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How currency fluctuations affect SME access to credit and investment decisions: The case study of Uganda, Kenya and Ghana

Executive Summary

Exchange rate fluctuations affect the major decisions made by Small, Medium Enterprises (SMEs) in developing countries. This policy brief examines how a depreciation or an appreciation of a country's local currency against foreign currencies affects SMEs' access to credit and investment decisions. The findings show that currency movements exacerbate existing financing challenges faced by SMEs. The results further indicate that SME decisions such as what to invest in and whether to engage in international trade or not are greatly affected by exchange rate volatilities. It is recommended that governments increase support to cheaper sources of credit that are easily accessed by SMEs, such as local saving groups. We also recommend sourcing inputs locally through import replacement and export promotion strategies that ensure stability in the demand and supply of foreign currency and reduce the foreign currency needs of SMEs that rely on imported inputs.

Introduction

Access to finance is among the major challenges SMEs face in developing countries. The International Finance Corporation (IFC) estimates that 65 million firms — 40 percent of SMEs in developing countries have an unmet financing need of about USD 5.2 trillion every year (IFC, 2017).¹ It is worth noting that exchange rate volatilities exacerbate this challenge and alter SMEs' investment decisions. For the past 30 years, the domestic currencies of developing countries have been fluctuating against foreign currencies, especially the US dollar. These currency movements are partly responsible for the existing SME financing gap and uncertainty in decision making. Interventions addressing major constraints SMEs face in developing countries have largely overlooked the role of currency fluctuations.

Concerning investment decisions, local currency depreciation would result in high input costs for SMEs that heavily depend on imported raw materials (Tambunan, 2019).² Additionally, as import prices increase due to depreciation, local demand for SMEs' products reduces.

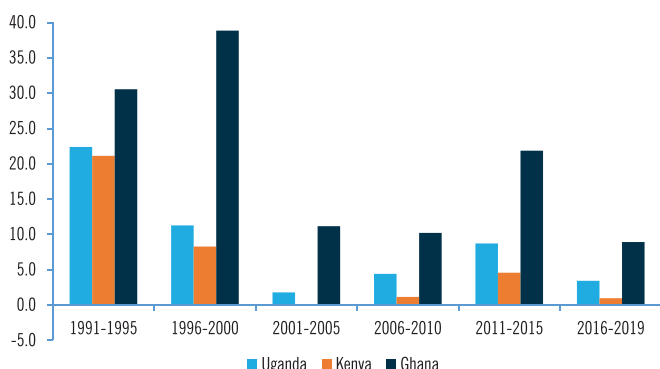
Regarding access to credit, local currency depreciation could result in credit rationing against SMEs as financial institutions shift their

asset (including loans) portfolio into more-paying foreign currencies (say, dollars). Furthermore, exchange rate depreciation makes existing foreign currency loans more expensive. This brief is based on the EPRC report on the effect of currency fluctuations on SMEs in Uganda, Kenya, and Ghana, and was developed in collaboration with the Netherlands ministry of foreign affairs. The report utilised secondary data, desk reviews of existing documents and qualitative data from Key Informant Interviews (KIIs) with stakeholders at different levels.

Findings

Movements in the values of the currencies for the selected countries are characterised by episodes of high depreciation in the 1990s and low depreciation in the early and late 2000s. Figure 1 reveals that out of the three countries, Ghana has experienced the highest depreciation rate, albeit having a higher-valued currency compared to Uganda and Kenya, suggesting convergence in the currency values of developing countries. However, this is happening at a sluggish pace. Such depreciation has implications on lending to SMEs. More specifically, depreciation of the local currencies makes it costly for financial institutions that rely on foreign capital

Figure 1 Changes in the values of currencies for selected countries (1991 to 2019)



Source: Author's own construction using data from WDI (2020)³

to meet their obligations to their lenders, making them increase lending rates as markup. Additionally, for SMEs with existing foreign currency-denominated loans, a local currency depreciation makes such loans more expensive, further making credit less affordable for such enterprises.

Access to credit by SMEs in developing countries remains limited.

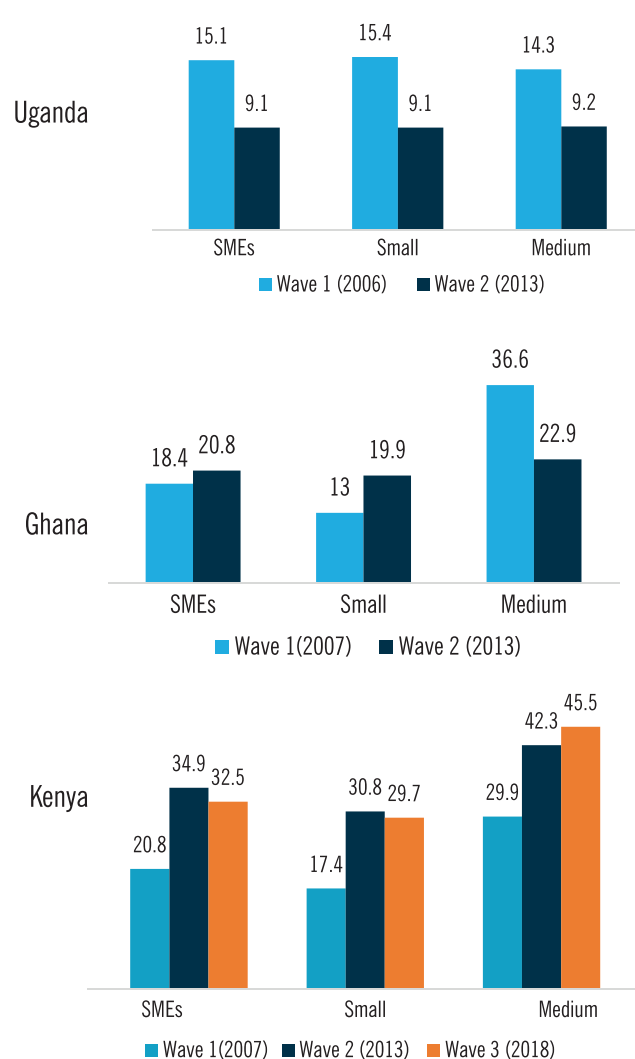
It's estimated that MSMEs in Uganda hardly survive their first year of start-up due to lack of access to credit (Lakuma et al, 2019).⁴ From the case studies of Uganda, Kenya and Ghana, it's notable that very few SMEs have lines of credit with formal financial institutions. More specifically, SMEs in Uganda are more constrained to access credit from formal financial institutions. Figure 2 shows that only 9 percent of SMEs had a line of credit with formal financial institutions by 2013, although the percentage was slightly higher in 2006 (15 percent).

In Ghana, a slightly higher percentage of medium firms had credit lines than small firms across the waves. However, only two in every ten SMEs had lines of credit as of 2013. Kenya presents the highest percentage of firms (both small and medium) with lines of credit, estimated at 33 percent as of 2018.

Exchange rate volatility is among the factors responsible for SMEs' low access to credit in developing countries.

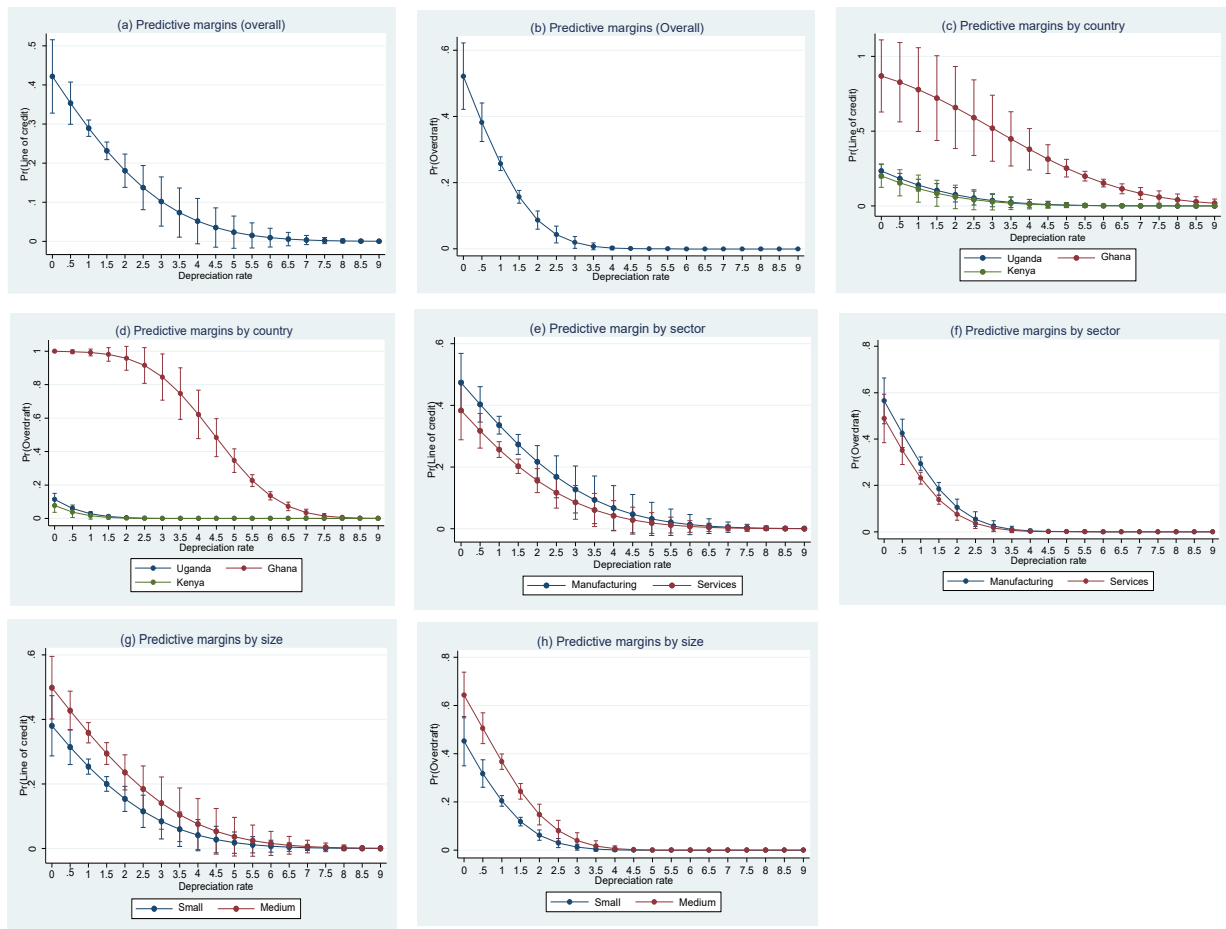
The results corroborate both the theoretical postulations and survey findings that currency depreciation negatively affects the likelihood of SMEs having lines of credit and overdraft facilities with formal financial institutions (Figure 3). As shown in panels (a) and (b) of Figure 3, the probability of SMEs accessing loans and having overdraft facilities drastically reduces to zero with an annual depreciation rate of more than 7% and 4.5%, respectively. Notably, SMEs in Ghana are more resilient to currency fluctuation than those in Uganda and Kenya. Whereas an annual depreciation rate of 5% is enough to wane out the likelihood of SMEs having a line of credit in Uganda

Figure 2 Percentage of SMEs with lines of credit in selected countries



Source: Author's own construction using WBES (2020)⁵

and Kenya, it takes 9% for the same impact in Ghana. Similarly, it takes a depreciation rate of approximately 8% for SMEs in Ghana to lose the chance of accessing overdraft facilities compared to only 2% for Kenya and Uganda. More so, an annual depreciation rate of less than 1% has no impact on access to overdraft facilities by SMEs in Ghana ((Figure 3; panel (c) and (d)). This possibly suggests regional differences regarding the impact of currency fluctuations on SMEs. Regarding sectors, whereas firms in the manufacturing sector have a high likelihood of having lines of credit and overdraft facilities, their probability of accessing a line of credit and overdraft facility falls faster with depreciation compared to service sector firms, such that in both sectors, the likelihood of having a line of credit and overdraft facility approaches zero with an annual depreciation rate of 7% and 4% respectively (Figure 3; panel (e) and (f)).

Figure 3 Impact of currency depreciation on access to credit and investment (predictive probabilities)

Source: Author's own construction (2020) using data from WBES and WDI

The impact of currency depreciation on access to credit is also size-specific, with the probability of small firms accessing lines of credit and overdraft facility approaching zero faster than medium firms. More so, medium firms are more likely to have lines of credit and overdraft facilities compared to small firms (Figure 3; panel (g) and (h)).

Exchange rate volatilities affect the investment decisions of SMEs in developing countries.

Findings reveal that an increase in currency depreciation is associated with a drastic fall in the probability of investing in fixed assets by SMEs in developing countries. Figure 4, panel (a) suggests that there is no chance of SMEs investing in fixed assets with an annual depreciation rate of more 6.5 percent. Whereas a lower rate of depreciation (less than 1 percent) annually has no impact on investment decisions of SMEs in Ghana, the likelihood of investing in fixed assets falls drastically with an annual currency depreciation rate greater than 1.5%. Similar to access to credit, currency fluctuation has a higher impact on investment decisions of SMEs in Kenya and Uganda. SMEs are likely to halt investment in fixed assets for an annual depreciation rate greater than 4% (Figure

4; Panel b).

In terms of sectors, investment by the manufacturing sector is slightly more affected by currency fluctuation than the services sector. In both sectors, annual depreciation of more than 6.5% completely wanes the chance of investing in fixed assets (Figure 4; Panel c). The findings are not surprising since the manufacturing sector mainly uses imported inputs.

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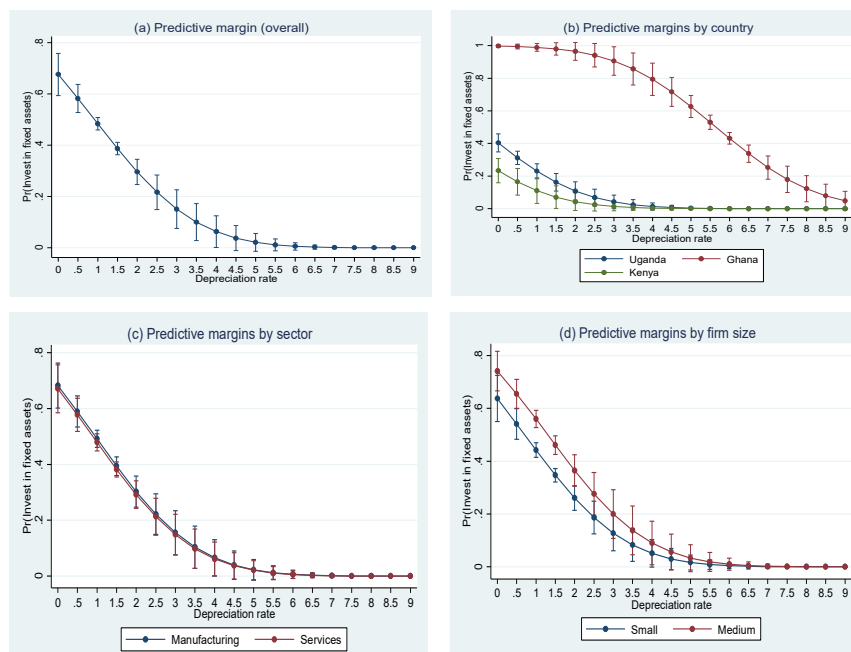
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Figure 4 Impact of currency depreciation on firm’s investment decision (predictive probabilities)



Source: Author’s own construction (2020) using data from WBES and WDI

Conclusion and policy recommendations

Currency fluctuations, primarily the exchange rate depreciation, heighten SMEs’ challenges in developing countries. The findings in this brief indicate that SME access to credit and their investment decisions are greatly affected by movements in exchange rates. The relationship between currency fluctuation, SMEs credit access, and their investment decisions is stronger amongst SMEs in the manufacturing sector that mainly use imported inputs. Smaller firms are more prone to risk.

Therefore, governments of developing countries should support alternative sources of cheap and accessible local currency loans for SMEs such as saving groups. This is pertinent to ensure a reliable flow of cheap credit to these enterprises regardless of the hiccups caused by exchange rate volatilities. This will fill some of the existing SME financing gaps, given that formal financial institutions like commercial banks consider such enterprises to be risky.

Localising the supply chains through import replacement and export promotion strategies will reduce the foreign currency needs of SMEs that rely on imported inputs and ensure the stability of the exchange rates by providing a stable supply of foreign currencies.

Endnotes

- 1 IFC (2017) <https://www.worldbank.org/en/topic/sme/finance>
- 2 Tambunan, T.T., 2019. The impact of the economic crisis on micro, small, and medium enterprises and their crisis mitigation measures in Southeast Asia with reference to Indonesia. *Asia & The Pacific Policy Studies*, 6(1), pp.19-39.

- 3 WDI (2020) <https://databank.worldbank.org/source/world-development-indicators>

- 4 Lakuma, C.P., Marty, R. & Muhumuza, F. Financial inclusion and micro, small, and medium enterprises (MSMEs) growth in Uganda. *J Innov Entrep* 8, 15 (2019).

- 5 WBES (2020) <https://www.enterprisesurveys.org/en/enterprisesurveys>

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