CHANGE IN THE BANK BEHAVIOUR AND EFFECT ON MICRO, SMALL, AND MEDIUM ENTERPRISES DUE TO MONETARY POLICY CHANGES: A REVIEW

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Abstract: Change in the Monetary Policy has an effect on the performance of the enterprise. Contractionary policy reduces the money supply and there will be rise in the interest rates. Industries which invest heavily and having high leverage are going to be impacted severely with negative monetary shock. Shortage of working capital funds and inadequate credit availability from banks and financial institutions may lead to sickness and closure of small firms. The tight monetary policy will make small enterprises to report less profit margins and hinders the growth due to inadequate credit availability and higher interest rates. Here an attempt is made to review earlier researches conducted and understand the effects of Monetary policy changes on small firms. The paper throws light on response of banks and an enterprise to change in the monetary policy.

Index terms: Monetary Policy, Bank Behaviour, Credit, Interest rate, Effect, MSME.

Introduction:

MSMEs in India are considered as the backbone and piller for the growth of the economy. Over the years this sector has been active player to industrialisation of rural and backward areas. This sector is more importantly a labour intensive and contributes to generation of employment. MSME sector faces lot of challenges and hindrances which obstructs the growth of these enterprises. Important and primary problem faced by these MSMEs is access to funds due to their high risk profile. They will be forced borrow funds from other sources at higher interest rates due to inadequate credit availability from banks. Inadequate and timely funds from the banks will certainly hamper the performance and growth of these enterprises. Apart from this if the interest rates charged on loans are higher it becomes more difficult for these enterprises to survive. The effect is more severe when there is tight monetary policy in place.

Yes, objectives of Monetary policy are to maintain a reasonable degree of price stability and to help accelerate the economical growth rate. Expansionary monetary is favourable for firms as the banks would be given an opportunity to lend at lower interest rates since the money available with them to lend is more. At the same time Contractionay monetary policy would hamper the performance of the industries as the credit availability is going to be tight and the interest rates on loans would be higher. This contractionary monetary policy will discourage the investment activities of the enterprises. MSMEs may find it difficult to obtain credit for their operations during the tight monetary policy.

Here an attempt is made to review earlier research conducted and understand the credit availabilty and interest rate effects on MSMEs due to monetary policy changes. The study also reveals that what are the effects of tight money and easy money policy on operations of the small enterprises. The study also covers changes in the bank behaviour in lending to small firms due to monetary policy changes.

Objective:

To review the various earlier researches conducted on Credit availability and Interest rate Effects on MSMEs due to changes in the monetary policy.

Need for the study:

India has seen frequent changes in the monetary policy during last eight years. Whether frequent changes in the key policy rates have disturbed the operations of small enterprises is the question. It is known that contractionary policy reduces the money supply and there will be rise in the interest rates. Like that an expansionary monetary policy will increse the money supply and lower interest rates would exist in the economy. There is need to go through the earlier researches conducted on effects of Monetary policy by various researchers. This review will help us to understand what difficulties the enterprises under go and which is the condusive environment for the growth of the industries. The review also helps us to know how small firms and banks behave during monetary policy changes.

Reasearch Methodology:

The reseach review is carried out using journals and articles available online. Various papers and articles related to Credit availability, Interest rates impact on MSMEs, The behaviour of banks during monetary policy changes and the impact of monetary policy on small firms have been reviewed. The inferences were drawn based on the imprtant fators which have influenced the small firms during monetery policy changes.

Literature Review:

Allen N. Berger and Gregory F. Udell (2002) examined the impact of monetary policy shocks to the banking system on the supply of credit to the small businesses. As small firms will not be having the access to capital markets, they will have to depend on banks and other financial institutions for external funding. Monetary tightening makes banks to reduce lending. Hence any monetary policy impact to the banking system will have substantial impact on credit supply to small businesses. This will have a significant impact on small businesses which depend on external funding. They also found that decline in credit worthiness due to monetary tightening make small businesses more difficult to obtain bank loans.

Motiniva Nayak (2017) in his paper wrote that commercial banks play an important role in providing external financial assistance to MSMEs. They extend credit to meet the needs of short term and long term invesmenments of MSMEs. It is discussed that credit to MSME sector is decreasing both in terms of share of total credit and growth rate. Decline in credit is going to affect the growth of the sector. It is understood that large banks do not lend risky loans due to MSMEs risky profile. The reason for decline in credit disrbursal to MSMEs is that the loans are less profitable as they involve higher transaction costs and monitoring costs.

Saibal Ghosh (2008) made his statement that constrained banks tend to reduce their risky loan portfolio following upon monetary contraction. In response to the interest rate shock constrained banks increase credit disbursal to less risky borrowers and decrease credit disbursal to risky borrowers.

James W. Christian and Warren F. Mazek (1969) found that the firms chose short term credit during tight money periods, if they are responsive to long term interest rates than to short term interest rates. As the small firms are more reliant on bank loans these firms are more sensitive and change their loan portfolio. It is also revealed that small firms are more able to get long term loan than short term loan from banks during tight money periods. Where in banks prefer to lend short term loans during the periods of tight money.

Shankar Acharya and Srinivas Madhur (1984) examined that whether existance of informal credit market weaken the operation of monetary policy. The monetary policy has a significant effect on the interest rate in the informal credit market also. A contractionary credit policy raises interest rates in informal credit market and the expansionary policy decrease the interest rates in the informal credit market.

Saibal Ghosh (2009) found that expenditures on firm investments are sensitive to interest rates. Industries with higher interest cost in total production are expected to be affected with rise in interest rates. Industries which invest heavily are going to be impacted harshly with negative monetary shock. Industries which are already burdened with loans are expected to face greater difficulty in obtaining additional funds from the market.

Nwosa Ifeakachukwu, Oseni Olasunkanmi (2013) examined the impact of bank loans to MSME in Nigeria for the period from 1992 to 2010. It was observed that effect of bank loans to MSME sector on manufacturing output was insignificant. But it is understood that there is need to moderate the interest rates on loans which will enhance the performance of the MSME sector.

Sherman J. Maisel (1968) found that Monetary policy changes influence the spending of selective units. Spending of the firm is influenced by price and availability of loan. Monetary policy influences interest rates which inturn influences the profitability of the investment. It is noticed that higher interest rates limit the ability to borrow which lead to contraction in investment.

Results of the study conducted by Saibal Ghosh and Saurabh Ghosh revealed that liquidity contraction lowers investment particularly in highly leveraged firms. Monetary policy measures, which affect market liquidity adversly, obstruct firm investments and the effect is more in small firms.

Robert E. Krainer (1966) found that new orders for machinary were inversly related to the interest rates. Lower interest rates were associated with high level of new orders for machinary. At the same time there were low level of new orders when interest rates were higher. He found that lower interest rates make the external funds easily available which influences the business people to raise capital.

For sales, inventory and long term debt, Mark Gertler and Simon Gilchrist (1994) constructed time series of growth rates for small and large firms. When they studied relative growth rates of sales, it was found that after tight money policy, small firms decline sharply when compared to large firms. Small firms appered to reduce the stock and borrowings significantly. They found that credit flow to small firms reduces when compared with large firms after tifght money.

K. Krishnamurty and D. U. Sastry (1996) considered ten individual industries for analysis. During the study it is revealed that inventory output ratio over the period 1950-62 showed downward trend, which was due to increse in the cost of borrowing. The interest rate factor may have a insignificant influence on inventories if interest cost is going to be a small proportion of total cost of holding inventories.

L M Bhole (1984) tried to identify whether there is any alternative for bank credit. When cost of funds from financial institutions and banks increase, firms tend to take more trade credit and give less trade credit. When availability of external funds becomes easy, they give more trade credit and take less trade credit. It was found that trade period depends on the rise in interest rates and credit availability froom banks. He concluded that Monetary policy variables can influence the volume of trade credit by influencing the length of the trade credit period.

Gert Peersman and Frank Smets (2005) estimated the monetary policy effect on output in eleven manufacturing industries in seven europian countries. It is found that industries which are more capital intensive are expected to be more sensitive to changes in the interest rates. Firms with higher leverage are expected to face greater difficulty in obtatining funds due to policy changes.

Mbugua Kamunge, Dr. Agnes Njeru, Ondabu Tirimba (2014) in their paper concluded that lack of access to long term credit for small firms forces them to depend on high cost short term finance. Enterprenuers depend on self financing or borrow from friends and relatives to run their business which will not enable them to function at best possible level. Finding finance for a start up is the biggest difficulty for enterprenuers in Kenya. Due to inadequate funds, small enterprises will not be able to expand, modernise their business and meet the orders in time.

Bawuah Bernard, Yakubu Awudu Sare, Alhassan Musah (2014) examined the interest rate effect on MSMEs and availability of funds in Ghana. Higher interest rates charged on borrowed loans has affected their business operation in the form of high production costs. The profit margins have significantly affected due to higher costs. It is also found that higher interest rates increase the probability of loan defaults. They believed that lower interest rates would help MSMEs to improve their business performance.

Mishu Tripathi, Sourabh Tripathi and Rikin Dedhia (2016) in their paper highlighted on growth opportunities and challenges for MSMEs in India. What they found is easy and fast credit is the most critical growth driver of MSMEs. The MSMEs start with minimum capital and their growth stops at certain point due to lack of external credit availabilty. Inadequate credit at right time is also one of the reasons for MSMEs lower profit margins which hinders the growth of the enterprises.

Bhushan Chandra Das, K.S.Chakraborty, Raveesh K selected 487 firms to conduct survey of firms in tripura in which only 237 units were working. Remaining units either reported as sick or closed. High rate of sickness and closure of units was observed in wood, jute, paper, tea and electrical products. Shortage of working capital funds and inadequate credit availability from banks and financial institutions were the reasons for sickness and closure of firms.

Ashok Thampy (2010) found that availability of adequate amount of finance is a major concern for SMEs. Government has adapted sevaral policy measures to increase the flow of credit to SME sector. Earlier research highlighted that financial liberalisation improves external credit accessibility to SMEs which are financialy constrained. But author showed a concern that that it is too early to conclude that small firms in India are not financialy constrained.

Findings:

Monetary tightening makes banks to reduce lending. Interest rates decrease in informal credit market due to expansionary cedit policy and a contractionary credit policy raises interest rates in the informal credit market.

In response to the interest rate shock constrained banks increase credit supply to less risky borrowers and reduce credit supply to risky borrowers.

Higher interest rates charged on borrowed loans has affected their business operation in the form of high production costs. Firms with higher interest cost in their total production are likely to be affected with increase in interest rates.

Industries which invest heavily are going to be impacted severely with negative monetary shock. Monetary policy influences interest rates and cost of borrowing influences the profitability of investment.

Industries which are already burdened with loans are expected to face greater difficulty in obtaining additional funds from market. Higher interest rates limit the firm's ability to borrow which lead to reduction in investment. Monetary policy measures which affect market liquidity adversly hamper investments and this effect is seen more in small firms.

Lower interest rates are associated with high level of new orders for investment in machinaries. At the same time low level of new orders observed when interest rates were higher. It is found that industries which are more capital intensive are expected to be more sensitive to changes in the interest rates.

Lack of access to long term credit for small firms forces them to depend on high cost short term finance. Monetary policy variables can be expected to persuade the volume of trade credit by influencing the length of the credit period.

Businessmen depend on self financing or borrow from friends and relatives to drive business which will not facilitate them to operate at their best. Due to inadequate funds, small enterprises are unable to expand, modernise their business and meet the customers orders immediately. Shortage of working capital funds and inadequate credit availability from banks and financial institutions are few of the major reasons to the sickness and closure of firm.

Conclusion:

Despite being a active player, MSME sector faces lot of challenges and hindarances which obstructs the growth of these enterprises. Important and primary problem faced by this sector is access to funds due to its high risk profile. The effect of inadequate finance and interest rates will be more during changes in the monetary policy. Bank lending reduces during contractionary monetary policy which will have a significant impact on small businesses. A contractionary credit policy raises interest rates in informal credit market and the expansionary policy lowers interest rates in the informal credit market. Lack of access to long term credit for small firms forces them to depend on high cost short term finance.

Industries with higher interest cost in total production are likely to be affected with rise in interest rates. Industries which invest heavily are going to be impacted severely with negative monetary shock. Firms with high debt are expected to face greater difficulty in obtatining funds due to policy changes. Monetary policy variables can be expected to influence the volume of trade credit by influencing the length of the trade credit period. High cost of bank credit is a challenge to small firms which will not enable them to operate at their best. Shortage of working capital funds and inadequate credit availability from banks and financial institutions are few of the major contributors to the sickness and closure of firm.

Easy and fast credit is the most critical growth driver for any MSME. Unavailability of credit at right time is also one of the reason for MSMEs lower profit margins which hinders the growth of the enterprises. There is need to moderate the interest rates on such loans to make more attractive which can enhance the performance of the MSME sector. Higher interest rates increase the chances of loan defaults. They believed that lower interest rates would help to improve their business performance. Researchers highlighted that financial liberalisation improves external credit accessibility to SMEs which are financialy constrained. But it is found that it is too early to conclude that small firms in India are not financialy constrained.

Scope for the research:

Monetary policy impact on small firms in various countries is studied here. It is observed that Monetary policy has a significant impact on small firms in various areas like Short term and long term investment, Inventories and trade credit, Loan portfolio, Performance and growth of the enterprises. The monetary policy effect seems to be different for Micro, Small, Medium and large enterprises as the capacity of accessibility to external funds differs. Hence there is further scope for the reseach to work on this area.

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