



Interest Rates and SMEs: A Study of Performance Dynamics in Arua Municipal Council, Uganda

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Abstract

Interest rate is viewed by many scholars as factor that has a direct influence on the performance of SMEs. This paper therefore examined the relationship between interest rate and the performance of Small and Medium Enterprises (SME's) in Arua Municipal Council, Uganda. A cross-sectional design adopting both the qualitative and quantitative approaches was utilized. With a population of 224 SMEs, a sample of 149 respondents was drawn using both purposive and simple random sampling techniques and this yielded a response rate of 87.3%. Validity and reliability of instruments was taken care of, and data was collected using self-administered questionnaires and interview guide. Quantitative data was analysed using SPSS while the qualitative data was based on the content analysis. The results indicated that, there is a positive significant relationship between interest rate and the performance of SMEs in Arua Municipal Council with a significant correlation coefficient ($r=0.270$, $\text{sig}=0.01$). In conclusion, the paper established that interest rate influences SME's performance. In order to enhance SME's performance, it's important for government to strengthen mechanisms for controlling the interest rates in order to strengthen SME's performance.

Key Words: Interest rate, Performance, SME's,

Introduction

Globally, provision of credit has been a longstanding strategy subject in the stages of development in all countries. In rural agrarian economies, local shahukars (a bill launched for those who faced some problem in the hands of money lenders before Maharaja Hari Singh) played the role of credit suppliers even before the entry of East Indian Company in India. After the Second World War, the rural credit supply basically to mobilize the much-needed support for agrarian services predominantly and to meet domestic market requirements, became part of strategy in the emancipated countries (Sharma, 2010).

Providing small loans to individuals, possibly within the groups as capital investment to enable income generating opportunities is the essence of microfinance. As the finding frontiers and helping the push out strategy of international finance capital progresses, various agencies took steps to project the microfinance as omnipotent concept in fighting poverty and meeting the needs of marginalized (Sharma, 2010). General Kofi Anan, in his briefing to the United Nation Capital Development fund (UNCDF), declared 2005 as the year of microfinance by the general assembly, He requested that the year (2005) to be a special occasion for giving impetus to microcredit programs (Anan, 2005)

However, the efforts to reduce poverty through microfinance cannot address the multidimensionality of poverty. It considers poverty as a consequence of unrealized market potentials. This is the reason for its focus on supply of credit as a way to realize the market potentials, leaving the structure of poverty untouched. It also refuses to recognize that the structures of poverty and social exclusion are widely spread and reinforcing each other. Microfinance is fully a commercial concept which cannot satisfy the socio-political needs to address the problems arising out of political economy. A borrower is supposed to be helped through micro-credit for one time to put it in use for productive purposes. This does not deal with market side ramification. In case of incomplete cycle of credit, the clients again are forced to borrow to repay the old dues. This results in a vicious cycle rather than creating a virtuous cycle (Sharma, 2010).

There are principal relationships that exist between MFIs and SMEs. Both rely on each other despite the fact that one's improvement can be said to profoundly depend on the other (SMEs on MFIs) (Salomey et al., 2013). SMEs and MFIs are tipped to lead the voyage into a destination of prosperity and supportable development (Danjuma et al., 2016). SMEs keep attaining dynamic levels of innovation through various services that are provided by them in the area of sales distribution supply, manufacturing and other services. A new wave of change on small-scale businesses has been introduced through the use of technology.

Local farmers are embracing agricultural inputs like fertilizers and modern technology through resourceful and attractive services that are being made accessible by both MFIs and SMEs (Opardjan, 2002). The poor people do not have access to formal banking services and they represent more than half of the population; hence, they rely on informal and formal microfinance institutions for loans (Danjuma et al., 2016). Access to loans is a major problem that SMEs are facing regionally, to keep in line and to guarantee that the needed funds are available and accessible at the right time.

In Uganda, lack of reliable information, as listed by all banks and MFIs, is the main hindrance to SME lending. However, the issue of collateral is a significant aspect in Uganda with 50 percent of the banks state the lack of adequate guarantees as an obstacle to SME lending (Calice, 2012). The Bank of Uganda stipulates that, all loans above a certain minimum must be adequately secured with first-class guarantees or a bond over property as the preferred security type. However, this makes it difficult for

Ugandan MFIs to lend to SMEs, due to the various challenges that this sector faces with such acceptable security.

Literature Review:

This study was hinged on the Microfinance Theory of Change which was first developed by Srikan, Marc and Kristi (2008). The Microfinance theory of change assumes that; a poor person goes to a microfinance provider and takes a loan (or save the same amount) to start or expand a microenterprise which yields enough net revenue to repay the loan with major interest and still have sufficient profit to increase personal or household income enough to raise the person's standard of living. Access to a savings mechanism increases choices and financial freedom, working to buffers hocks and helps households maintain consistent spending level over time (Dupas & Robinsion, 2013). The theory further establishes that small loans fuel economic self-sufficiency. Further research indicated that, micro loans increase household consumption; give women more clout in their communities; encourage the use of contraceptives and improve the nutrition of young children (Nathanael, 2004). Not so many are using microfinance in a way that will raise them from the ranks of poor- poverty reduction because there aren't that many opportunities the thriving enterprises in the absence of robust local economic development (Dunfor, 2013). Robust microfinance policies encourage investment opportunities that comes with its associated benefits to the small and medium enterprises.

This theory aided the study because it established the relationship between MFIs and SMEs. This relationship develops when an entrepreneur visits a micro finance provider to request for a loan to expand the venture, and is able to pay back the loan as per the agreed terms and conditions stipulated in the agreement. This aids the development of trust and mutual respect among the parties involved. The microfinance theory of change is based on the belief that, low-income earners (SMEs) will take microfinance loans from MFIs and will invest the money in a viable business and manage the business to yield major return on the investment.

Besides the strengthening and expansion of existing SMEs, the support for new enterprises can contribute to development and growth. In order to strengthen this position of SMEs, access to financial and non-financial services should be made available because it contributes to the performance of expansion of these enterprises (Kapila & Mead, 2002). Financial service should include the provision of micro-credit and loans. Banks and MFIs have sought to broaden their loan portfolio; SMEs have become an increasingly attractive customer group. There are many available financial opportunities for small business to access (Bawuah et al., 2014). However, Leippoid et al. (2006) opined that, financial institutions in Ghana were rather cautious about lending to SMEs groups because of high default rates and its possible risk associated with the sector.

Research on the credit channel of monetary policy contends that higher interest rates lead to a decline in the availability of internal and external finance relative to credit needs of firms. These channels are vital to most SMEs which are most constrained in their access to finance.

In their study, Gertler and Gilchrist (1994) found that, US manufacturing firms were disproportionately affected during period of rising interest rates. High interest rate compels small business to reduce inventories, incur high production cost and experience sharp falls in sales which ultimately affect their profit margins and growth. On the contrary, larger firms have the ability to uphold debt levels, increase inventories, and experience a considerable smaller level decline in their turnover and growth (Ehrmann, 2000).

The effect of high interest rate can be seen in the balance sheets of small businesses. The promised return on the credit may well differ from the expected return on a credit due to the presence of default risk. The lender has to recognize that by setting high risk may have actually reduced the probability of repayment. The causes of poor loan recovery are the high interest rates, poor appraisal and weak monitoring, late disbursement of loans and negative attitude towards the loan (Yaron, 1994).

The high interest rates affect the ability of SMEs to fully service their loans. The high interest rate heightens the loans to SMEs (Stiglitz, 1990). According to Mckinnon and Shaw (1973), a low real interest rate is a disincentive to savings, whereby reducing the ability of credit. The main idea behind Mickinnon-Shaw hypothesis is that, the financial sector should be liberalized for interest to be determined by the interplay of demand and supply. As a result, nominal and real interest rate will increase saving mobilization. However, Mckinnon hypothesis was criticized by Stiglitz & Weiss (1981) and Besley (1994) who opine that, interest rate cannot function as allocator of credit because borrowers with high risk maybe considered than those with potential good business with lower risk.

Banks in developing countries tend to be less exposed to SMEs. Firstly, banks provide lower share of investment loans, and charge higher fees and interest rate (Yeboah et al., 2014). Interest can be defined as the premium received by the lender after a stated period. From the borrower's point of view, interest is the cost of capital at the time of obtaining a loan. According to (Agbazzo & Omane, 2012), interest rate in the context of demand for credit by the SMEs is the measure of the price paid by a borrower to a lender for use of financial resources for a time interval. Banks believe that lending to SMEs entails higher risks and larger transactions costs (Aldaba, 2012), thereby justifying their high interest rates (Mungiru & Njeru, 2015). According to (Osoro & Muturi, 2013), many inefficient firms that had been favoured by government and getting credit at low rates simply collapsed when the financial sector was liberalized. The high interest rates charged by the formal and semiformal sectors are high, which crowd the benefits associated to informal sector financing.

Methodology

To explain the relationship between interest rate and performance of SMEs in Arua, Uganda, a cross-sectional design using both qualitative and qualitative research methods was used. The study population was made by SMEs in Arua Municipal Council. The study targeted 149 respondents from a study population of 224 SMEs in Arua. The samples were drawn from Small, and Medium Enterprises.

A mixed method approach was used by the study using both qualitative and quantitative approaches. Given the objective of the study, the quantitative data from the respondents was the most focused on and it was substantiated by qualitative data from key informants. Key informants' interviews were conducted using key informants interview guide. A total of 137 respondents were involved in the study. To ensure data quality, reliability and validity tests were conducted.

The Content Validity Index was calculated and found to be greater than the minimum of 0.70 as stated by Amin (2005). The reliability was calculated based on the Cronbach Alpha coefficient (CAC); all the variable items were found to be reliable as their values were greater than the 0.7 threshold.

The sample was drawn into strata of SMEs categories. The selection of the sample from the categories was randomly done. Based on calculations made using the Yamane (1967) formula, the sample was made by 149 SMEs. This sample was distributed using proportion of each category; the SMEs to be

part of the study were randomly selected while interviews with key informants was purposively done. Completed questionnaires were reviewed to ensure accuracy, consistency and completeness of information before leaving the field. Data from the questionnaires was arranged, coded, edited for consistency and easiness and later entered using Statistical Package for Social Scientists (SPSS). The qualitative data from key informants was triangulated to ensure completeness and substantiate the quantitative data.

Results And Discussions

This study had a sample of 149 distributed in the 2 SMEs categories from the total target of 224 SMEs, the researchers were able to collect both quantitative and qualitative data from 137 respondents that yielded 87.3% response rate.

According to the results in Table1, the findings show that demographically the majority 60.4% of the study respondents were males whereas 39.6% were females. The high percentage of the male respondents reflects the general pattern in those who are engaged in SMEs.

Descriptive statistics on interest rates:

The descriptive statistics for interest rates are presented in Table 2 in the appendix. The global mean for interest rates was 3.23 with a standard deviation of 0.366. This meant that, the respondents were divided on the state of interest rates in Arua Municipal Council. About a half of the respondents agreed that, interest rates were favorable and improved SMEs' performance, while, the other half disagreed. The respondents agreed that "MFIs offer loans with high interest rate," (mean=4.33 rounded to 4, SD=.61) the respondents overall agreed, with 59.0% agreeing; 38.1% strongly agreed; 0.7% were neutral; and, 2.2% disagreed.

SME's Performance:

In order to examine the level of agreement and/or disagreement on the different items used to measure the dimensions of employee performance in the questionnaire, item mean and standard deviation were used.

The responses were anchored on the five-point Likert scale ranging from strongly disagree, disagree, neutral, agree and strongly agree. The details are shown in Table 3 in the appendix.

Furthermore, SME's performance was measured in terms of sales turnover, employment creation, growth in capital and profitability. The agreement or disagreement as to whether Interest rate influence SME's performance or not is widely spread around the mean of around 2.78 with a standard deviation of .200. This means that, the respondents were divided on the state of SMEs performance in Arua Municipal Council. About a half the number agreed that SMEs performance had improved, while the other half disagreed.

Inferential Statistics:

To understand the relationship between the study variables: interest rate and SME's performance, the Pearson's correlation test was performed. This test provided coefficients that allow numerical interpretation between the two variables. The interpretation was made based on the results summarized in Table 1.

Table 1: Correlation between the variables

Variables	Mean	Std. Deviation	Coefficient (r)
Interest rate	3.23	.366	1
Performance	2.78	.200	.270**

** Correlation is significant at the 0.01 level (2-tailed)

N=137

Source: Primary data

The results reveal that Pearson coefficient of correlation for interest rate and performance is 0.270 with the correlation significant at 0.01. Hence, we conclude that there is a significant positive correlation between Interest rate and SME's performance. In other terms, the lower the interest rate, the better the performance of SMEs in Arua Municipal Council, Uganda.

To predict the performance of SMEs in Arua Municipal council, a regression model was used (Table 5). The results revealed that interest rate (fixed, and variable interest) explain 7.6% of the performance of SMEs. This means that there are other factors that explain the performance of SMEs in Arua Municipal Council, Uganda. Further, the results indicated that interest rate (beta=.273, $p < 0.01$) is a significant predictor of SMEs performance. Such interest rate parameters are combined predictors of SME's performance ($F = 3.559$, $p < 0.01$).

Table 2: Regression analysis of the variables

		Unstandardized		Standardized	T	Sig.
Model	Variables	Coefficients		Coefficients		
		B	Std. Error	Beta		
1	(Constant)	2.169	.267		8.121	.000
	Interest Rates	.149	.047	.273	3.191	.002
R		.275 ^a				
R Square		.076				
Adjusted R Square		.055				
R Square Change		.076				
F Change		3.559				
Sig. F Change		.016				
Dependent Variable: Performance						
Predictors: (Constant), Interest Rates						

Source: Primary data

The study reveals that a majority of SME owners in Arua Municipal Council are male, reflecting broader gender disparities in entrepreneurship. This finding aligns with research by Kabeer (2005), who highlights the structural barriers and socio-cultural norms that limit women's participation in economic activities, including access to credit and ownership of productive assets. Addressing gender inequalities in SME ownership and access to finance is crucial for promoting inclusive economic growth and poverty reduction.

The results indicate a significant positive correlation between lower interest rates and improved SME performance. This finding is consistent with the literature on the impact of interest rates on business

profitability and investment decisions. Studies by Beck et al. (2008) and Beck and Demirgüç-Kunt (2006) have shown that lower interest rates stimulate investment and entrepreneurship, leading to higher productivity and growth in SMEs. Therefore, policies aimed at reducing interest rates and enhancing access to affordable credit can catalyse SME development and contribute to overall economic development.

The study also highlights the challenges posed by high interest rates in microfinance lending, particularly by MFIs. This observation echoes the concerns raised in previous studies by Armendáriz and Morduch (2010) and Ledgerwood (1999), which emphasize the trade-off between financial sustainability and social impact in microfinance operations. High interest rates may deter microfinance clients, especially low-income entrepreneurs, from accessing loans and hinder their ability to invest in productive activities. Balancing financial viability with social mission remains a key challenge for microfinance institutions seeking to promote inclusive finance.

Conclusions And Recommendations:

The study examined the relationship between interest rate and the performance of Small and Medium Enterprises (SME's) in Arua Municipal Council, Uganda. Data was collected by administering self-administered questionnaires as well as face to face interview with key informants. The data was coded and analysed using SPSS and descriptive and inferential statistics were generated. Most of the respondents were males (60.4%), The highest age range was 31-35 year (32.1%) and 58.2% had attained basic education requirement of certificate while 50% had been in business for between 5-10 years.

The correlation results reveal that there was a significant positive correlation between interest rate and SME's performance in Arua Municipal Council. The more the more flexible the interest rates, the better the performance of SMEs in Arua Municipal council became. The regression analysis corroborates this by revealing the positive and significant coefficient β for the interest rate.

The study revealed that, though majority of the respondents agreed that, there is high interest rate charged on the microfinance loans, funds have positively impacted on their businesses. This means, through microcredit, individuals do manage to come out from poverty and can improve on income of the households which enabled them to fulfill their basic needs, hence there is reduction in vulnerability. In addition, MFIs can enhance the expansion of business of their clients when they incorporate other services such as, training and regular monitoring. Therefore, provision of sufficient fund with favourable interest rate could enhance creation of a new class of small businesses leading to the expansion of middle class and widen the distribution of economic resources. MFIs provide affordable finance services which help the small and medium enterprises to maintain the self-sufficient financial sustainability, directly having a positive impact on their livelihood. High interest rate and other unknown costs not mentioned are challenges in accessing microfinance credit which leads to poor performance.

Building on the findings, the study emphasizes the importance of policy interventions to address the challenges faced by SMEs in accessing affordable credit. Drawing from policy recommendations proposed by Morduch and Haley (2002) and World Bank (2004).

The study recommends that;

Measures to promote financial inclusion, such as interest rate caps, credit guarantee schemes, and capacity-building initiatives for SMEs. Additionally, enhancing the regulatory environment, improving credit information systems, and fostering public-private partnerships can create an enabling ecosystem for SME growth and innovation.

Given the significant impact of interest rates on SME performance, there is a need for policymakers to explore mechanisms for regulating interest rates charged by microfinance institutions (MFIs) and other lenders. This could involve setting interest rate caps or implementing interest rate subsidy schemes to ensure affordability for SMEs while maintaining the financial sustainability of MFIs.

To empower SME owners and borrowers to make informed financial decisions, there is a need for enhanced financial literacy programs tailored to the needs of SMEs in Arua Municipal Council. These programs could cover topics such as loan management, investment planning, and risk mitigation strategies to build the financial resilience of SMEs.

MFIs should consider expanding their range of financial products and services beyond traditional credit offerings to better meet the diverse needs of SMEs. This could include savings accounts, insurance products, and business development support services aimed at improving the financial health and resilience of SMEs.

Collaboration between government agencies, financial institutions, and development organizations can facilitate the provision of targeted support to SMEs in Arua Municipal Council. Public-private partnerships could involve initiatives such as credit guarantee schemes, technical assistance programs, and market linkages to enhance the competitiveness and sustainability of SMEs.

Future research should focus on conducting longitudinal studies to track the long-term impact of policy interventions and external factors on SME development in Arua Municipal Council. By collecting data over time, researchers can identify trends, challenges, and opportunities for SME growth and inform evidence-based policy formulation.

Training and capacity-building programs should be designed to equip SME owners with the necessary skills and knowledge to effectively manage and grow their businesses. This could include workshops on business planning, marketing strategies, financial management, and technology adoption to enhance the competitiveness of SMEs in local and regional markets.

Recognizing the gender disparities in SME ownership, there is a need for targeted initiatives to support women entrepreneurs in Arua Municipal Council. This could involve providing access to finance, mentorship programs, networking opportunities, and gender-sensitive business development services to empower women-owned SMEs and promote gender equality in entrepreneurship.

By implementing these recommendations, policymakers, development practitioners, and stakeholders can foster an enabling environment for SME development, promote inclusive economic growth, and alleviate poverty in Arua Municipal Council, Uganda.

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