

MONETARY POLICY AND THE PERFORMANCE OF SMALLMEDIUM-SCALE ENTERPRISES IN NIGERIA (2013-2023)

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ABSTRACT

The study investigated the effect of monetary policy and SMEs performance in Nigeria from 2013 to 2023. Various monetary policies, have been adopted by the government over the years, through Central Bank of Nigeria. Despite the increasing emphasis on the regulation of monetary policy, the problem surrounding the performance of SMEs still persists. Such problems include high interest rate and unstable exchange rate. The main objective of this study was to examine the effect of monetary policy on the performance of SMEs in Nigeria. The research design adopted for this study was ex-post-facto research design, Vector Error Correction Model (VECM), and Granger Causality Test were required to investigate the effect of monetary policy on small and medium scale enterprises performance in Nigeria. Inferential statistics were used to analyze the time series data, whereas the Johansen cointegration approach was employed to test for the long-run relationship among the series. The findings revealed that there was a significant effect between interest rate (INTR) (0.0327), exchange rate (EXRT) (0.0245) and performance of SMEs in Nigeria. Therefore, the study recommends that monetary policy should be set in such a way that the objective it wants to achieve is clearly and transparently defined in response to the dynamics of the domestic and global economic developments for the performance of Small and medium scale enterprises in Nigeria.

Keywords: Exchange rate, Interest rate, monetary policy, SME, Profit after tax.

1.0 INTRODUCTION

There is a general agreement among economists in relation to the long run relationship between money, output and inflation. However, this consensus is not clear with regard to short run relationships. To understand both the long run and short run relationships is essential for the conduct of monetary policy since the Central Bank of Nigeria aims to influence the macroeconomic variables mainly through regulating the cost and availability of money (i.e., interest rates, exchange rate and credit availability). The objectives of monetary policy include increase in Gross Domestic Product growth rate, accumulation of financial savings and external reserves, improvement in the balance of payments, as well as stability in Naira exchange rate, reduction in the rates of inflation and unemployment, the policy as well as instruments applied to attain these objectives, however, these objectives until recently have been far from adequate. Economic development is one of the major objectives of many countries in the world and economic growth is fundamental to economic development” (Ajisafe & Folorunso, 2002).

Money must be managed because it introduces a potential threat to the stability and growth of SMEs in Nigeria. The ultimate aim of monetary policy should be to cancel out disturbances if and when they occur, thus assuring a steady flow of total demand that will continually absorb the steady low of total supply. Under conditions of perfect competition, this is bound to be accompanied by the full utilization of available productive resources. (Udude, 2015).

Creating and maintaining a stable monetary environment is enormously important for the Nigerian economy. The existence and survival of these small and medium scale enterprises to

a large extent depend on adequate robust economic policy and financing, as has been observed by Ovat (2013) and Afolabi (2013).

Churchill and Lewis (2013) “identify growth stage models as those attempts to link growth with particular stages of development”. However more examination is needed of SME's capability to adapt, deploy skills and focus assets and of how such procedures lead to ultimate success. Despite the increasing emphasis on manipulation of monetary policy, the problem surrounding the performance of SMEs in Nigeria still persists. Such problems include high interest rate, unstable foreign exchange rate.

SMEs all over the world are greatly affected by the monetary policy frameworks of the government; the success of SMEs depends largely on the effectiveness of the various monetary policies of the government. Since no business operates in a vacuum, it is pertinent to address the various issues common in its economic environment. However, this study intended to subject these issues to empirical examination in order to evaluate the effect of monetary policy on the performance of SMEs in Nigeria.

Monetary policy is important in the Nigerian economy for effective exchange between economic agents. Hence it is trite knowledge that the more volume and frequency of exchange, the faster the economy grows. The monetary policy function between real goods and money builds confidence that useful goods produced can be exchanged for value. Its decisions transmit monetary innovations to demand for real goods and services to achieve performance targets.

The study was guided by the following research questions:

- i. To what extent does interest rate affect the performance of SMEs in Nigeria?
- ii. To what extent does exchange rate affect the performance of SMEs in Nigeria?

The main objective of the study was to examine the impact of monetary policy on the performance of small and medium-size enterprises in Nigeria. Other specific objectives include:

- i. To evaluate the effect of interest rate on the performance of SMEs in Nigeria.
- ii. To examine the effect of exchange rate on the performance of SMEs in Nigeria.

The following hypotheses were formulated for the study:

H0₁: There is no significant relationship between interest rate and the performance of SMEs in Nigeria.

H0₂: There is no significant relationship between exchange rate and the performance of SMEs in Nigeria.

2.0 LITERATURE REVIEW

Concept of Monetary Policy

Monetary policy is one of the prime economic management tools that governments use to shape economic performance. Monetary policy is said to be quicker at resolving economic shocks (Uniamikogbo & Enoma, 2001). Kahn (2010) observed that monetary policy objectives are concerned with the management of multiple monetary targets among the price stability, promotion of growth, achieving full employment, smoothing the business cycle, preventing financial crises, stabilizing long-term interest rates and the real exchange rate. Kahn (2010) further state that these objectives are all not consistent with each other is obvious, as the preference of monetary policy objectives is anchored upon the weights assigned by monetary authorities or country priorities. Experience shows that emphasis is usually placed on maintaining price stability or ensuring low inflation rates. There are two major control

mechanisms of monetary policy used by Central Banks at any point in time and this control mechanism are usually referred to as tools/instruments of monetary policy and they have effects on the proximate targets. Monetary instruments can be direct or indirect. The direct instruments include aggregate credit ceilings, deposit ceiling, exchange control, restriction on the placement of public deposit, special deposits and stabilization securities while indirect instruments include Open Market Operation (OMO), cash reserve requirement, liquidity ratio, minimum discount rate and selective credit policies.

Monetary policy has vital roles in the short-run i.e. It is used for counter cyclical output stabilization, while in the long run, it is used to achieve the macroeconomic goals of full employment, price stability, rapid economic growth and balance of payments equilibrium. (Imoughele, & Ismaila, 2014). In implementing monetary policy, a central bank can act directly, using its regulatory powers, or indirectly, using its influence on money market conditions as the issuer of reserve money (currency in circulation and deposit balances with the central bank). The term “direct” refers to the one-to-one correspondence between the instrument (such as a credit ceiling) and the policy objective (such as a specific amount of domestic credit outstanding). Direct instruments operate by setting or limiting either prices (interest rates) or quantities (amounts of credit outstanding) through regulations, while indirect instruments act through the market by, in the first instance, adjusting the underlying demand for, and supply of, bank reserves. (Alexander et al., 1996) Using indirect instruments, the central bank can determine the supply of reserve money. Strictly speaking, the central bank can determine the supply of reserve money in the long run only under a fully flexible exchange rate regime. Even under a pegged or managed exchange rate regime, however, central bank transactions affect reserve money, at least in the short run. These transactions affect banks' liquidity positions, which results in adjustments to interbank, money market, and bank loan and deposit interest rates to re-equilibrate the demand for, and the supply of, reserve balances.

One important aim of monetary policy is that of stabilizing the economy, that is, it should stimulate the economy in recession and dampen it in periods of inflation. In our opinion, monetary policy is the process by which those in helm of monetary authority of a country, for example the central bank or currency board, controls the supply of money, targeting an inflation rate or interest rate to ensure that there is stability of price and the citizens have general confidence in the currency. According to Uchendu (2006), there are three main channels (liquidity, credit and exchange rates) through which changes in monetary policy affect small and medium enterprises (SMEs) activities. The author buttresses that liquidity channel, sometimes called money or interest rate channel, exist when nominal short-term interest rates react to changes in liquidity conditions to influence the operations of SMEs in an economy. The basic characteristic is that the effect is felt economy wide. On the other hand, the credit or loan channel works mainly through banks. In this mode of transmission, household and SMEs/arms receive fewer credits especially from banks during periods of liquidity squeeze.

Monetary Policy Transmission includes the change in monetary decision announced by the control bank, and the subsequent chain of reactions that ultimately change aggregate demand and inflation in the economy.

Interest Rate

An interest rate is the amount of interest due per period, as a proportion of the amount lent, deposited or borrowed (called the principal sum). The total interest on an amount lent or borrowed depends on the principal sum, the interest rate, the compounding frequency, and the length of time over which it is lent, deposited or borrowed (Sepehri & Moshiri, 2004). It is defined as the proportion of an amount loaned which a lender charges as interest to the borrower,

normally expressed as an annual percentage. During the era of direct monetary management (pre-1986) in Nigeria, interest rates were administratively determined such that economic activities were influenced principally through variation in the volume of credit granted to borrowers. When economic controls were relaxed as part of Structural Adjustment Programme (SAP) launched in mid 1986, the inter-bank market and the emerging rates became an important means for the transmission of monetary policy in Nigeria. Money market conditions generally dictated interest rate developments. From the early 1990s, the effectiveness of inter-bank market weakened as distress borrowing by illiquid banks contributed to interest rate movements.

Exchange Rate

An exchange rate is the price of a nation's currency in terms of another currency. Thus, an exchange rate has two components, the domestic currency and a foreign currency, and can be quoted either directly or indirectly. In a direct quotation, the price of a unit of foreign currency is expressed in terms of the domestic currency. In an indirect quotation, the price of a unit of domestic currency is expressed in terms of the foreign currency. Exchange rates are quoted in values against the US dollar. However, exchange rates can also be quoted against another nations currency, which are known as a cross currency, or cross rate. Exchange rates can be floating or fixed. A floating exchange rate is where market forces determine a currency rate. This is the norm for most major nations.

Small and Medium Enterprises

As early as the late 1940s, Organization for Economic Co-operation and Development, OECD (2004) noted that the notion of small and medium-scale enterprises (SMEs) were introduced into the development landscape, and the primary aim was to improve trade and industrialization in the present developed nations. Ever since, there has been no consistent definition of SMEs (McAdam & Reid, 2005). The definitions of SMEs are usually derived in each country, based on the role of SME in the economy, policies and programmes designed by particular agencies or institutions empowered to develop SME. For instance, a small business in the developed economies of countries like Japan, Germany and United States of America (USA), maybe a medium or large-scaled business in a developing economy like Nigeria.

In an attempt to separate small enterprises from medium enterprises, a Survey Report on MSMEs in Nigeria (2013) defines small enterprises as those enterprises whose total asset excluding land and building are above 5 Million Naira but not exceeding 50 Million Naira with total workforce of above 10 but not exceeding 49 employees. While the medium enterprises are those enterprises whose total asset excluding land and building are above 50 Million Naira but not exceeding 500 Million Naira with a total workforce of between 50 and 199 employees. Form the above SMEs concepts; it is evident that performance is an important phenomenon in small and medium enterprises. In fact, their survival essentially depends on their power to participate in the market with other big companies. Growth decreases the possibility of closing small businesses (Rauch & Rijskik, 2013). Strengthening is important not merely for the enterprises and their owners but for all stakeholders since these companies thrust forward the economy by underscoring diversity of products and services.

Theoretical Review

Monetarism Theory

The theoretical base that was found adequate for this work is the monetarism theory. The monetarist theory, as popularized by Milton Friedman, asserts that money supply is the primary factor in determining inflation/deflation in an economy. According to the theory, monetary policy is a much more effective tool than the fiscal policy for stimulating the economy or slowing down the rate of inflation. Monetarism is the primary alternative macroeconomic

theory to Keynesian economic theory; monetarists believe in extremely limited government economic intervention, while Keynesians argue for active government intervention. The Classical theorizing on the control of monetary variables to influence economic performance premises on full employment as hardened by Sayes law. Even as evolved, the Classical theory encourage the use of a rule in money supply, price, and direction for a healthy economy. Keynesian monetary policy theorizing on the other hand takes off below full employment. Monetary policy therefore should be discretionary on the sort of imbalance that turns up, to return the economy back to fuller performance. Both streams of assumptions and arguments are pertinent to the subject of this study and replete in aspects of monetary policy making and execution.

Assumption of the theory

Its emphasis on money's importance gained sway in 1970s just how important is money? Few would deny that it plays a key role in the economy. But one school of economic thought, called monetarism, maintains that the money supply (the total amount of money in an economy) is the chief determinant of current dollar GDP in the short run and the price level over longer periods. Monetary policy, one of the tools governments have to affect the overall performance of the economy, uses instruments such as interest rates to adjust the amount of money in the economy. Monetarists believe that the objectives of monetary policy are best met by targeting the growth rate of the money supply. Monetarism gained prominence in the 1970s bringing down inflation in United States and United Kingdom and greatly influenced the U.S. central bank's decision to stimulate the economy during the global recession of 2007-2009.

The CC-LM Monetary Theory

Bernanke and Blinder developed the credit and commodity (CC) variation to improve on the IS in IS-LM model in (1988). It is a neo-Keynesian theory. The model includes three assets: money, bonds and loans. It supposes that economic agents do not use the money supply as such, the money demand is constituted only of deposits that banks maintain a reserve of. This amount is assumed constant, and it is also assumed that deposits do not pay interest; this is a model in which prices are fixed equal to unity, in such a way that real and nominal quantities are equal. Finally, it asserts that the money market is described by the LM function. A central bank can set its intermediate targets in terms of both a monetary and credit aggregate. The validity of the choice depends on the relative stability of the demands for money and credit. If the disturbances that affect the money demand are empirically more significant than the disturbances that affect the credit demand, then a policy based on an intermediate target formulated in terms of a credit aggregate is more warranted than one formulated in terms of a monetary aggregate and vice versa. It is assumed that both lenders and borrowers choose between bonds and loans based on the returns each of these generates. The CC-LM model is a variant of the traditional Keynesian IS-LM model but without suffering from the defects of that model. Unlike the IS-LM model, which focuses only on the interest rate (cost of funds) channel by assuming perfect substitutability between loans and bonds, this model includes the credit channel to allow roles for both money and credit in the transmission of monetary/financial shocks to real economic activity. While bank credit is important in influencing the level of aggregate spending, the credit restraint experienced by banks in passive evasion of risks indicates a breakdown of the bank-lending channel. The inclusion of the credit channel in the transmission mechanisms of monetary policy therefore provides a richer understanding on the inextricable link between the financial and the real sectors.

Empirical Review

Onyei (2018) examined the impact of monetary policy on the Nigerian economy using the Ordinary Least Squares Method (OLS) to analyse data between 1981 and 2008. The result of the analysis shows that monetary policy represented by money supply exerts a positive impact

on GDP growth and Balance of Payment but negative impact on rate of inflation. The findings of the study support the money-prices-output hypothesis for Nigerian economy.

Udoh et al. (2018) inspected the influence of Nigeria's monetary policies on SMEs' growth. The findings indicated that there is no statistically significant association between the growth of SMEs in Nigeria and the exchange rate or inflation, however there is a marginally significant association between the growth of SMEs in Nigeria and the interest rate (INR).

Otugo et al, (2018) studied how small and medium-sized businesses affect Nigeria's economic expansion. According to the study's analysis, small and medium-sized businesses, government spending on small and medium-sized businesses, job creation, commercial bank credit to small and medium-sized businesses, and lending rates to small and medium-sized businesses all contribute to Nigeria's economic growth. In Nigeria, corruption has a detrimental effect on economic expansion. All of the explanatory factors, however, have a big impact on Nigeria's economic development.

Aminu et al (2018) used time series data ranging from 1986 to 2016 to examine the impact of small and medium-sized firms on Nigeria's economic growth. The study's findings demonstrated that small and medium-sized firms in Nigeria contribute favorably to the development of the Nigerian economy by showing a positive and substantial association between production growth and small and medium-sized enterprises. **Gap in Literature**

It was observed that a study done by Aminu et al. (2018) used time series data ranging from 1986 to 2016 to examine the impact of small and medium-sized firms on Nigeria's economic growth. The data for this study was far back in 2016 which may differ from the data the researcher used in this study. This study filled this gap.

3.0 METHODOLOGY

The researcher employed ex-post-facto. This was because expo-facto has no manipulation of variables but a study of independent factors as they influenced or affected effectiveness issues in foreign direct investment. The population comprises all registered micro businesses and small and medium enterprises in Nigeria, totaling 41.5 million (41,469,947 micro businesses and 73,081 small and medium enterprises) according to the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN, 2020). Hence, this research used secondary data collected from the Central Bank of Nigeria statistical bulletin. It was based on secondary data source because, ADF unit roots test, Johansen Cointegration Test, Vector Error Correction Model Analysis and Granger Causality test were required to investigate the effect of monetary policy on small and medium scale enterprises performance in Nigeria.

Model Specification

This was to express the relationship between the independent variable monetary policy proxied by (interest rate and exchange rate) and the dependent variable which is the index of performance proxied by profit after tax of SMEs in Nigeria. The multiple regression model employed in this research work was given as follow:

$$y_{1t} = \alpha + \beta_1 INR_t + \beta_2 OEXR_t + \mu \dots \dots \dots (i)$$

$$\Delta PAT_{t,j} = \beta_0 + \sum_{i=1}^{n1} \beta_{1i,j} \Delta INR_{t-1,j} + \sum_{i=0}^{n2} \beta_{2i,j} \Delta OEXR_{t-1,j} + \mu_t \dots \dots \dots (ii)$$

$$Y=f(x).....(i)$$

Where:

(Y)PAT = SMEs profit after tax ;

(x)MP = Monetary policy;

INTR = interest rate; EXR = Exchange Rate; α =

Intercept or constant; β = Parameters or co-efficient of

explanatory variables; and μ = Error term.

4.0 DATA ANALYSIS AND DISCUSSION OF FINDINGS

Table 4.1: Result of the ADF Unit Roots for Stationarity

Levels 1st Difference

VARIABLES	ADF Statistic	1% Critical value	5% Critical value	ADF Statistical	1% Critical value	5% Critical value	Remarks
PAT	- 3.260503	- 4.273552	- 3.551153	- 4.656039	- 3.699871	- 2.976213	1(1)
INT	- 2.587968	- 4.273552	- 3.551153	- 7.435113	- 4.243642	- 3.544377	1(1)
EXR	- 1.971426	- 4.273552	- 3.551153	- 5.478730	- 4.243642	- 3.544116	1(1)

Source: Author's compilation using E-View 9.5

As shown in table 4.2 above, the unit root tests result indicated that all the series namely; Profit after tax, interest rate, exchange rate unit root and are stationary only after first differencing, at 1% and 5% significant levels. This follows the decision rule which states that when the value of the computed ADF test statistics exceeds its critical value, the null hypothesis is rejected and the alternative accepted. The stationarity of all the series in the same order was thus a motivation to run for co-integration tests. This is aimed at finding the presence or absent of any long run relationship among the series. This corroborates with the submission by Woodridge (2002) and Grene (1997) that when more than one variable is not stationary at levels, there is every need to run a co-integration test in order to verify if the series have any long run equilibrium relationship.

In view of the above therefore, since the variables are stationary at difference orders, there was the need for a test for co-integration test using the Johansen (1991) co-integration technique.

The results is presented in table 4.2 as shown below:

TABLE 4.2: JOHANSEN COINTEGRATION TEST

Series: PAT, INTR, EXR,

Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test (Trace)

Included observations: 3

Hypothesized No. of CE(s)	Eigen value	Trace Statistic Value	0.05 Critical	Prob.**
None*	0.439132	49.32836	47.85613	0.0484
At most 1*	0.375439	32.93237	29.79707	0.0327
At most 2*	0.059151	17.51624	15.49471	0.0245
R-squared	0.887677	Mean dependent var		15.97610
Adjusted R-squared	0.868956	S.D. dependent var		1.445261
S.E. of regression	0.523184	Akaike info criterion		1.697818
Sum squared resid	6.569315	Schwarz criterion		1.933559
Log likelihood	-19.61837	Hannan-Quinn criter.		1.771649
F-statistic		Durbin-Watson stat		0.812816
Prob(F-statistic)	0.000000			

Source: Author's compilation using E-View 9.5

Trace test indicates 2 cointegration at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

In table 4.2 above, the outcome of the cointegration test employed using both the trace and max-eigen test statistics indicates the presence of a long-run relationship among the three variables at 5% level of significance, thereby leading to the rejection of the null hypothesis of no cointegration. From the result it is therefore evident that profit after tax, interest rate, exchange rate are cointegrated. This result is in consonance with the findings of Onyei (2018) and Udoh et al . (2018) whose findings indicated a significant and positive relationship between interest rate and exchange rate.

Granger Causality Test

TABLE 4.3

Pairwise Granger Causality Tests

Sample: 2010 2021 Lags: 2

Null Hypothesis:	F-Statistic	Prob.
PAT	3.53832	0.0448
INT	4.89397	0.0140

PAT	4.43470	0.0312
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Source: Author's computations using Eviews 9.5

Table 4.3 above, depicts the result of the relationship among the variables. The result suggests that Interest rate and exchange rate causes profit after tax, hence the null hypothesis that INT and EXR does not granger causes PAT cannot be rejected. The result also indicates that a bidirectional causality runs INT to EXR to PAT.

5.0 CONCLUSION AND RECOMMENDATIONS

Having examined the influence of monetary policy on the performance of small and medium scale enterprises in Nigeria, the results have shown that major determinants of SMEs performance are policies directed on interest rate stabilization, exchange rates management. The implication is that the interplay of these variables are important to keep SMEs alive in Nigeria. The policy insinuation therefore, is that monetary policy should be set in such a way that the objective it wants to achieve is clearly and transparently defined in response to the dynamics of the domestic and global economic developments.

Based on the findings, the following recommendations were made:

- (i) High interest rates have the tendency of making SMEs to collapse within a short period of time and thereby discourage prospective investors from borrowings. Hence, there is the need for monetary authorities to make more reasonable policy decisions on interest rates on loans granted to the SMEs sector, so as to encourage borrowers to undertake profitable ventures for business expansion, SMEs sales growth and improvement in added value.
- (ii) There is need for a consistent monetary policy framework that should bring about realistic exchange rate with emphasis on its role to directly promote output and productivity of the SMEs. Policy makers should consider exchange rate policies as a long-run to the problem of growth in foreign goods demand.

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