IMPACT OF HIGH INTEREST RATES ON THE PERFORMANCE OF SMALL & MEDIUM SIZE ENTERPRISES: A CASE STUDY OF KABALE MUNICIPALITY

BY

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A RESEARCH REPORT SUBMITTED TO THE FACULTY OF EDUCATION IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF BACHELORS DEGREE OF ARTS WITH EDUCATION OF KABALE UNIVERSITY

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DECLARATION

I hereby declare that this report is my original work and has not been previously submitted to any institution or anywhere used for academic presentation for any award.

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APPROVAL

This Report has been submitted for review with my approval as supervisor:

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DEDICATION

With gratefulness, I dedicate this work to my parents Mr. Bagorogoza Francis and Mrs. Tumukunde Jane, my brothers and sister and my beloved friend MR. Mugyenyi Kenneth for having strived in mentoring me till this day and through their toil, sacrifice and hard work, made me attain this level of education.

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Many of us have dreams or ambitions we hope to fulfill someday. My own to write a book to be read by masses might never have succeeded had it not for my almighty God for giving me the love, wisdom, confidence and grace which has been sufficient for me throughout my education and this research. Also my lecturers who have enabled me acquire knowledge. Special thanks go to my great supervisor Ms. Nkamusiima Dianah who has worked tirelessly and sacrificed her time from commencement to denouncement of my research to ensure that I do not only complete this research but also be well equipped for any other research that might come my way.

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LIST OF ACRONYMS

BOU	Bank of Uganda
CBS	Commercial Banks
FIS	Financial institutions
MFIS	Micro Finance Institutions
NGO	Non-Governmental Organization
SMES	Small and Medium Enterprises
TBS	Treasury Bills
GDP	Gross Domestic Product
UBOS	Uganda Bureau of Statistics

ABSTRACT

The Small and Medium size enterprises present the most dynamic economic foundation for growth, income and employment creation. However, this vital sector has been greatly affected by the high interest rates being charged by financial institutions on borrowed capital in Uganda. The main objective of the study is to assess the impact of high interest rates on growth and financial performance of Small and Medium Enterprises in Kabale Municipality. The researcher will not only employ cross sectional research and descriptive but analytical research design also. Data will be collected basing on the objectives and questionnaires distributed to 50 respondents.

Key words: Interest Rates, Performance, Small and Medium Enterprises

CHAPTER ONE

1.0 Introduction

This chapter comprises of background of the study, statement of the problem, purpose of the study, general objectives, specific objectives, research questions, and scope of the study, significance of the study and definitions of key terms.

1.1 Background of the Study

Currently at the Kabale municipality (Uganda), the banks provide loans to large and medium scale industries at interest rate ranging between 11 percent and 13.25 percent and small industries between 10 percent and 16.50 percent. The bank lending rates on working capital to small businesses range between 10.5 percent and 18 percent. These commercial banks now offer interest rates ranging from 5.25 to 12. 7 percent on fixed deposit schemes, while the rates for savings accounts varies between 10 percent and 16.50 percent (Habibullah et al, 2020).

Kabale municipality is located in the Kabale District of the Kigezi sub-region it is approximately 420 kilometers (260 mi), by road, southwest of Kampala, Uganda's capital and largest city.ill The town lies 2,000 metres (6,600 ft) above sea level. The coordinates of Kabale are: OJ 15 00S, 29 59 24E (Latitude:-1.2500; 29.9900) It lies approximately between: - latitude 1°10 North and 1 °35'North and Longitude 3330East and 34°20'East. The district covers a total area of 1,771.74 sq.km, out of which 1,440.98 sq.kms is land area while 330.76 (18.7%) is covered by open water bodies and swamps/wetlands. Source; Google (2 July 2018).

According to the 2018 national population census, Kabale municipality had approximately 41,350 inhabitants. The Uganda Bureau of Statistics (UBOS) estimated the population of the town at 44,200 in 2017. In 2020, UBOS estimated the mid-year population of Kabale at 44,600. The 2019 national population census conducted in August, put the population of Kabale at 49,667UBOS, 2019)

In Uganda, the number of SMEs is increasing as more and more people are becoming jobless through layoffs and retrenchment from both public and private sectors and others failing to get jobs. With SMEs contributing to 70 percent of the country's total GDP and employing more than 2.5 million people, Ankunda (2017). There is great need to support these SMEs to ensure the survival of this sector which up to 90 percent is private for the country to achieve sustainabie economic growth since these enterprises support a large number of the population as they estimated to be over 80,000 enterprises in the country, Ankunda, (2017).

The Small and medium size enterprises present the most dynamic economic foundation for growth, income and employment creation. The Government has continued to support the Small and medium size enterprises through economic, financial and regulatory policies that provide an enabling environment and sustainable growth and development. More private sector involvement has been encouraged through a wide range of measures and incentive policies to improve the micro-enterprises operations such as access to credit is being emphasized. Small and medium size enterprises are being encouraged to start the production of some intermediate industrial inputs particularly on a sub-contracting basis between the large and small firms (Davis et al, 2019).

Small and medium size enterprises are presumed to be behind most of the socio-economic transformation in east Africa, and play a significant role in Uganda's development process. This is because during the early stages of economic development these enterprises embodied unique evidenced by the rapid rate of investment and enterprise growth. The development of the sector is therefore critical in reducing poverty in Uganda. SMEs are generally under-capitalized, suggesting major operational difficulties in accessing credit and pursuing corporate goals, (Ninsiima et al, 2017).

Enterprises that successfully sought out credit receive very modest amounts; probably reflecting the level of the activities in which enterprises are involved. The implication is that since the micro-enterprises sector does not have adequate access to credit, its potential role in reducing poverty and in Uganda's socio-economic transformation is unlikely to be realized.

Since 1987, the Ugandan government has implemented a number of policy measures under the Economic Recovery Programme to create an enabling environment, where the private sector is encouraged to participate in economic growth. The annual inflation rate has been brought down over the years from 256 percent in 2018 to the current single digit levels and economic activities have been deregulated to pave a way for the private sector to become the engine of growth, Ssendula, (2020).

According Korngold (2020), noted similar findings in Latin America in his research regarding small business loans. This revealed the benefits of small loans to "tiny" businesses, as they were alternatives to the bank loans which attracted high interest rates. Designing these appropriately so that they catered for the particular needs of the SMEs borrowers (in terms of the rates and pay-back periods, etc) and also assist in creating jobs.

In the last few years, it has become evident that there are high interest rates prevailing in Uganda on borrowing from financial institutions and banks. This has had a direct impact on the Small business enterprises because the contraction of credit availability and loss of borrowing opportunities perpetuates negative effect, Ahimisibwe (2019). This has led to low profitability and decrease in internally generated finances for reinvestment. Commercial banks lending rates are still much higher than the deposit rate, though the interest rate spread narrowed down to 4.83 per cent points at the end of march 2020 from 5.00 percent points in December 2019 (Siddique, 2019).

1.2 Statement of the Problem

Small Business Enterprises attracts 90 per cent of the Ugandan's population, especially in this era of retrenchments where there are few white and blue collar jobs, Uganda Investment Authority, (2019). Thus many Ugandans, old and young educated and uneducated, engage in small businesses as a means of livelihood and hence they provide sustenance for many citizens and contribute substantially to the economy. It provides employment to over 2.5 million of Ugandans. However, they are faced with many challenges that include lack of adequate capital to either start or expand the already started business. This is because Uganda is said to have the highest interest rates in the region that range from 15 per cent to 25 per cent, new vision, (2020). Most of their financing therefore comes from own savings, friends and relatives and community welfare groups.

Despite the effort of the Bank of Uganda to cut down its bank rate by 3.4 percent points in 2020 the interest rates that financial institution are charging is still very high that it is ranging from. 15 per cent to 25 per cent hence hindering business enterprises from getting access to credit for their genesis or expansion. This issue of interest rates in Uganda continues to occupy policy makers in government and BOU as well as bankers, borrowers and just about anyone who has interest in the economic structure of the country. The concern is that interest rates are too high given the inflation rate in the country on one hand and *low* interest rates on deposit on the other hand.

1.3 Objectives of the Study

i. To assess the impact of high interest rates on the growth of SMES Kaba1e municipality.

ii. To assess how high interest rates have affected the financial performance of SMEs in *Kabale* municipality.

iii. To highlight the suggested ways through which SMEs can *deal* with the high interest rates in Kabale municipality

Despite its perceived importance in generating employment and production, the SMEs in Uganda have very inadequate access to credit. This is because of the high interest rates charged on amounts borrowed from banks and Financial Institutions. Most of their financing therefore comes from own savings and informal credit markets controlled by NGOs and community **welfare groups. A few SMEs have also been able to obtain credit from some micro financing** institutions and government-initiated projects for poverty eradication, (Agaba, 2019)

1.4 Significance of the study

The study *will* provide literature that will form a foundation for further interest rate researchers and scholars of various academic institutions.

The study will be of great significance to government policy makers and vanous enterprises stakeholders.

Pandey defines interest rates as "a price for a loan capital" it is the price that a borrower pays in order to be able to consume resources now at a point in time future. On the other hand interest rates are a price that lenders receive for foregoing current consumption in order to take advantage of resources at some point in future Apps (2017).

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CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chater resented the related literature related to the area of research.

2.2 Theories on interest rates.

The classical theory looks at what may be termed as the real economic variables. It argues that the level of real interest rates is determined by; the level of savings and level of investment in capital equipment. It emphasizes that the more people wish to save the lower will be the level of

interest rates, as the supply of loanable funds rises relatively to demand. On the other hand, the more people wish *to* invest the greater will be the demand for borrowed funds, other factors **constant, the higher will be the rate of interest (Apps 2017)**

The Keynesian theory disregards the relevance of money. It argues that the use of money is *simply* to determine the *absolute* price *level* and hence does not affect level of savings and investments. The theory emphasizes that supply and demand for money is an interaction of the two variables that determines interest rates. The more money that people wish to hold, the higher *will* be its price and the grater the supp I y of money the lower the price *will* be (Cox 20 17).

The two theories above as used to explain levels of interest rates can be reconciled.

Thingan (2018) noted contributions of Klein who critically analyzed the theories and concluded that if the two theories are explained in terms of share and stock analysis thy ·In come to the same thing. He emphasized that since the loanable funds version is a flow analysis of interest rate determination, it can be reconciled with the liquidity preference theory.

Cox (2017), took his position on the reconciling the two theories. **He** argued that while the Keynesian theory seeks primarily *to* explain short-term changes in interest rates, its 43 consistent with explaining long-term changes in interest rates that are proposed by the classical theory. Equally, much as *the* classical theory primarily explains long-term changes, it is inconsistent with explanation of short-term changes in interest rates as advanced by the **Keynesian theory.**

When the borrower approaches a lender. he is confronted with two different types of costs +4 he or she will incur *to* obtain any amount of money from any financial institution that is to say, **cost incurred in trying to get a loan and after getting a loan.**

1. Financial costs is the actual cost of money, including the interest to be paid for the use of the loan and the fees paid to the lender for processing and disbursing the loan. The borrower will incur *this* cost when *servicing* the loan he/she got from any source **r fonding that will be requiring refund with interest.**

n. Transaction costs are indirect *costs* incurred *to* obtain loans e.g. transport cost *to* lenders *place,* cost of obtaining documents required for the loan, the cost of time spent by the

borrower fulfilling the requirements for the loan. Transaction costs are usually greater than financial costs if lenders are inefficient in their loan approval or disbursal process. Because transaction costs do not benefit either the lender or the borrower, lenders should minimize them to the greatest extent possible. Financial costs on the other hand provide income to the lender in the form of interest and few lenders who minimize transaction costs make it easier for borrowers to afford higher financial costs (Heimsing, 2017). Financial costs should be established carefully by the lender in order to generate the income that the institution needs for survival and growth.

There are three basic costs that lending institutions must cover with their income. First, financial cost of the funds in their portfolio known as the cost of funds. Secondly, the Cost of maintaining a loan loss reserve so that the portfolio does not recapitalize when Loans are defaulted and lastly other operating costs that include the salaries of staff, rent and other operating expenses.

To be self-sufficient a financial institution must cover the above cost with income generated by financial services. The loan portfolio (Funds lent to borrowers and funds on deposit available to lent) procedures a gross rate of return or yield which is the interest and fee income divided by the average portfolio self -sufficient lending institution have a rate of return high enough to cover all of their costs, and keep the value of their funds from deteriorating because of the effect of inflation (Heimsing, 2017).

2.3 Causes of high interest rates

The interest rate charges on a loan will depend, to some extent on the risk of default. Borrowers that look equally risky to the bank suffer rising interest rates. This is due to the fact that banks tend to incorporate the risk factor in the loan portfolio that normally carries a higher interest rate (Kohn 2017). Banks have experienced numerous frustrations in attempting to recover nonperforming loans through the judicial process, this makes the banks incur additional costs in lengthy litigation processes. These costs are reflected in interest rates.

Juli an (20 18) pro vi des that a large increase in government borrowing *to* finance current spending will push up interest rates if there is no parallel increase in private sector saving. This will occur even with stationary inflation rate.

Real interest rates in one country will be influenced by external factors such *as* interest rates in other countries and expectations about exchange rate movements. When interest rates in oversees countries are high, interest rates on domestic currency investments may need to be comparably high to avoid capital transfers abroad and a fall in the exchange rate of the domestic currency against other currencies (Cox 2017).1 the Ugandan scenario for instance, Juma Kisaane, the DFCU bank managing director says, the bank sources funds from other financial institutions abroad which price their money at the prevailing market rates 'Therefore the loans we advance that we advance cannot be priced below the rate at which we access the funds".

West on (20 19) attributes changes in the level of interest rates to supply and availability of funds *to* borrowers. He argues that, within a framework of general and financial patterns, short-ten interest rates patterns and forecasts can be analyzed through the use of flow of fonds accounts. These accounts depict the behavior of major kinds of suppliers and demanders of funds. They helped to determine the direction of pressure on interest rates. He added that, a period of high interest rates reflects tight money, which in turn is associated with tight reserve positions at commercial banks. At such times interest rates rise.

bankers argue that the prevailing macro-economic environment influences the cost of fans p instance, the Annual Headline Inflation rate for the year ending February 2020 rose to 6.0 per cent from 5.0 per cent recorded for the year ended January 2020. When there is inflation for instance, the monetary authorities tend to rise the statutory interest rates and reserves as a way of reducing money supply in the economy. This automatically will force the other finanei] institutions to raise their interest rates.

The poor repaying culture among some customers increases the lending risks for bank. Risl customers are charged high interest rates while *less* risky customers can negotiate for good rates on the loan. Poor lending particularly by government owned banks due to political influence in approval of non viable loans as well as insider lending and fraudulent activities by directors in indigenous and Asian owned banks.

1.

2.4 Small and Medium Enterprises

SMEs are arbitrary and vary significantly according to different stages of economic *development* and economic structures, Castel-Branco, (2019).Some analyses define them in terms of total revenue, while others use the number of employees as an indicator (world business council for sustainable development, 2018).Although SMEs definition is individual country specific and is based on size and level of economic development, there is not yet an agreed definition for SMEs in Uganda. Attempts have been made to define SMEs in developing countries, for instance Elaina (as cited by Albaladejo, 2018) defines Small enterprises are firms that *employ* between 5 and 19 workers while medium enterprises are firms that employ between 20 and 29 workers therefore an SME is a business with a head count ranging from 5 employees to 99 employees.

According to Kasekende and Opondo, (2019) medium enterprises in Uganda employ 50 to 99 workers while *small* enterprises have a minimum number of 5 and a maximum of 50 workers with a value of assets including land, building and an annual income turnover of between Ugx 10 million to Ugx 50 million.

2.4.1 Performance of Small and Medium Enterprises

Firm performance is a multi-dimensional concept; it may be financial or non-financial. Firm's performance can be measured by sales growth and development of new markets and products, (Tadlianvini et al, 2018).

A sale is the pinnacle activity, involved in selling products or services in return for money or other compensation. It's an act of completion of a commercial activity. Sales growth is often used as a measure of performance. The assumption is often made that if sales increase, profits will eventually follow, Thomas and Mason, (2018).A key determinant of success *in* a firm's growth is sales provided of course, that the profits and cash flows generated from sales are adequate to cover the costs incurred in generation of the revenue.

Sales growth can only be achieved by a business enterprise that has adequate capital to carry out activities *like sales* promotion. To get this capital firms need sources of funds of which borrowing is one of the most common sources of fund. When one borrows he or she has to pa back with an interest of which these interest rates as per now are high leading to low

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Performance of SMEs. That is, reduced sales growth (poor performance) due to high inter **rates.**

New markets development do not emerge nor do they appear but they are made by the activities of the firm, Anderson and Gatignon, (201 9).New markets are created when firms correct! y sense a latent need to communicate their solution to that need. AS new market can be created by carrying out marketing activities like product design, branding, promotion, pricing, *sales* and distribution of established products or innovating new products, Pawakapan, (2020)

Innovation increases public welfare and as such new markets are thought to rise because buyers recognize the will be better off, Anderson and Gatignon, (2019).For most firms, successful new Products are engines of growth, Cohen, Eliashberg and Ho, (2019).New products generate fun4 profitability and prevent obsolescence of the firm's product line, Pauwels, Silva-Risso. Srinivasn and Hanssens, (2017).Indeed aggregate evidence suggests that profitable firms do innovate, ***Pauwels etal,* (2017).**

Development of new markets and products can only be achieved by an SME that has adequate capital to carry out activities like advertising so as to capture new customers and maintain the existing ones. To achieve this, firms need funds of which borrowing is one of the most common sources of fund. When one borrows he or she has to pay back with an interest of which these interest rates as per now are high leading to low performance of SMEs. That is, minimal **development of new markets and products.**

2.5 Effects of high interest rates on SMEs

The issue of high interest rates being charged on borrowers of funds has posed a great problem to owners who can only borrow in small amounts. This has led to either closure or stagnaf4 their business and those who have not began the business end up not starting one because of 14 **of lack of capital.**

SMEs in Uganda have been given low priority. Despite recent attempts to rectify the situation, our knowledge of SMEs is still rudimentary and incomplete. SMEs suffer from loss 4r profitability and lack of investments, which promote growth, due to poor credit offered to them and non access to bank loans. This is due to high costs of borrowing from commercial banks and other FIs.

Until the 1960's many economists attributed the relatively *small* size businesses in the less **developed countries *to* the scarcity of capital and administrative experience.** *It* **was often argued** that with economic growth modern forms of large-scale production *would* in one sector after another supersede the small-enterprises. In order to ensure orderly transition small-enterprises were seen to deserve support. Small-enterprises as quasi-sponge for urban employment and provider of inexpensive consumer goods with little or no import contest serving an important pressure releasing and welfare-augmenting function, Kilby, (2017).

Small-enterprises also contribute *to* long-run industrial growth by producing an increasing number of businesses that prow up and out of the small sector. Thus the emergence of wholly modem small-enterprises Uganda industries is likely to be a presequite for any enduring industrialization in that country.

Credit markets are partly shaped by lenders' strategies for screening potential borrowers and for addressing opportunistic behavior encouraged by the inter-temporal nature of· loan contracts. These problems are acute in the developing countries where information asymmetries are more pervasive especially among the resource base poor. Financial markets in such countries tend to be highly dualistic and fragmented with weak linkages between the formal and informal

components. The formal segment of the markets tends to be characterized by the market imperfections demonstrated by high concentration ratios with only a small number of financial institutions exerting considerable market power. Attempts to protect depositors against corporate excesses often lead to share capital requirements that Work against the need to encourage competition. On the demand side, firms choose between external and internal financial sources in consideration of the need to maximize profits, Dercon and Fafchamps, (2020)

Credit markets are peculiar as their transactions involve heterogeneous goods since the qualities of credit contracts vary due to differences in the creditworthiness of borrowns. Rather than being contemporaneous, debit transactions are also inter-temporal since credit is exchanged for a promise to repay later. Lending activities *also* tend to be transactions intensive and the information available to contract parties not always symmetric. The parties often posses different information on risks and profitability of projects. Intermediaries tend to have only subjective assessments of projects for which funds are sought. High transactions costs come on the way of attempts by intermediaries to procure adequate information from borrowers. These and other conditions mean that changes in the price of credit affect the quality of the debt contract and the intermediary's expected returns, Jennings (2018).

\n important consequence of these peculiarities is that the outcomes of credit market equilibrium often embody some rationing, so that among seemingly homogeneous borrowers, some receive credit while others do not, even when they are willing to borrow on existing credit terms. Suppose lenders consider borrowers as homogeneous group even when they are unable to adequately determine the relative quality and risks of each borrower due to the cost of acquiring such information. Suppose further that borrowers are deficit spenders who borrow to finance expenditures in excess of initial resources schedules. Expected returns by intermediaries decline due to adverse selection and adverse incentive effects of high credit costs. One adverse selection increases loan portfolio risks. Aware of this, lenders tend to raise the price of credit to a level where expected returns are maximized. This level often excludes small, risky and costly borrowers who would have been drawn in had the price of credit been higher. To shield themselves against these effects, lenders insist on credit prices to maximize expected returns and then ration available credit accordingly, Maddalla, (2019).

In developing countries, informal credit arrangements enjoy less transaction costs and loan losses because they are restricted to close networks' that derive from kinship, neighborhoods, professions, workplaces, economic activities and other mechanisms that encourage regular interactions. They therefore offer solutions to the information and enforcement problems that formal arrangements often face. However, the volume of credit available through these informal arrangements ends to be highly limited, (Mookherjee, 2019).

On the other hand, the consumption of credit tends to be inversely related not only to interest rates but also to collateral requirements. Micro businesses tend to have a poor collateral base and therefore get excluded from the credit market. Even when their asset base *is* rich, property rights problems reduce the collateral value of such assets. Where entrepreneurs can successfully seek out credit from formal sources, they may not bother to borrow because of limited ability to comprehend debt management and costs of borrowings, fear related to potential hidden costs, previously disastrous experiences with financial services, presence surrogates such as savings and credit associations, and cultural norms that discourage borrowing. The mere presence of financial services even within very close proximity does not therefore guarantee the demand for and use of credit. The credit seeking decision is a three-stage process, in the sense that enterprises have first to decide on whether or not they need credit. Once the decision at this level is in the affirmative an entrepreneur then decides on an appropriate source of approach. *A* decision has also to be made about the level of credit to seek out, Kimuyu and Omiti, (2020).

l.6 Factors that commercial banks consider when Giving Credit to Small and Med; Enterprises

Unlike formal finance, informal lenders often attach more importance to loan screening than *to* monitoring the use of credit. Screening practices often include group observation of individual habits, personal knowledge by individual moneylenders and recommendations by others, and creditworthiness. In-group lending programmers, members are made jointly liable for the loans given. The joint liability plus the threat of losing access to future loans motivates members to perform functions of screening loan applicants, monitoring borrowers and enforcing repayment. Investigations of the effect of intra-group pooling of risky assets shaw *that* groups exploit scope and scale economies of risk by pooling risks and entering into informal insurance contracts. This confirms the *role* of social cohesion in-group repayment, Zeller, (2017)

In-group lending; the financial intennediary reduces the recurrent transaction costs by replacing multiple small loans to individuals by a large loan to a group. This enables financial intermediaries *to* bank with poor loan applicants who would not receive any loans ++4, individual loan contracts due to excessive unit transaction costs. One of the mos imp#,

rationales for a group lending is the information and monitoring advantages that member based financial institutions have compared with individual contracts between bank and borrower. The main argument in the rationale is that in comparison with distant bank agents, group members obtain information about the reputation, indebtedness and wealth of the applicant. They are also able *to* use social sanctions to compel repayment. However, **it** has been shown that a number of factors may undermine repayment performance of group lending under join liability. These include reduced repayment incentives for individual borrowers where other members default, and the incentive to borrow for riskier projects under group based contracts .. There are strong incentives for individuals with similar risk characteristics to form credit groups while other scholars have indicated that group lending schemes work well with groups that are homogeneous **and jointly liable for defaults, Huppi and Feder, (2017).**

2. 7 Conclusion

From the above literature, for *the* success of these SMEs their capital base needs to epan4 r which credit from financial institutions is one of *the* major sources of financing. This source of financing attracts interest of which the level of interest may encourage or discourage potential investors from borrowing that is, high interest rates reduces the level of borrowing hence lowering the performance of SMEs and low interest rates increase the level of borrowing which in tum improves the performance of SMEs. This means that *the* government needs to do more that will encourage reduction of interest rates to enable SMEs access finances easily. With this kind of government intervention *the* Ugandan economy growth rate will automatically increase a° it is clear that SMEs contribute a lot in the economy especially as the main sour r **employment.**

3.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

ln order to obtain the information required to meet the objectives of the study was necessary to obtain data from *different* sources, including review of previous studies, interviews and questionnaires. The rest of this *section* details the approaches to be used to obtain the required **information and how the data was analyze4**

3.2 Research Design

The Researcher employed cross sectional research *design* to gather data due to the time limit of the research. Both descriptive *and* analytical research designs which involve qualitative and quantitative approach *when* collecting data *were* used so as to describe observations *and examine* **the findings.**

3.3 Survey Population

The population constituted the small *and* medium business operations such as operations of metal works, garages, shops, salons, grain millers, secretarial bureaus, hardware's, supermarkets bookshops, schools, hotels *and* restaurants from Kabale municipality which make up a **population of 75 business operators.**

3.4 Data sources

The researcher used both primary and *secondary* sources of data. Primary data was obtained from the *respondents* of Kabale municipality by use of self-administered questionnaires and **interview and the secondary data.**

3.5 Sampling techniques

The researcher also intends to use a *sample* size of 50 *respondents* from Kabale municipality which included hotels, restaurants, salons, supermarkets, schools *and* Hardwares.

The researcher selected *all* the respondents from the mentioned enterprises using simple random **to draw representative** a **sample from each category of business since it gives every ones an equal** chance of participation.

3.6 Data Collection

The research instruments were used by the researcher to collect data were researel questionnaires and interviewing.

The researcher also selected at random all businesses that were fit in the category of small and **medium business enterprises and gave them questionnaires to fill in. Once the respondent agreed** to assist in the research, the interviewer either;

a) Ask the respondent questions contained in the questionnaire and filled it himself.

b) Giving the respondents the questionnaire to fill out at the moment.

c) Left the questionnaire with the respondent to be collected later;

During interviewing, the researcher asked questions and the respondents gave responses immediately which were documented and later on analyzed and conclusions made. This method increased response rate and was less costly in terms of money.

3.7 Data Analysis

All responses from questionnaires were edited for accuracy in data. The data was then manually coded, organized and analyzed using the frequencies and percentages and there after interpreted it.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND DISCUSSION OF FINDING

4.0 Introduction

This chapter contains the findings of the study and their analysis, which was carried out as a view of exploring the effects of high interest rates *on* the performance of small and medium enterprises. *A* case study of SMEs in Kabale Municipality. The total number of people who responded to the questionnaires/ interview was 50 which represented a l 00 per cent response of the sample size.

4.1 Findings on the demographic characteristics of the respondents and SMEs 4.1.1

Gender and age of respondents

ln order to avoid biased responses, the researcher obtained a sample size of 50 businessmen and business women as indicated in the *table;*

Table 4. 1: Showing gender and age of the respondents

Age	Gender		Percentage	
	Male	**Female**	**Male**	**Female**
18-30	6	5	12	*10*
31-40	13	11	26	22
41 and above	9	6	18	12
	28	22	S6	4_4

Source: primary data

Table 4.1 indicates that more male respondents participated in the study than females. This is shown by the biggest percentage of 56 per cent compared to 44 per cent for females. It therefore implies that during the research most businesses are operated by males and it is so because in most cases women are left at home while men are looking for money *to* sustain their families.

Fesults in tabie 4.1 *reveal* that majority of the respondents who participated were in +4 314 years bracket and *above* 41 years respectively. This is so because at this age most people need more to sustain their families for instance if they have children who are studying they tend to be at high schools, colleges and universities which forces people to work harder. This scenario IOI€es *even* those people who are employed to open up businesses so as to *have* extra soureg r income. Also it is at the category of 41 years and *above* that you will find those people who *have* **retired from their jobs and they opt to invest.**

4.1.2 Respondents' level of education attained

The researcher had an interest in the academic qualifications of the respondents as part of their bio data and the responses were given as shown in the table below;

Table 4. 2: Showing education level of respondent

Level of education	/ Frequency	Percentage *(%)*
Bachelor	12	24
Diploma	17	34
A-level	9	18
O-level	7	14
Others	5	1 a

Totals	SO	**100**

Source: primary data

Table 4. 3: Showing Sources of finance and their proportionate financing

Sources of Fund	**Frequency**	**Percentage** (%)
Friends and relatives	14	28
MFis	8	16
Own savings	18	36
Commercial Banks	6	12
Other sources	4	8
Totals	50	**100**

Source: primary data

Own saving had the highest percentage of 36 as a source of starting or additional capital. According to the respondents, they preferred raising funds through this means because it was cheap and reliable and no repayment was required. 28 per cent of the respondents raised funds from friends because very *low* or no interest was charged, the procedures of obtaining the money were simple and short, no collateral was required, repayment was on condition that the business made profits and the repayment period was considerable.

Sixteen per cent of study sample got their finances from Micro-finance institutions because; the interest rates were lower compared to commercial banks, most businesses met requirements to borrow from MFIs and most MFis offered financial management guidance.12 per cent borrowed from CBs because; funds were readily available from the bank, the interest charged was not fluctuating and availability of information concerning commercial banks. 8 per cent of the respondents got funds from other sources for instance, sale of property because they were at reach.

Own savings and family sources form the most important sources of initial capital forming 36 per cent and 28 per cent respectively. *Also* according to further research they form important sources of additional capital. This is because their conditions are lenient as compared to the others. Though other sources of financing are also lenient from the research we found out that some people do not have those extra sources of funds like a property to sell and if it is available they are not willing to make it the opportunity cost of investing hence the low percentage.

Considering the low incomes and savings rate in the country, SMEs fall back on these sources out of desperation. The small proportion of SMEs that receives some credit receives very modest amounts reflecting low activity *levels.*

4.2.1 Problems encountered in financing the business through borrowing

Raising funds through Friends and relatives according to the respondents had some challenges hence the 28 percentage. The main *problems* were lack of trust and confidence in relation to repaying the money, funds from the latter were not sufficient, there was lack of specified duration for repayment of the funds. It was unsafe to involve friends and relatives to avoid their

4.

influence in the management and running of the business, it was strenuous to the family members and friends and also issues concerning the families internally were another problem.

According to the respondents borrowing from commercial banks had its problems like Interest rates were high, they (respondents) found it hard to obtain collateral required, other respondents said repayment period was short and the credit worthiness evaluation process was long and strict **on them hence limited the amount they *could* borrow.**

MFIs as a source of finance according to the respondents had the following challenges; little information was available concerning MFIs, others said that macro-finance institutions are bureaucratic, problem in getting the collateral needed, repayment period was short and that MF/s were not trustworthy because most of the MFIs that are started in Uganda collapse as soon as **they are started and *people* end up *losing* their money.**

Other sources of funds for instance, sale of properties according to the respondents said they did not have the properties to sell and superstitions that selling of a property like land to invest, the **business cannot prosper.**

Generally SMEs face difficulties in accessing credit thus undercapitalized. Of *all* the sources of capital available, they are only able to apply successfully to a small proportion. This is because entrepreneurs lacked about *80* per cent of collateral and information required.

4.2.2 Period of repayment of loans

Table 4. 4: Showing repayment period of loan

Repayment period (years)	Frequency

0-2	**8**
2-4	**2**
>4	**5**
Total	**15**

Source: primary data

From table 4.4, the response was very low because most of the respondents depended on their own savings and funds from friends and families as their startup capital or expansionary capital of which have less or no repayment period at all on these forms of raising funds. Out of the 50 respondents 70 per cent did not respond to this question. It is only *16* per cent that said that their repayment period was between O to 2 years, 4 per cent between 2 to 4 years and l O per cent said that they were given a period of above 4 years to repay their loans. This response represented **only 30 per cent of the sample size.**

The duration of repayment depended on the amount of money borrowed as *small* amounts had a Short repayment period. As the amount borrowed increased, the repayment period would be l6, This is reflected on the interest rates charged and how the interest rates were calculated. Large amounts borrowed lead to long repayment period and in this case interest was calculated annually. The amount borrowed from MFIs faced the smallest interest rate charges and shortest repayment period as compared to CBs. The monthly interests charge *was* the majority because of **the amounts borrowed were *relatively in low* amounts.**

4.2.3 Interest rates perception on borrowings

Table 4. 5: Showing perception interest rates in Uganda

5.

	Frequency	Percentage
Too high	15	30
High	34	68
Average	*1*	2
Low	-	
Too low	-	
Source: primary data **Total**	50	10 0

A high percentage of the respondents believed that the interest rate in Uganda are high and too high as shown in table 4.5.*This* clearly brought out the problem that the researcher was **researching about.**

When trying to get the information concerning the businesses of the respondents only 12 out of the sample of 50 which represents 24 percent were willing to disclose their initial capital and also *only* 15 respondents which represents 3 0 per cent defined the size of their businesses using sales.
"(ajority used year of starting the business and the number of employees respen

A credit seeking decision is a three-stage process. Enterprises first decide on whether or not *they* need credit once that decision is affirmed further decision has to be made regarding the OPP"Opriate source if they will reconsider borrowing an additional decision relates to ++ 4,, Tedit to seek out. But even when SMEs felt a need for external credit, they did not A3 ; their perceptions on the costs of applying for a loan outweighed the expected benefits, sometimes they lacked enough money to meet the application costs and also had to shy off sometimes due to

a poor collateral position. Thus the decision to reconsider borrowing again depends on the **preference and *its credit position* status.**

"enerally in Uganda commercial banks' lending rates remain high averaging between 18 pen and 26 percent. This has mainly been due to lack of competition in the banking sector. This was brought about by; few banks controlling a large market share, high operational inefficiency, high **operational costs and high risk of borrowers, BOU (2019).**

6.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION; 5.0

Introduction

This chapter discusses the summary of the findings, conclusion and recommendations r {4 research study; this was explained from the analyzed and presented data in quantitative and qualitative analysis. The summary of the findings gave an in-depth explanation found on impact of high interests in financing on the performance of SMEs. The answers to the research questions were discussed and the study conclusions were drawn from the findings. The study gave several recommendations and suggestions for further studies were made to address other problems of **high interest rates that were not *explored* by the study.**

5.1 Summary of findings

The research has established that high interest rates charged on borrowings has greatly affected the financial performance as well as the investment levels in SMEs. It is well established that long term borrowings appeared to be expensive by observing the borrowing habit. This is because the risk is perceived to be higher. For instance, a small percentage of 6 of the people interviewed borrow long term loans with a repayment period of more than 4 years as they have a higher interest rate compared to *18* per cent who borrow short term loans which attract lower **interest rates.**

Short term borrowings were charged considerate interests because their risk is perceived to be low. The main problem with short term borrowing is, repayment may be required before the funds borrowed re-generate income to repay the initial borrowing plus interest, thus threatening investment decisions and also the money obtained might not be enough.

Most of the times long term borrowings discouraged entrepreneurs from borrowing due to high

7.

interest charged and also confidential infonnation required. This had an adverse impact on
investment decisions.

A Way **from banks** which charge high interest rates. Others said forming their own SACCOS a better option. Others advocated for strengthening of personal savings. Majority of the respondents said that increasing the size of their businesses in order to increase their chances of getting credit even when charged high interest rates as they will not erode all their profits.

5.3 Conclusion

It was established that high interest rates charged on borrowings greatly affect the growth, financial performance and *the* investment levels of SMEs. This is because it becomes hard for an Investor to expand his or her businesses to match up or even out compete the competitors. S3,, potential investors end up not making their dreams come true due to funds shortage and others **start businesses which do not even *celebrate* their first birthday.**

We established that Small Business entrepreneurs who borrow from Commercial Banks and other financial institutions borrow in Small amounts and not large amounts. This is associated to large amounts of funds required in repayment of the loans obtained and short repayment period, **which inhibits large amounts borrowed.**

We also established that there were a number of problems faced by SMEs in funding their businesses. The problem faced by most respondents was the high interest rates charged on borrowing loans from CBs, lack of collateral, lack of access to credit, lack of enough cash to meet the application costs, lack of knowledge of available loans and short repayment *period*

ln order to combat the above difficulties, educational opportunities should be expanded to improve on the literacy and numeracy of the entrepreneurs in order to improve access to credit **by SMEs and *collateral levels* should be lowered.**

After carrying out the research it was established that majority of investors preferred using own savings and funds from their friends and relatives to finance their businesses mamn reasons being **convenience and less costly.**

In conclusion, the research has established that the interest rates charged on borrowing play a vital role in obtaining the finances of SMEs thus determine the growth, financial perfonnance **and investments in the SMEs.**

5.4 Recommendations

From the observations and findings enumerated herein, the researcher recommends as follows:

80 per cent of the respondents said that the interest rates are too high and should be lowered to enable availability of funds to SMEs. High interest rates discourage borrowing. dee Vestments, retard economic performance of business in the country and hinders r4 ;, domestic investments hence the BOU should control government borrowing which raise {+ interest rates and should place a Treasury Bills benchmark on government debt tu reduce market **imperfections or it can also reduce the bank rate.**

Since the age of an enterprise is important in accessing credit, shortlife expectancy of SMEs especially informal ones is an impediment to credit access. High mortality rates mean lost opportunities not *only* of accumulating business experience but also for building credibility and reputation necessary for accessing credit from financial institutions and suppliers of inputs and products. It is therefore necessary to put in place business 'clinics' for extending managerial 443 **financial 'First Aid'.**

5.5 **Suggestions for further studies**

Because of the limited time and funds, it was not possible to cover effectively all the areas of interest in the study and therefore more research is needed on the following area; the effect of high cost of living on the expansion of businesses, the impact of market forces on interest rates **and the effect of financial institutions profitability motive on interest rate levels.**

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Appendix I

QUESTIONNAIRE

The researcher is conducting purely an academic research *as* a partial requirement for award of Bachelors degree of science with education ofKabale University.

The study is to find out the relationship between interest rates and performance f SMEs in this Kabale Municipality. I am requesting you to humbly respond to *the* questions.

Please be assured that your response will be treated with strict confidentiality.

PART A: PERSONAL DATA

Please fill or tick the right response *that* describes you for each of the following items. (Please **tick in the box where applicable)**

1. Gender

Male

Female

2. Age

18-30 years

31-40 years 41 years and above

3. Highest *level* of education attained

Bachelor Diploma

0-leve]

others...........

Part B: BUSINESS INFORMATION

l- hen did you start the business and with how much capital2..............................._____ 2. What is *the* size of your business in terms of: **(Optional)**

Sales .... Employees......................... Assets ....

Part C: IMPACT OF HIGH INTEREST RATES ON THE GROWTH OF SMALL g MEDIUM SIZE ENTERPRISES

1. What are the sources of funding for your business

O Friends and relatives O Own saving

O Micro Finance Institutions

O Commercial banks Other sources (Specify)

2. **Which of these institut ⊔ have you ever borrowed from? (Tick were applicable)**
   a. Commercial bank?
   b. Micro finance? O
   c. Fiends */Relatives* []
   d. Other sources (Specify)

....

3. What was the repayment period of the *loan* or the borrowed money?

0-2 years O 2-4years O 4 years and above D

4. **What are the interest rates charged ....**
5. What are the reasons that make you fund your business with funds from the above sources and not any other? ....:, ...
6. What *problems* did you experience in borrowing from

a. **Friend and relatives ....**

....

b. Commercial banks

....

....• .. , ...

c. Micro-finance institutions ....

... .

d. Other sources ....

11 Do the interest rates charged on your loan discourage you from borrowing again from these sources O Yes O No

9.

12 What is your perception on the loan interest charged?

Too high	*High*	Average	Low	Too *low*
	–			

Part D: HOW HIGH INTEREST RATES AFFECT THE FINANCIAL PERFORM4NC OF SMALL & MEDIUM SIZES ENTERPRISES

13. Do you think that high interest rates have affected your financiai performance?

O Yes O No

14. If **yes, please rate the extent to which the financial performance has been affected in** (**13)** above:

Positively	*Negatively*	Averagely	Adversely

15. Do you intend to expand your business O Yes D No

16. How do you intend to raise your

funds?...

Part D: *WAYS* THROUGH WHICH SMALL & MEDIUM SIZE ENTERPRISES CA+ DEAL WITH THE HIGH INTEREST RATES IN UGAND

ll. What suggested ways do you think that small & medium size enterprises can use to sf74j **their businesses from high interest rates in Uganda?**

....

....

l8. Do you think small & medium size enterprises like yours can still borrow from ban]9

....•. ....

....

19 How do you perceive interest rates in Uganda?

Too High	**High**	**Average**	**Low**	**Too *low***