THE IMPACT OF MACRO ECONOMIC FUNDAMENTALS ON PROFITABILITY OF SMALL AND MEDIUM SCALE ENTERPRISES (SMES) IN A RECESSED ECONOMY

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Abstract

This study investigates the influence of macro-economic fundamentals on Small and Medium Scale Enterprises (SMEs) during the era of economic recession in Nigeria. The study employed secondary data obtained from annual statistical bulletin together with primary data retrieved from a well-structured questionnaires to owners/managers, Senior Staff and Junior Staff of fifteen (15) selected SMEs in Benin City, Edo State of Nigeria. The ordinary least square regression technique was employed to analyze the data set. The results revealed that the impact of inflation and exchange rate on SMEs profitability was negative and significant during economic recession in Nigeria. However, government policies was also seen to show a statistical negative impact on profitability of small and medium scale enterprises during the period under investigation. Based on the findings obtained from the empirical analysis, we carefully recommend there must be increased efforts from the government and other related agencies to assist in diversifying the revenue sources of small and medium scale enterprises. There is need for related authorities to provide contractionary fiscal or monetary policies that will combat inflationary pressure, with precautionary measures that will equally curb unemployment.

Keywords: Economic Recession, Government Policy, Inflation Rate, Interest Rate Hike, SMEs.

Introduction

It is no doubt that Nigeria is blessed with both abundant human and natural resources. Hence, the catalyst needed for development is effective and efficient utilization of these abundant resources. Small and Medium Scale Enterprises (SMEs), came into limelight because of the need for development in all sectors of the economy. The trend in the economy tends to constrain the operations of the SMEs. Fluctuations in the economic fundamentals vis-à-vis pose a challenge on the operations of the SMEs Agbonifoh, Agbadudu & Iyayi, (2005). SMEs are viewed from the perceptive of amount of capital invested, size of employment, annual sales turnover, total assets or a combination of these Inegbenebor, (2006). Ekpeyoung and Nyoung (1992) are of the view that there is no universal definition of SMEs since classification of a business into small or medium is based on qualitative and subjective judgement.

Economic recession is a consequence of failed macroeconomic policy that was expected to curb inflation, reduce interest rate and aggregate decline in government expenditure Gbenenye, (2014).Over the years, SMEs have encountered many challenges ranging from unstable government policies, high cost of production, lack of capital, exorbitant interest rate, poor infrastructures, exchange rate swing, inflation and lots more. This signifies that whenever the economy is performing well the general expectation of most investors and shareholders is that companies would perform well and thus shareholder's wealth is maximized. Economic performance of a country is judged by the stability in macroeconomic variables, such as exchange rate, inflation rate, consumer price index, Gross Domestic Product, stock market index and interest rates. Hence, policy makers at both the macro and micro levels expect that economic conditions would remain stable and favorable to sustain business performance. Moreover, it is the wish of potential and existing investors that these macroeconomic elements remain pleasant so as not to threaten the firm's ability to meet up with set objectives. Firms make several operational and strategic decisions (include financing decision, investing decision and operational decisions) which are usually moderated by the fundamentals of business operating environment. Hence, organization management must pay particular attention to their operating environments when formulating and implementing survival and growth strategies Otokiti & Awodun, (2003).

The major economic crisis which Nigeria has encountered was the economic recession that hit her in the 1980s. This was remarkably due to the inability of the nation to manage its oil boom which occurred in the 1970s. Consequently most SMEs went into extinction and made a good number of the populace jobless. It is on record that the recession of the 80's prompted the intervention of the federal government to introduce Structural Adjustment Programme (SAP) in 1986 as a policy tool. This survival strategy "which some authors termed as harsh policies" on business organizations, government institutions, and private individuals was altogether ineffective due to its negative impact on the economy Iyoha, Oyefusi & Oriakhi, (2003).

The SME sector is the center of productivity as it relates to export expansion, creation of foreign exchange earnings, import substitution, employment creation, promotion of investments and development of other sectors Fakiyesi, (2005). However, the recent economic downturn of 2015 crippled the activities of financial institutions making them unable to carry out their credit obligation to manufacturing small and medium scale business sector. Notwithstanding the enormous consequences, the Nigerian government through policy efforts of the Central Bank has remained committed to the growth and development of SMEs. This stance has been successively reflected in the Bank's policies over the years. In particular, the CBN has through its credit guidelines over the years, and until very recently, required commercial and merchant banks to allocate stipulated minimum credit to SME. At the international level SMEs in Nigeria have an improved operational environment. The liberalization of trade through WTO Agreements has also provided awareness through which SMEs could access international market. Another opportunity is the African Growth and Opportunity Act, which favour imports from African countries to the United States. All of these inputs imply that revisiting key macroeconomic fundamentals together with government policies will form vital instruments in reviving an already recessed economy. Hence this study empirically focuses on the effects of macroeconomic fundamentals on profitability level of SMEs in Nigeria. The study also takes a look at the connection between government policy and SME profitability.

Objectives of the Study

The main objective of this study is to investigate the effect of macroeconomic fundamentals on profitability of SMEs in a recessed economy. However, the specific objectives of this study are:

1) To evaluate the impact of higher inflation rate on profitability of SMEs in a recessed economy.
2) To access the effects of interest rate hike on profitability of SMEs in a recessed economy.
3) To find out the effects of government policies on SMEs profitability in a recessed economy.

Research Hypotheses

The following are the hypotheses which the researcher seeks to test.

Ho_1: Higher Inflation rate does not significantly affect SMEs profitability during recession period.

Ho_2: Interest rate hike does not significantly affect SMEs profitability during recession period.

Ho_3: Government policies do not significantly affect SMEs profitability during recession period.

Conceptual Literature

Economic Recession

The term economic recession is referred to as a critical economic meltdown characterize in the global economic crisis Gbenenye, (2014). This situation is evident in virtually all countries in the world (developed and developing). Economic recession simply means global economic meltdown, financial crisis, credit crunch, and economic downturn. It represents a tightening of the economy usually for a certain period of time. Marcourse (2003) is of the opinion that economic recession is a time of falling output and real income accompanied by gloomy business expectations. In other words, it's a period in which demand is growing more slowly than before, so that majority of businesses discover that they are selling less than they expect. However, various economists differ on the concept of economic recession. Some see it as a slowdown in economic activities that brings down consumer spending and often also raise unemployment levels and subsequent reduce GDP for two consecutive quarters coupled with 2% or more in the rate of unemployment.

Jhighan, (2006) posit that economic recession is just a phase of the business cycle generally representing a decline in economic activities which may be occasioned by a decline in major economic variables. Accordingly, the incidence of economic recession distorts the level of gross domestic product (GDP) of the affected countries with cyclical effect seen in terms of severe liquidity crunch. It also enables nations to experience fluctuations in its economic activities cutting across every sector of the economy. Often a time, these fluctuations creates lasting impact on both large and small businesses, the government and the entire citizenry, (that is, it either makes them better or worse off) Marcourse (2003). The effects of economic recession can be found in decline in GDP growth rate, increased poverty rate, upward shift in unemployment level via jobs loss which promotes prostitution, political thurggery increased crime rate among others. This situation also give rise to unprecedented rise in infant mortality rate, share prices crash, critical squeeze in consumer credit facilities, closure of companies and many more thus making it difficult for the economy to achieve Development Goals Fabunmi & Aileonokhuoya, (2009).

In most cases economic recession surfaces slowly such that the time span needed to compile and verify from economic data whether or not a recession is underway will obscure many in that a recession may well be under way or even over before government agencies are able to declare it officially. It should be noted that when is not checked it gradually metamorphoses into economic depression which might spell doom for any economy. Economic recession is also viewed from the angle of business cycle. According to Professor Mitchell, business cycle is a fluctuation found in the aggregate economic activities of countries that align their work mainly in small and medium scale business enterprises. In addition, Marcourse (2003) suggest that trade cycles consists of a sequence in which a recession is followed by recovery which leads to a boom. To the National Bureau of Economic Research (NBER), an economic recession is a significant decline in economic activities in virtually all aspects of the economy with a life span of just a few months.

Nexus between Inflation Rate and Organizational Profitability

Inflation continues to be a fact of economic life in most countries. High inflation rates have seriously eroded monetary values in most developing countries over the past two decades, and have brought forth new patterns of economic behaviour Davidson & Weil, (1995). Inflation means rising prices and it shows the increase in cost of living. In economics, inflation is explained as rise in the general level of prices of goods and services in an economy over a period of time. With the rise in price levels a unit of currency will buy fewer goods and services. As a result, the purchasing power of such currency will be reduced. In other words the real value of money will be lost day by day along with inflation Smith & Anderson, (1996). A low inflation rate is beneficial to a country and zero or negative inflation is considered as bad. Also, a high inflation is harmful to an economy and it affects an economy in many ways. High inflation distorts consumer behaviour thereby creating difficulties for business organizations to predict the future and accurately calculate prices and returns from investments. Consequently, business confidence deepens. Furthermore, panic buying erupts which destabilizes consumer markets and creates unnecessary shortages. High inflation results to income redistribution such that the fixed income earners and those lacking bargaining power will become relatively worse off as their purchasing power falls. In the event of high inflation, if the demand for higher wages by trade unions is met, wage-price spiral may occur this may further aggravate the inflation problem Packer, (1997).

Nexus between Interest Rate Hike and Organizational Profitability

Interest rates have been observed to have diverse impact on organizational financial profitability. High interest rates are likely to curb business investments and innovation and could also increase loan defaults in the banking system and bank business financing consequently affecting business revenues and profits negatively. When interest rate is raised, the general effect is to lessen the amount of money in circulation, which works to keep inflation low. On the other hand, lower interest rates give companies an opportunity to borrow money at lower rates, which allows them to expand their operations and also their cash flows. When interest rates are declining, the economy is expanding in the long run hence; appropriate interest rate should be set to maintain interest rate at desired levels while encouraging economic development.

Nexus between Government Policies and Organizational Profitability

The New Deal during the American Great depression in the later part of the World War II, and the post-war economic expansion (1945–1973) were considered as manifestations of the Keynesian school of thought. Keynesian economics submit that decisions taken by the profit-seeking private sector operators sometimes lead to inefficient macroeconomic results Sullivan and Sheffrin, (2003). Keynesians argue that increasing government spending and reducing tax rates are the best ways to stimulate aggregate demand during recession or low economic activity, thereby building the framework for strong economic growth and working towards full employment. They postulated that the resulting deficits would be paid for by an expanded economy during the boom that would follow. Therefore, they advocate active fiscal policy responses by the government to stabilize output over the business cycle. This opinion is also held by Blinder, (2002) who posit that economic revival can be achieved by government investment policies focused on greater spending into the general.

Government Policies towards SME Growth in Nigeria

Ihugba, Odii and Njoku (2014) in their study identified government's inconsistent industrial policies as a critical challenge militating against the growth of SMEs in Nigeria. They argue that frequent changes in power (from military to democratic rule and vice versa) among others have led to the formulation of industrial policies which have been detrimental to SMEs growth in the country. According to the authors, the Nigerian government is not doing enough to encourage SMEs growth unlike in Ghana and Kenya where the SMEs sub-sector is a significant vibrant instrument notable for the reduced unemployment and poverty rate in both countries. The study of Elumilade, Asaolu and Oladele (2010) on micro-enterprises financing Osun state of Nigeria revealed that micro-enterprises were found to be inadequately financed as a result of high interest rate, low personal savings and unfavorable government policies. In another related study, Ogujiuba, Fadila and Stiegler (2013) studied the problem of accessing finance in Nigeria and reveal that small loans are extremely costly in terms of administration. The study also showed that profit levels are too meager to sustain the activities of these SMEs.

Recommendations emerging from these studies suggested that government agencies should provide sound macroeconomic policies that will create an enabling environment for entrepreneurship activities to buffer SME growth further creating an all-round development of the economy. In other words, governments policies should be able to stimulate private sector investments Gbenenye, (2014) In response to the development, Ogujiuba, Fadila and Stiegler (2013) suggested that relevant government agencies should enforce laws and regulations on leasing, contracts and corporate tax that will stimulating SMEs development leading a path way for alleviating poverty in the economy.

Empirical Literature

Researches have been carried out on the impact of various macroeconomic variables on organizational profitability in developed and developing countries around the world. Each research normally takes a particular aspect of economic variables and examines its impact on a sector of the economy. A number of studies indicate significant relationships between exchange rate, interest rate, inflation rate, GDP fluctuations variables and organizational performance of Small and Medium Scale Enterprises SMEs.

Daisy and Kwenin (2013), investigated how specific macroeconomic conditions influence US Corporate Profit Growth. Using Autoregressive Distributed Lag (ARDL) co-integration approach, the study evaluates short and long-run dynamics of organizational profit growth in an environment characterized by specific macroeconomic conditions. Evidence show that trends in corporate profit growth are not entirely immune to macroeconomic perturbations or constrained economic conditions as recent corporate profit growth conditions, which suggest that although modeled macroeconomic conditions have no statistically significant impact on organizational profit growth in the short run however in the long run, conditions such as macroeconomic uncertainty, inflation expectation and fiscal policy volatility depress or have significant constraining effect on corporate profit growth.

Osoro and Ogeto (2014) investigated the effect of macroeconomic fluctuations on the financial performance of SMEs in Kenya. The study discovered evidence that foreign exchange, interest rate and inflation rate have significant effects on the performance of Small and Medium Enterprises. The study recommended that the government should come-up with strategies and policies to protect the SMEs and agricultural sectors due to their immense contribution to the economy of the country by formulating policies aimed at controlling the effects of rapid fluctuations of the macro economic factors and their effects on the various sectors.

The key macroeconomic indicators used in the study of Zeitun, Tian, and Keen (2007), were nominal interest rate, changes in money supply, the production manufacturing index, inflation, exports, availability of credit and Islamic credit to examine the macroeconomic determinants of corporate performance and failure among 167 Jordanian companies for the period 1989-2003. The unanticipated changes in interest rate negatively and significantly affect firms' performance proxy by ROA. This means that higher interest rate significantly raise the cost of debt at which the required rate of return will be lower than the cost of debt, therefore firms reject profitable projects due to the high cost of borrowing, which affect negatively firm's profit. Unanticipated changes in inflation, money supply, and credit availability negatively and insignificantly affect firms' performance. The production manufacturing index and Islamic credit facilities positively and significantly affect firm's performance, while export was found not to have any significant impact on firm's performance.

According to Enterprises Survey (2011) the main effects of the economic crisis during 2009 and 2010 were the overall negative impact on total demand (mentioned by 62% of all enterprises) and the increase in customer payment terms (mentioned by 50% of all enterprises). Problems with obtaining finance (credit constraint) were mentioned by approximately 40% of enterprises. There is also a clear size class effect: smaller enterprises more often mention negative effects of the crisis than larger enterprises. This is consistent with the fact that between 2008 and 2010 SMEs' employment decreased more than large enterprises' employment.

According the study of Kolesnikova and Liu (2011) during the recession of 2009/2010 SMEs are losing proportionally more jobs than large firms. Moreover, SMEs also take longer to rehire than large firms. SMEs are also more likely to close down a business during economic contraction, which means that some of their job losses might be considered permanent. Re-creating these jobs take longer time than rehiring.

Ratanapakorn and Sharma (2007) investigated the short and long term relationship between US's S & P 500 and six macroeconomic variables of short and long term interest rate, money supply, industrial production, inflation and exchange rate and found that all macroeconomic variables affect the share price in the long run but not necessary in the short run.

Economic Capabilities Theory

The Dynamics of Capability theory is the firm's ability to integrate, build and reconfigure external competence to address rapidly changing economic variables. This theory emphasizes the need for a firm to use core competence in coping with the economic turbulent. Dynamic capabilities are necessary if a firm must engage competitively and take opportunities within its operating spheres. It also connotes the firms' ability to convert its core competencies to take up opportunities in its operating environment.

Methodology

Research Design

Agbonifoh & Yomere (1999) defines "research design as a plan that guides the researcher in the various stages of the research process". It shows the population under scrutiny as well as the sample size. Agbonifoh and Yomere (1999) revealed that the population refers to the totality from which a sample is drawn. Small and Medium Scale Enterprises in Benin city will constitute the population of the study. The sampling method adopted for this study was the judgmental sampling method which was a type of non-probability sampling method where the selection of the sample is based on the researcher's judgment due to the purpose of the study. The sample was drawn from a population of service delivery and production business enterprises within Benin City metropolis, who has an employment of at least 11 persons and at most 300 persons and who have been in business for over (3) years.

Primary data relating to the respondent was extracted from a sample size of 100 respondent selected from 10 small and medium scale businesses which include the following, J. Charles (Nig) Ltd, Orchard Pharmacy Ltd, Mouka limited, Emaxy Accessories ltd, Ejike Transport Company, F morris Petrol Ltd, Bruzee Photos, GT Fast Food and Restaurants, Samotaka Holdings and Mikes Bakery Ltd. However, secondary data relating to the variables of interest rate and inflation rate were extracted from Central Bank of Nigeria (CBN) annual statistical bulletin 2017. The study employed the Ordinary Least Square (OLS) regression technique in analyzing the data set. The analysis of this study was performed using EViews 8.0 econometric software.

Model Specification

The study adopted the OLS regression technique which is poised to explain the changes in the value of the regressand due to changes in the regressors with a key assumption that the dependent variable is a linear function of all the independent variables. However, the ordinary least square regression model with an error term is further represented in equation 1 below

$$PROF = \beta_0 + \beta_1 INT + \beta_2 INF + \beta_3 GOVPO + e_t \quad \text{.................................} (1)$$

Where,
PROF = Organizational Profitability (measured with a well-structured questionnaire)
INT = Interest Rate (Data were handpicked from CBN statistical bulletin 2017)
INF = Inflation Rate (Data were handpicked from CBN statistical bulletin 2017)
GOVPO = Government Policy. (Measured with a well-structured questionnaire)
β_0 = Constant
$\beta_1 - \beta_3$= are the regression coefficients to be determined
e_t = Error term

Presentation and Discussion of Results

The study adopted the OLS regression technique in testing the hypotheses formulated in the study. The result of the regression result was presented in the table below:

Table 1: Ordinary Least Square Regression Results

Variables	int	inf	govpo	intercept
	-0.097 **(-2.193)** **{0.000}*****	**-0.664** **(-7.987)** **{0.000}*****	**-0.134** **(-2.663)** **{0.000}*****	**1.470** **(2.801)** **{0.006}****
Adj R^2 = 0.39				
F-statistics = 21.47				
Prob F = 0.000				
Hetero F = 0.5216				

Source: Author's Computation (2018)

It would be observed from the table above that the coefficient of determination (adj.R^2) is 0.39. This shows that about 39% of the systematic variations which occur in the dependent variable were jointly explained by the independent variables under study. The remaining 61% was captured by the error term. This implies that the model was good enough for statistical prediction. The F-statistic value of 21.47 with a probability value of 0.000 showed a significant linear relationship between the independent variables and dependent variable.

Following the results in the table above, we find that the macroeconomic variable of interest rate (INT) was negative and statistically significant. The significant is because the variable passed the individual test of significance at more than 1% level. This therefore suggest that during the period of economic recession, interest rate charges on small and medium scale enterprises significantly reduced the profit levels of theses SMEs under study. Furthermore, the variable of inflation (INF) showed a positive and statistically significant impact on organizational profitability during the period under review. This indicates that profitability of SMEs declined during the period of economic recession as a result of upward movement in inflation rate. Again the significance of the variable is because it passed the individual test at 1% level.

The empirical finding also revealed that government policies (GOVPO) impacted negatively and is seen to be statistically significant at 1% level. This shows that effective implementation of government policy would assist SMEs in coping with the challenges of economic recession. To test for the presence of heteroskedasticity in the result, we employ the Harvey heteroskedasticity diagnostic test which revealed that there is no heteroskedasticity in the regressions F-statistic (0.5216) This result also compliments the result obtained from F- statistics result which lends credence to the fact that the result from this study may be relied upon for policy implementation and recommendation.

Discussion of Results

The empirical evidence from the ordinary least square regression showed that interest rate is negative and statistically insignificant in impacting on organizational performance. The study therefore suggested that we accept the alternate hypothesis that interest rate given to entrepreneurs/managers in other for them to secure loans was detrimental to their profit levels during the period of economic recession. Inflation rate is seen to be statistically significant again negatively impacting on profitability of these enterprises. The result lends credence to the findings of Ogujiuba, Fadila and Stiegler (2013) who asserted that access to small loans by microenterprise is difficult due to high cost of administration, high interest rate and a surge in inflation rate. The study therefore suggested that we reject the null hypothesis that interest rate and inflation has no significant effect on profitability of SMEs during the period of economic recession. Government policies are seen to be statistically significant with negative effect on organizational profitability. This finding ratify the findings of Ihugba, Odii and Njoku (2014) whose result shows that Nigerian government is not doing enough to encourage SMEs through sound policies. Therefore, we reject the null hypothesis which states that government policies have no effect on profitability of SMEs in Nigeria.

Conclusion and Recommendations

From the extensive review of the related literature and the field work done in the research, one can conclude by affirming that to a very large extent, economic recession can pose severe threats to decision-making units (individuals, businesses, government). Hence, proactive measures should be instituted to check its sudden occurrence while remedial measures should be instituted to ameliorate its likely (negative) effects. Government and relevant agencies must wake up to its responsibility of its wants to achieve its development goals, while SMEs must not depend on government to be spoon-fed.

Indeed during an economic recession, many businesses (except a few) are faced with the threat of liquidation. Hence drastic measures (actions) is needed to be taken by government and all stake holders (especially SMEs) to ensure that the economy is revamped.

However, the following recommendations are suggested for consideration and further policy action.

(1) There must be increased efforts from the government to diversify the revenue sources of small and medium scale enterprises. Measures to improve revenue generation, transparency, accountability, good governance and public functionaries are needed at all levels. More so, to curb the negative impacts of economic recession, the need for prioritization of projects and programmes is very important, efficient management of scare resources and cost reduction strategies should be adopted. SMEs must develop an effective management information system that will help it discover and respond to rapid changes in its environment (most especially the political and economic environment).

(2) There is need for related authorities to provide contractionary fiscal or monetary policies to combat inflationary pressure, however precaution must be taken to obtain optimal levels since sub-optimal levels may lead to massive unemployment. Furthermore, sound policies should be provided and implemented in order to have a hub of small, medium and skill-intensive enterprises spread across all nock and crannies of Nigeria

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Appendix

Ordinary Least Square Regression Results

Dependent Variable: EREC
Method: Least Squares

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.470530	0.524144	2.805585	0.0062
INT	-0.097499	0.081672	-2.193781	0.0007
INF	-0.664236	0.083160	-7.987490	0.0000
GOVPO	-0.134397	0.080804	-2.663253	0.0008

R-squared	0.441779	Mean dependent var	3.716129
Adjusted R-squared	0.392963	S.D. dependent var	0.603124
S.E. of regression	0.458151	Akaike info criterion	1.318822
Sum squared resid	18.68130	Schwarz criterion	1.427751
Log likelihood	-57.32523	Hannan-Quinn criter.	1.362805
F-statistic	21.47840	Durbin-Watson stat	1.114270
Prob(F-statistic)	0.000000		

Heteroskedasticity Result

Heteroskedasticity Test: Harvey

F-statistic	1.116827	Prob. F(3,89)	0.5216
Obs*R-squared	3.374045	Prob. Chi-Square(3)	0.3375
Scaled explained SS	5.221846	Prob. Chi-Square(3)	0.1563