.Introduction

Every developing nation's development depends on the private sector of the country. In Ghana, available data from the Registrar General Department indicates that 90% of companies registered are micro, small and medium enterprises (Mensah, 2004).The small and medium scale enterprises contributes immensely to the development of the nation in terms of taxes to the state, provision of quality goods and services to the larger public at a comparatively reduced prices as well as its contributions to poverty alleviation.

The small and medium enterprises face many challenges, but the most significant among them is that of financing decision of their operations. Different governments in Ghana have tried at different times to assistthese enterprises in addition to assistance givenby other development partners and foreign donors yet the challenges have remained unresolved. This renders these enterprises with no option but to run to financial institutions for assistance. Going to those financial institutions also bringsnew phenomena for these SMEs. Among them are the exorbitant interest rates?What are the requirements do one need to have access tosuch facility? These are some of the few questions that come to mind when the issue of financial institutions and interest rates arise.

This issue put MSMEs in a dilemma whether to depend on their own savings, family savings, friends'assistance, government and donor support or financial institutions to finance their operations. This study tries to investigate the effect of interest rate on MSMEs access to funds and their financing decision in Wa municipality. In doing so, the study takes a look at the extent to which interest rate affect Micro, Small and Medium Enterprises' financing decision.

2. Theoretical and Empirical Literature

Innovation capability of Ghanaian MSMEs is not only in developing new goods or services but also in stimulatinginvestment interest in new ventures being created. Although Ghanaian firms have been criticized for not beinginnovative enough, MSMEs have attempted to change this phenomenon (Agyapong 2010). The innovativeness of these small ventures is to create a paradigm shift by altering the conventional ways in the terms of available technology, strategy, skills and styles (Jun & Deschoolmeester, 2003). Mukras (2003) alludes that the attraction of the MSMEs as an alternative employment generator derives from the very nature and characteristics which made the sector relatively more accessible to the poor, the less skilled and the less sophisticated.

Nonetheless, the development ofinnovation and its commercialization through entrepreneurial activity has helped generate enough incomes forthose involved to alleviate their poverty levels as well as to promote economic growth for developing countries.Financial assistance and support to strengthen these small informal and formal businesses can lead to higher profits, wages and employment levels which in turn can contribute to a bottom-up transition out of poverty for entrepreneurs and workers. (Sievers & Vandenberg, 2007). It is believed that the formalization of informal business activities can contribute to increasing tax-incomes for the government which will give it the impetus in the long run to invest the money, for instance, in health care and education systems.

Besides the strengthening and expansion of existing MSMEs, the support for new enterprises can contribute to development and growth. Kapila & Mead (2002) argue that in order to strengthen this position of MSMEs, access to financial and non-financial services should be made available to them because it contributes to the performance and expansion of these enterprises. Financial services should include the provision of micro-credits and loans while non-financial services incorporate a wide range of Business Development Services (BDS). BDS activities refer to group training, individual counselling and advice, the development of new commercial entities, technology development and transfer, information provision, business links and policy advocacy.

It is observed that as banks and other financial institutions have sought to broaden their loan portfolio; MSMEs have become an increasingly attractive customer group. Evidence made by Bawuah et al (2014) indicates that there are enough and available financial opportunities for small businesses to access even though Leippoid et al. (2006) havefound a contrary opinion and assertthat financial institutions in Ghana were rather cautious with lending to MSMEs groups because of high default rates and its possible risks associated with the sector. The issue of availability of funds for MSMEs has been confirmed to exist by Bawuah et al. (2014), another contending issuesuspected to be bothering small businesses is high interest rate. Research on the credit channel of monetary policy contends that higher interest rates lead to a declinein the availability of internal and external finance relative to credit needs of firms. This channel is deemed to be most important for small businesses which are most likely to be constrained in their access to finance.

This view is consistent with Gertler and Gilchrist (1994) findings which show that small US manufacturing firms are disproportionately affected during periods of rising interestrates. High interest rate compelssmall businesses to reduce inventories, incur high production cost and experience sharp falls in sales which ultimately affect their profit margins and growth. In contrast, larger firms have the ability to uphold debtlevels, increase inventories, and experience a considerably smaller decline in their turnover and growth as opined by Ehrmann (2000). The effect of higher interest rate on credit can be seen in the balance sheet of these small businesses.

Thebalance sheet effect is that higher interest rates weaken firm balance sheets partially by reducing expected future profits and partially because small firms have long-term physical assets but mainly short term liabilities. This maturity disparity implies that net current cash flows decline when interest rates increase, and also that the present value of assets declines relative to the present value of liabilities. The latter makes the firm less creditworthy, reducing its ability to raise external finance. Greenwood (2003) finds that firm investment is most sensitive to interestrates when maturitymismatch is high and that this relation is most pronounced for financially constrained businesses.

Providers of credit attributed the high interest rate to high cost of administration of overdue loans and defaulters which eventually push up lending cost without corresponding increase in loans turnover. Defaulters of loan reduce financial institutions resource base for further lending, thus, weaken staff morale and affecting the borrower's confidence. The consequence is that financial institutions must set the risk premium sufficiently high to compensate for the risk leading to differentials in the required return and the expected return on a loan.

Saunders and Cornett (2007) added that the promised return on the credit may well differ from the expected return on a credit due to the presence of default risk.However, the lender has to recognize that by setting high risk may have actually reduced the probability of repayment.In Africa, loan repayment performance has been very poor and this has affected the small business financing. For instance, about 45% small agriculture loans granted in Ghana are not repaidas bemoaned by (Aryeetey and Nissanke2000).Success stories of loan recovery are not easy to come by in Africa and for that matter Ghana.

Examples in Ghana and other developing countries have shown that government credit programs to assist MSMEs are not self-sustainable. This is because almost all the District Assemblies in Ghana are still to recover the Poverty Alleviation Fund (PAF) they disbursed to borrowers as far back as 1996. The reason is that many borrowers of such funds see such loans as a gift from the government for voting the government into power. As a result, they do not see the need to pay back the loan when it is due (Agbelie, 2001).

Trying to understand how firms choose their capital structure has been of great interestto scholars around the world for a very long time. Effort has been made in trying toexplain the proportion of debt relative to equity, instead of the exact combination ofdifferent kinds of securities, such as long-term verses short-term debt(Frank andGoyal 2007). From the past50 years, different theories on capital structure have emerged.Theories explaining capital structure and the variation of debt ratios across firms range from the irrelevance of capital structure, proposed by Modigliani and Miller (1958), to a host of relevance theories.According to the irrelevance theory, the amount of debt relative to equity only serves to determine the successive split of cash flows between debt holders and equity holders, and this relativity does not affect the aggregate value of the company. The theoryonly holds in the synthetic world of M&M, where capital markets are perfect, i.e. no taxes, no business transaction costs (Myers 2001).

Though the theory today does not make much sense because of the many strict and unrealistic assumptions, it brought about something else very valuable, thus the focus on capital structure theory. “The Irrelevance Proposition” triggered a wave of research trying to develop evidence against M&M, that is to say financing actually matters.Some of the later day theories were the “static trade-off” theory,the dynamic trade-off,and the pecking order theory.Bevan and Danbolt(2000) stronglyargue that empirical evidencesshowthat capital structure studies tend to focus on large firms in developed countries.It is only in recent years that we are beginning to see a few studies examiningcapital structure issues either in developing countries or among small firms in developed countries (Booth et al. 2001; Mira 2001; Bhaduri 2002).

In the framework of the trade-off theory it is hard to argue that SMEs would not face the same trade-off between interest tax shield and distress costs. However it is possible that SMEs might put more emphasis on certain issues or face problems that large listed companies will not face the same degree due to their ability to withstand such threats. One possible reason that could explain why SMEs might not follow the trade-off theory is simply lack of knowledge among managers. If the financing decision should be made according to the trade-off theory, it is naturally a necessary that managers are aware of the advantages of an interest tax shield (Jensen and Uhl, 2008). This should not totally rule out the fact that a business would not enjoy the advantage of the trade-off theory.

What may be so dangerous to a manager's ignorance of this theory may be his/her inability to determine the optimal level of the capital structure to avoid financial distress. This problem is bound to happen toMSMEs since most of them are led by entrepreneurs with their expert skills lying within a field different from finance.Therefore, they might not possess the knowledge or for some other reason, be ignorant of the interest tax shield and therefore do not take advantage of it (OECD 2006). If SMEs managers are not aware of debt levels within which they have to operate to enjoy the benefits of leverage, they might tend to operate below or above expected debt levels. One possible reason why SMEs could have a different capital structure from their largelisted counterparts could be that their bankruptcy costs propensity ishigh due toa lot of them being family owned (Jensen and Uhl, 2008).

Besides the expected financial distress costs and theeconomic loss due to bankruptcy, family owned company are most likely to represent agreat amount of sentimental value to the owners.

Therefore one can argue that thisdimension of distress costs will increase the expected costs of debt, thus, lowerthe optimal capital structure of family owned companies. In 1984, Myers proposed an alternative approach to capital structure theory by introducing the pecking order theory. This theory states that “firms prefer internal financing to external financing, and if external financing has to be used, the cheapest possible security is chosen first. The pecking order theory is, therefore, contrary to the trade-off theory.

This is because it is able to explain why profitable firms have less debt compared to less profitable companies. The reason is not that they have a low target debt ratio, but that they have ability to generate sufficient internal funds to finance necessary investments (Myers 2001).The pecking order theory fits SMEs not because of theoretical factors but by circumstances of the fact that SMEs lack external financing schemes compared to large listed companies.

3. Data and Methodology

This study involves both qualitative and quantitative methods. A multiple research method was employed to permit the researcher to make use of bothquantitative and qualitative data collection techniques and data analysis procedures. Saunders *et al.* (2007) emphasised the use of the multiple method saying; “not only is it perfectly possible to combine quantitative and qualitative within the same piece of research, but in our experience it is good to do so. Though, the two approaches have distinct procedures in terms of research directions, any single approach is unduly simplistic in this study. The choice of approaches has also become necessary because of what we sought to achieve. We used descriptive survey for this study. This is because we wanted to portray an accurate profile of persons, events and situations in order to obtain information which can be analysed and patterns extracted and comparisons made.

3.1 Population, Sampling and Sampling Techniques

The population of this work was small business enterprises in the Wa municipality in the Upper West Region of Ghana. Since the population for this work is large, the convenience and random sampling techniques were used for the sampling of respondents. Convenience sampling was used to select the areas (suburbs in Wa municipalities) where respondents were drawn from. According to Baumgartner, Strong and Hensley (2002), convenience sampling is selecting the research participants on the basis of being accessibleand reasonably representative of the population of interest. Five areas were selected and these areas were based on the information provided by office of National Board for Small Scale Enterprise (NBSSE). Uniform numbers were not selected from the areas because the sample frame provided by NBSSE indicated a dense numbers of enterprises in some areas than others. As a whole, 200 enterprises were chosenfor the research. The table 3.1.1 below shows the various areas selected and the number of enterprises selected from the respective areas.

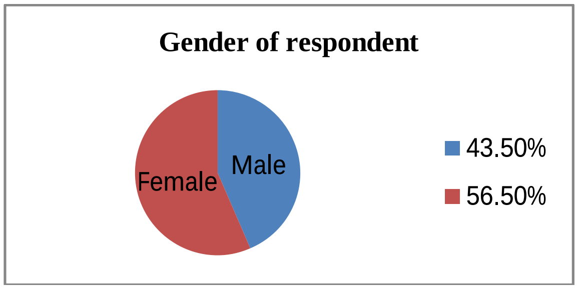
Table: 3.1.1: Sample Areas and Number of Enterprises

AREA	NUMBER OF PEOPLE
Degu	20
Wa central market	80
Hospital	30
Kambale	45
Bamahu	25
Total	200

4.Empirical Result and Discussion

This part presents the analysis of the findings from data collected through questionnaires, both open ended and close ended. It is specifically focused on the analysis of the responses gathered from respondents on the survey questionnaire administered and data collected following the research outlined in the previous chapter. A total of 200 respondents were used for the study as stated earlier. This defines the gender of the respondents employed. They constitute male and female. From the questionnaire administered, majority of the respondent were females totalling n=113 (56.5%) while the remaining respondents totalling n=87 (43.5%) were males. This is represented in the pie chart below.

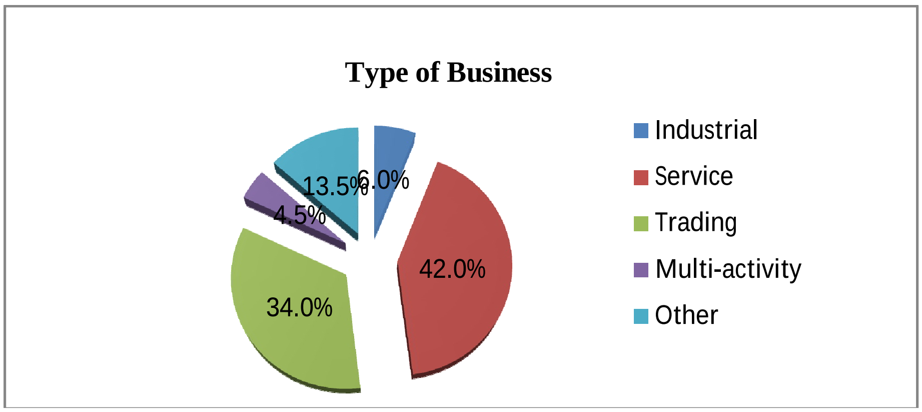
Figure 4.1: Gender of Respondents



Source: Field survey, (2014)

Another question posed to respondent was: what type of business do you deal in and the responses are presented in the figure below.

Figure 4.2: Type of Business



Source: Field Survey, (2014).

From the figure4.2 above, it could be seen that service type of business is mostly operated by MSMEs which takes up 42% (n=84) of the total industry. The trading business also takes the next major component of 34% (n=68) whiles the other forms of business shares 13.5% (n=27) as well as the industrial nature of business taking up 6% (12) with the multi-activity type of business taking the least of 4.5% (n=9).The respondents were also asked to respond to thequestion: Have you ever accessed credit facility from any financial institutions since the operation of your business. The following were the responses given by the respondents.

Table 4.1: Access to Credit Facility for Business Operation

Access to credit facility for business operation	Response	Percentage (%)
Yes	98	49
No	102	51
Total	200	100

Source: Field Survey, (2014)

The table 4.1above shows the responses given by respondents on their ability to access credit facility from any financial institution since the operation of their business. From the questionnaires administered it was revealed that 49% (n=98) respondents have had access to credit facility from the various financial institutions and 51% (n=102) of the respondents indicated that they have not accessed any credit facility. The follow up question was for those respondents who responded "Yes" to indicate the number of times they applied for a facility from financial institutions. The responses given are represented on table 4.2 below.

Table 4.2: Number of Times SMEs Applied for Loan from Financial Institutions

Number of times SMEs applied for loan	Frequency	Percentage (%)
Once	24	24.5
Twice	28	28.6
Three times	23	23.5
Four times	14	14.3
Five times	9	9.1
Total	**98**	**100**

Source: Field Survey, (2014)

From the table above it could be observed that majority of MSMEs that have applied for loan twice from financial institutions are 28.6% (n=28) and the least have applied five times with only 9.1% (n=9) respondents. 24.5% (n=24), 23.5% (n=23) and 14.3% (n=14) respondents have applied once, three times and four times respectively. In order to know more about the reasons why 102 respondents responded "No" to the question in table 4.2, they were further given three probing questions to answer and below are the questions and respective answers. They were asked whether they knew of some existing financial institution that could provide credit facilities to them. Most of the respondents said they were fully aware that financial institutions give credit facilities to help MSMEs grow and expand and a few of them said they were unaware and uninformed about such bank loans.

Table 4.3: Awareness of the Existence of Bank Loans

Awareness about bank loan	Response	Response (%)
Yes	96	94
No	6	6
Total	102	100

Source: Field Survey, (2014).

From the table above 94% (n=96) of respondents indicated that they are aware that banks give loan especially to MSMEs to support their operations whilst only 6% (n=6) were unaware that banks give loans to small businesses. If "Yes" (that is if you are aware), why have you refused to access a facility from any of the known financial institutions? This was a follow up question from table 4.3 above and the responses are provided in table 4.4 below.

Table 4.4: Reasons for not Accessing Credit Facility

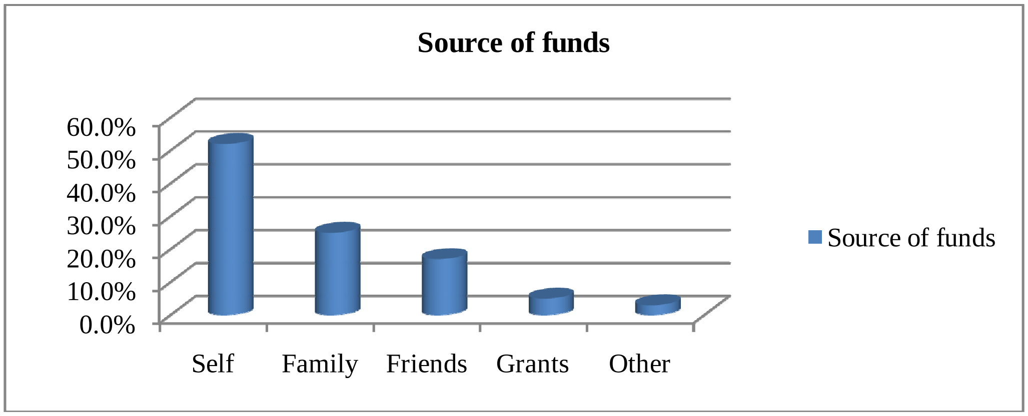
	Response	(%)
Repayment Problems	12	12.5
High interest rate	54	56.2
No Collateral/Guarantors	30	31.3
Total	**96**	**100**

Source: Field Survey, (2014).

From the table above, 12.5% (n=12) of the respondents gave repayment problems as their reason for not accessing credit from the financial institutions, 56.2% (n=54) of the respondents said high interest rate charged on credit was deterring them and 31.3% (n=30) of the respondents indicated lack of collateral (guarantors) as their reason.The respondents were further asked to respond to the question: If you have responded "No" in table 4.3 above, what then is the source of your business fund? From the figure below, 51% (n= 52) of the respondents finance their business through their personal savings (self) as against minority 3% (n=3) of respondents whose business activity is financed from other sources.

This is because majority of respondents are not enlightened on how they can expand their businesses using other sources of fund. In addition to that, there is the fear of their inability to re-service the borrowed funds because the survival of their families depended on profits generated from the businesses. 24.5% (n=25) and 16.6% (n=17) of the respondents said they got their funding from families and friends respectively. Only 4.9% (n=5) of respondents finance their business through grants. Although, SMEs have various sources and options in contracting funds for their business operation they are usually limited only to equity or debt financing.

Figure 4.3: Sources of Fund for the MSMEs



Source: Field survey, (2014)

Respondents were asked of how they would score the interest rate that is charged on credit given to them for their operations. This is done to finds out whether interest rate charged on the loans given are very high, high, moderate, low or very low. The business performance is greatly dependent on the judicious use of resources acquired (loan) for operation and hence the higher the interest rate charged, the greater challenge it presents the business to strive and redeem its debts. The table below shows the responses given by the respondents from whom data was gathered.

Table 4.5: Scoring of Interest Rate

Interest rate score	Frequency	Percentage (%)
Very High	32	32.7
High	29	29.6
Moderate	28	28.6
Low	6	6.1
Very Low	3	3.0
Total	**98**	**100**

Source: Field survey, (2014)

From the table drawn above, it could be observed that interest rate charged on credit facilities by financial institutions were perceived by respondents to be very high with at least 32.7% (n=32) and 3.0% (N=3) respondents saying interest rate is very low. About 29.6% (n=29), 28.6% (n=28) and 6.1% (n=6) of the respondents were of the view that interest rate charged is high, moderate and low respectively. One of the questions posed to the respondents was to know how the interest rate affected their businesses. The respondents gave emotional views on the effect of interest rate on their business operations. Most of the respondents gave an account on how interest rate charged on borrowed funds are high which they say has dire consequences on business operations in the form of high cost of production and prices which slow down business progress as well as reducing their profit margin. Others were also of the opinion that the higher the interest rate on funds borrowed the greaterthe chances of default. This makes the payment of loan very difficult if not impossible.

On the other hand, respondents indicated that moderate and low interest rate charge on credits strategically boost the chances of their business growth and prospects since there is more cash at hand to venture into profitable projects with less to pay on interest at the end of the period. These respondents also believe that low interest rate helps to improve business performance. The following below summarized the opinion given by the respondents on how interest rate affects SMEs operations.

- It slows down business operation and hence reduces profit margin of MSMEs.
- Higher interest rate increases the chance of default in payment.
- The higher the interest rate the lower the returns on capital employed.
- Moderate and low interest helps to improve business performance.

Data gathered on the respondent was to find out whether MSMEs use debt or equity as their financing decision. The respondents gave the various information relating debt and equity financing. The table below shows the structure of debt and equity used by respondents in financing their business operations.

Table 4.6: Debt and Equity Capital Structure

Debt and Equity capital structure used	Frequency	Percentage (%)
Debt only	49	24.5
Equity only	102	51.0
Both debt and equity	22	11.0
Both but more equity	19	9.5
Both but more debt	8	4.0
Total	**200**	**100**

Source: Field survey, (2014)

Debt and Equity financing isa major decision that MSMEs make in running their businesses. These two major decisions affect small business operations because they either consider using one or both. The table above indicates that majority of respondents 51.0% (n=102) use their own resources. Equity financing according to most of the respondent, offers them the best option in order to stay out of bank loan troubles. 4% (n=8) forms the minority of the respondents who said they use both debt and equity but more debt to finance their business. 11.0% (n=22) use both half borrowed funds and half owned funds.

Those respondents who use only debt in financing their business fall within 24.5% (n=49) as against 9.5% (n=19) that use debt but more equity to operate. From the above opinions given by the respondents, it is evident that MSMEs mostly use equity as their financing decision. Why they chose a particular capital structure was investigated and it emerged that majority of the respondent 60.5% (n=121) indicated they preferred using their own fund (equity) rather than borrowing because it saves them their peace of mind. Thus, the high interest rate charged on borrowed funds and the short term repayment period makes it very difficult for them to consider using debt finance. On the other hand, 39.5% of the respondents said they prefer debt financing to equity because it is the only source that can help them grow their businesses. Interestingly, these respondents acknowledged the positive contribution of borrowed funds (loan) though it comes with high interest rate. They prefer to take risk as it is normal with every business dealings.

Discussion

There is high awareness of MSMEs (respondents) regarding financial institutions providing credit facilities to their members. This is consistent with Bawuah et al. (2014) who find that there are financial institutions that supports MSMEs in Ghana and MSMEs knowledge are high relative to these facilities existence. However,acknowledging the availability and existence of financial institutions do not necessarily guarantee access because Ghanaian financial institutions are still cautious in lending to these MSMEs (Leippoir, 2006).Though MSMEs awareness of existing financial institutions and support are high, majority ofthem 56.2%(n=54) have refused to access those available facilities because of high interest rates as shown table4.4. Extant literature has it that higher interest rates lead to a decline in the availability of finance and induces small businesses to reduce inventories, incur high production cost and experience sharp falls in sales which eventually affect their profit margin (Ehrmann, 2000).

The majority of these respondents who have refused accessing credit facility as a result of high interest rate seem to be consistent with those respondents who have actually accessed credit. Table 4.6 shows that those who have accessed credit at least once intable 4.2 also scored interest rate to be very high or high.Indeed small businesses are disproportionately affected during periods of rising interest rates, posited by Gerter and Gilchrist (1994). Some of the respondents also indicated that high interest rate account for their inability to repay loan contracted from financial institutions since greater business resources will have to be used to pay back interest on credits contracted. This finding confirms and perhaps explains Aryeetey and Nissunke, (2000) claim that loan repayment performance by small businesses in Ghana has been very poor. Financing decision of most of the business respondents was clearly equity financing. Table 4.6 depicted that 102 out of the 200 respondents indicated using equity finance only and when asked why the majority chose that capital structure, they responded that it saves them their peace of mind. Thus, the high interest rate charged on borrowed funds and the short term repayment period makes it very difficult for them to consider using debt financing.

This is also consistent with the Pecking order theory which states that firms prefer internal financing to external financing, and if external financing has to be used, it should be at a cheaper cost. The findings show that businesses opt for equity financing in the Wa Municipality is an indication that MSMEs are deprived themselves of the opportunities that comes with debt financing.

5.Conclusion

Evidence from the ensuing analysis shows that majority of MSME businesses have resorted to the use of equity financing for their operations. This is attributed to several factors of which interest rate was the leading factor. From all indications, interest rate affects choice of financing decision of MSMEs in Wa municipality. In order to help these small enterprises, the cost of credit facilities should be reviewed downwards to enable smooth repayment and increase in the demand for loans by MSMEs to enable them grow their businesses which will in effect have ripple effect in the economy. MSMEs should also reduce the reliance on banks and take advantage of institutions set up by the state to assist them in terms of finance and training needs. Institution such as Ghana Venture Capital Trust Fund (GVCTF) and Micro Finance and Small Loans Centre (MASLOC) are viable options in terms of loans availability to MSMEs in Ghana.

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