Effect of Interest Rates on the Survivability of Small Industry

(Case Study of Matta Mughal Khel Loom Weavers)

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Abstract

The paper is aimed to discover the underlying causes of the default of the Hand Loom Weavers at Matta Mughal Khel Cluster in District Charsadda that resulted in to the default in recovery for the SME Bank (Now Khushali Bank). The paper revolved around tracing those situational factors that contributed in bringing these Hand Loom Weavers in to default. The paper sums up with the recommendations that can bring SME sector in Pakistan at par with the international standards.

Key words: SME banks, SME enterprises, Recovery, Default, Handloom weavers, Matta Mughal Khel

Introduction

Matta Mughal Khel(MMK) is a village located closely with the boundary of Mohmand Agency (FATA), and comes under the jurisdiction of Tehsil Shabqadar, District Charsadda of North West Frontier Province (NWFP). MMK is famous for its textile production which operates in the form of cottage industry and produces a number of product lines. Matta being a cluster famous for textile production has attracted a number of micro financing institutions and lenders in various decades. The textile producers, in general are called as the weavers and they live in the form of a community called weavers community. Various financing institutions have offered financing facilities to the Weavers Community which have not only enhanced the productivity of the Matta textile cluster but also improved the socio-economic status of the residents of Matta Mughal Khel (MMK).

Weaving profession has its own history at MMK and it is considered as a noble profession among the weavers and the residents of MMK. Recently a number of financial institutions have claimed

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the cases of default of weavers at Matta Mughal Khel cluster. Weavers due to attraction in more capital availed the financing facility of various financial institutions and thus some of them succeeded in repayment of loans but later on due to unavoidable circumstances the rest of them were unable to repay the financing amount to the banks with the inclusive interest amounts. As the smooth operation of weaving requires the involvement of the females as well therefore, according to the sources, females were provided with the financing facilities. Initial amount of financing was kept nominal; later on with the successful repayment of loans the financing limit of amount was increased. But the facility was made available to the females of the weavers' community only. Later on the financing facilities were extended to the weavers as a whole and thus a number of outcomes appeared. This resulted in the conversion of the Hand Looms into Power Looms and the default cases of various business units or looms.

Research Methodology: Using cluster sampling technique cluster of Matta Mughal Khel was taken as a focused population of this research. The sample included eighteen units out of total defaulted loom weavers who were unable to pay their debts along with the respective mark up rates.

The hypothesis around which the research revolved around to prove or disprove was:

H1 = High Interest Rates leads to default

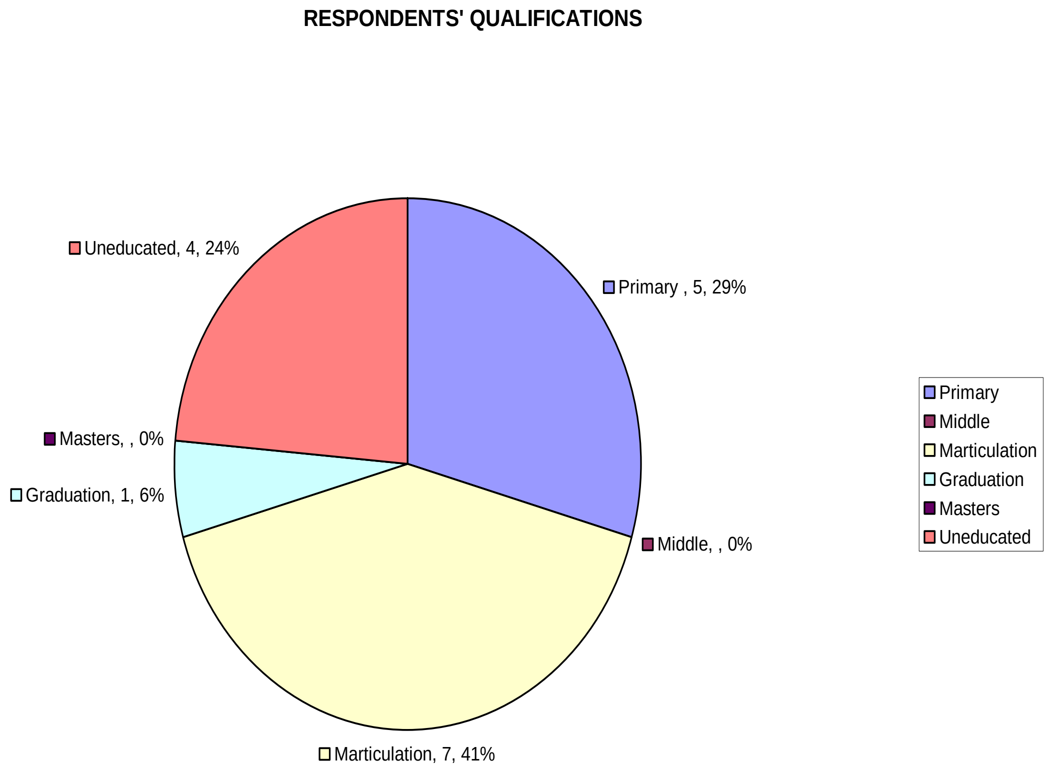
H 0 = High Interest Rates do not lead to default

Questionnaire and interview methods were employed as research instrument for collection of data. Data collected through questionnaire was subsequently counter checked with the responses obtained through interview method. The interviews were mainly group based in nature at typical gathering places called 'Hujras". The data collected was analyzed using Statistical Package for Social Scientists (SPSS) and the results are presented diagrammatically using Bar Charts and Histograms etc.

DATA ANALYSIS

Respondents' Qualifications: The majority of the weavers were found uneducated or matriculated or of primary level education with following break up:

- 41% of the sample is matriculated
- 24% is uneducated and
- 29% is of primary level.

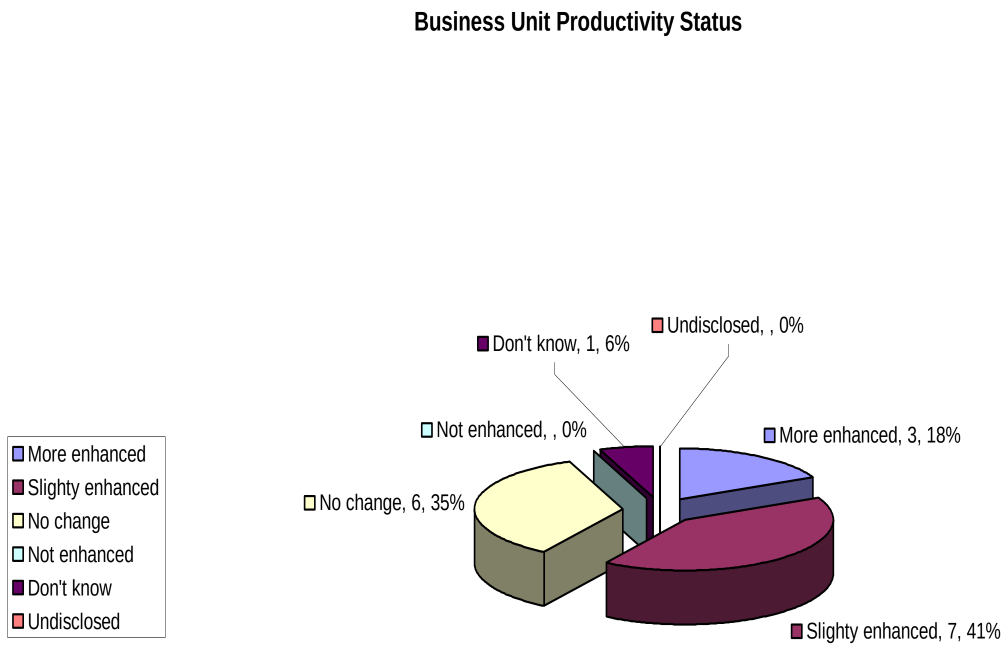


Source: Field Survey

This implied that they lacked the basic technical education -a pre-requisite for an entrepreneur. Furthermore, an analysis underlines the important fact that a major portion of the cluster engaged in SME, were improperly trained. Resultantly, they lacked the capacity to undertake the business activities up to the desire level.

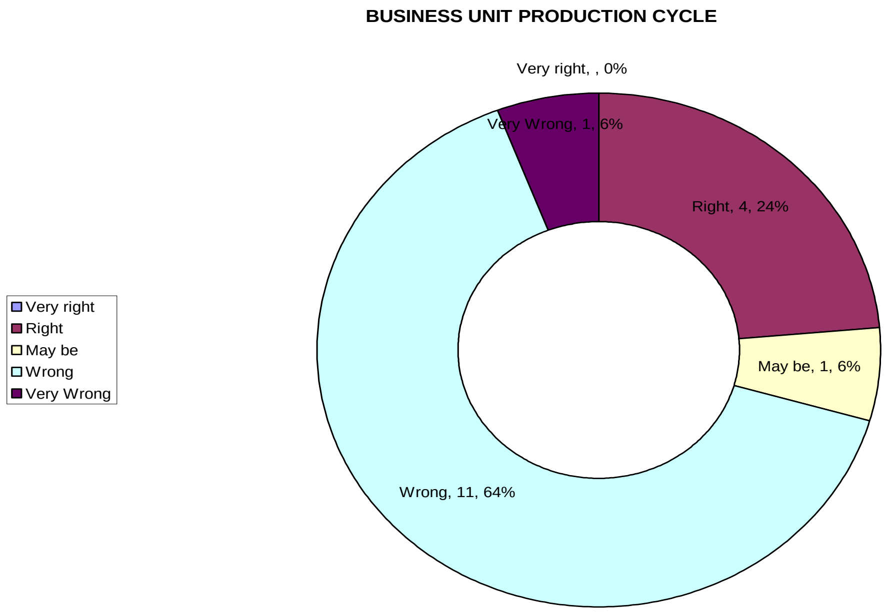
Mark-Up Rate: 100% of the sample is of the views that mark-up rate charged 13-18% was too high to pay. However, they declined to declare exact figure of the mark up, which is averaged by the research for the purpose of this research as 16%.

Business Unit Productivity Status: The analysis regarding the productivity of the respondents' business unit upon availing financial facility showed that 41% of the sample's productivity slightly enhanced. However 35% seemed no change in their business productivity. A small proportion, comprising 18% of the data, attributed their business productivity to the financial facility availed. That clearly shows that majority of the respondents were not much satisfied of the financial facility availed. Furthermore, they were unable to gauge the affect of loan taken, owing to the lack of proper record of their income and profit. Also, they did not carry out the cost-benefit analysis, a pre-requisite for a project.



Source: Field Survey

Mark Up Effect on Business Units Default: Over 76% of the respondents regard high mark up rate charged by the bank as the main cause of their business to default. The research found that the weavers were not taken on board while fixing interest rates before extending the loan to them and their pay back capacity was not taken in to consideration as well. Hence, instead of a financial asset, the facility, proved to be a burden on their businesses.



Business Unit Production Cycle: The analysis shows that the business production cycle was not followed. 64% of the respondents stated that financing bank did not follow the business production cycle whereas, 24% contradicted the majority. Owning the majority's view the research considers that bank did not take the weavers – the stake holders of the project, on board at the time of lending. Resultantly the re-payments timings were not linked to the production cycle hence the weavers failed to pay back the loan on time thereby ending up at default of their businesses.

Lack of Entrepreneurs Capacity & Ability: The financing institution had brought in no positive change in the production process of the entrepreneurs. Rather, high mark up on the face of low demand and low profit margin left no room for the entrepreneurs to spend any amount for modernization of their production facilities. However, other than interest rate, the unwillingness of the entrepreneurs to pay back the loans along with interests is also another negative factor that contributed in default. Other factors include: less working capital to run the business, inconsistency in financing, lack of management capabilities, mismanagement of the fund, demand and supply forces, lack of proper documentation and accounting of the business activities, uncertainty in the market, inability of the association in handling the problems of the weavers and long hour outages were the other factors responsible for the unwillingness of the weavers to pay back the loans.

Value Chain Process: The value chain analyses revealed number of depressing facts in availability of raw material, costs of raw materials, warehousing facilities, supplier's side and the seasonal variations in the prices of raw materials. The most of the raw materials was purchased from the far flung areas of Lahore, Peshawar, Rawalpindi, Islamabad and Karachi that resulted in high transportation charges thereby substantially adding up in to the cost of production. High cost of production compelled the entrepreneurs to keep the survival pricing and low profit margin otherwise the sale could have been gone down to its lowest ebb. On the bargaining power also switched towards the supplier side because of limited number of the suppliers. Furthermore seasonal fluctuations affected consistency in prices of the raw material especially in the summer season.

Production Operation: The analysis regarding the number of production units, quality control measures, cost of quality control, seasonal variation effects on production processes, the calculation of cost per unit, ratio of production per annum and other production operation activities shows the following results.

- Each of the weavers owned 1 to 20 handlooms. On average it came three business production units per weaver. It implied every weaver having more than one production units.
- The quality standards maintained were to avoid differentiation in threads, mismatching in colors and timely management. It shows that quality standards were simple and at times, poor. Since there were no hard and fast rules for quality standards which, in return, affect the quality of the products. The quality control measures did not cost the business. However, in term of extra payment to labors, it affected to some extent. It analyzes that being simple or poor in nature, quality control measures did not cost the businesses.
- The seasonal variations had affects on the production process. In winter season the prices of the raw material went upward, resultantly; increase the prices of the products. However, in summer seasons the raw materials' prices lowered down. Hence, the prices of the final products decreased.
- There was no systematic mechanism or accounting formula for the calculation of profit. However, each weaver adopted his own method for profit determination, which was quit simple and unsystematic. It shows that owing to the lack of technical education a proper formula was failed to be adopted.
- The ratio of production per annum was different from weavers to weavers, depending on the capacity of production and availability of resources. It ranged from 1400 pieces/ annum to 24000pieces per annum. This shows that the capacity of the production units could be increased.

- The production cycle followed either demand based or supply based production. However, in some cases production cycle followed both demand and supply based productions.
- The orders were received in bulk in summer seasons in the month of May and June. However, those were received in winter seasons too. The duration of production cycle ranged from five to twelve months. On average it was of eight months.

PACKING SECTION:

Regarding the packing materials, packing costs, packing shapes, colors etc the analysis revealed the following information.

- Specific packing used for packing goods. Plastic was mainly used for packaging. It was simple in nature and cheap in price. However, some were not even used it. It analyzes that they were not aware of the importance of the packaging.
- The packing material cost the entrepreneurs; however, being substandard in quality so did not affect the price of the product. The packaging cost varied from packaging to packaging. It ranged from 10 paisa's per unit to 70 paisa's per unit.
- The raw materials used in packing were purchased either from the Punjab province or from local market. It implies that it was easily available in the market.
- The analysis further shows that there were no systematic mechanisms for their packing of the products. These were done manually. However, there were some weavers having the facilities of packing machines.

SUPPLIER SECTION:

Regarding the supply of goods, distribution channel for goods, place of distribution etc the analysis shows the following results.

- The finished goods i.e. shawls were supplied to the markets such as Peshawar, Mardan, Rawalpindi, Swat, Quetta, China and Dubai. It implies that it had sold out across the country and exported. Furthermore, there was a broad market for the goods manufactured.
- The value chain or distribution channel used for the goods was either personal selling or retailing and whole-selling. However, personal selling was widely used with an aim of large profit margin. Since middlemen reduced the profit margin of the manufacturers.
- The goods manufactured were also supplied to the open market and the total duration of supplying goods from the place of production to the market was 3 to 7 days. On average it took 5 days to transfer goods from warehouses to the market.
- The supply duration could not be reduced to 1 or 2 days owing to the number of reasons.

i. Due to the unavailability of personal transport.
ii. Lack of use of modern means of communication and business transaction such as e-mail, banking transaction and online dealing etc.
iii. Moreover, lack of viable communication system and resources mobilization is another reason for delay.
iv. Lack of logistical facilities in the area from the part of government.

FINDINGS

1. The above analysis indicates that 41% of the respondents were matriculated, which implies that a vast section of the respondents were not highly educated. They lacked the technical skills and knowledge, a prerequisite for an entrepreneurship. That factor indirectly affected the business operations and hence the ultimate motive of profit maximization. The low level of education did not serve the purpose for enhancing the business productivity and profit maximization. Resultantly, the weavers could not pay back the required mark-up, fixed by the bank. Owing to such reasons their business defaulted.

Low literacy ratio of the respondents, besides low income, affected the social attitude of the respondents too. They were reluctant to use modern machineries and tools, which resultantly, worsen their businesses. Hence, low productivity led to low profit, which simply indicated that the respondents were unable to pay back the interests and faced businesses default.

2. The analysis showed that 82% of the respondents were married while 18% were single. That ratio implied that majority of the respondents were married. That statistics indicated the following information:

- Every respondent was the sole bread earner of his family; hence, he was responsible for his family expenses such as food, shelter and cloth etc, so it added an extra burden on his income.
- The married respondents had the responsibilities of the dependents and according to the data gathered it was 6-8 percent number of dependents per person. These dependents included children, wife, parents and relatives etc; hence, there were not other means of income other than weaving so the weavers had to spare a hefty percentage of profit to pay the expenses. That, resultantly, squeezed their profit margin. Consequently, they were failed to pay back the interests and faced businesses default.

3. Almost the entire respondents-100% was of the view that bank charged 13-18% mark-up rate, which by taking average was calculated as 16%. The official documents also revealed that mark-up rate was 16%. That implied that mark-up rate was too high which was unable to pay back in the business production cycle. The profit earned by the weavers was not that much to adjust the interest payment. Hence, the abnormal interest rate led to the businesses of the entrepreneurs to default.

4. The Analysis showed that 41% of the respondents opined that their business productivity slightly enhanced by availing the financial facility. However, 35% were of the view that no change took place by availing such facility. Only 18% were satisfied from the facility. The statistics Implied that respondents were not satisfied from the modality of the financing facility, it showed that the respondents were not taken onboard or into the confidence prior to extending the facility. The dissatisfaction of weavers from the financing facility hampered the profit maximization; hence, they were unable to pay back the mark-up which automatically led to their businesses default.

5. The analysis regarding the business units' default implied that 76% of the respondents attributed the high interest rate to their business default. The mark-up rate was too high to be paid with reducing their profit margins. The weavers, after paying the interest rate, were left with meager profit. In order to pay back the interest rate in specific period of time they had to sacrifice a substantial portion of their profit and, some times, their working capital. By doing so, they were unable to maintain their business activities; hence, their businesses faced default.

The statistics, hence forth, clearly indicates that weavers were not comfortable with the abnormally high interest rate. Since it was unfeasible to pay back, so instead of boost their businesses up it proved to be an obstacle for their businesses development.

6. The analysis indicated that financing facility was supportive in nature for the business units, however, the interest rate being high enough, nullified the positive effect of the facility availed. 76.42% opined that interest rate greatly affected the positive effect of the facility. Actually, the financing facility might proves to be an asset and additional sources of working capital if interest rate charged on the facility was feasible, however, its higher ratio unlikely proved to be a liability. Resultantly, despite that additional source of financing the weavers were unable to maximize their profits and their businesses defaulted.

7. 64% the respondents were of the view that the financial institute did not follow the business production cycle. However, 24% replied it was following that. It implied that business unit production cycle was an important element while extending a financial facility. The paying back of interest to the bank depends upon the business production cycle. The bank did not follow the business production cycle and the weavers had to pay back the interest before the completion of business cycle, from their working capital. Resultantly the profit margin decreased and the businesses sorely affected. Hence, the businesses led to default.

8. The findings of the analysis regarding the financing shows that financing by the bank was favorable for the businesses concerned; however, owing to the abnormal high interest rate it did not serve the purpose and instead of providing solace to the businesses it led to their default. 70% of the weavers attributed the higher interest rate for their business default. Moreover, the findings indicated that besides higher interest rate, other reasons such as, inconsistency in financing, low demand and low supply, lack of following the business production cycle by the bank, demand and supply factors, etc are the reasons for entrepreneurs' unwillingness to pay back the loan an hence businesses default.

It is pertinent to mention here that financing was not done according to the convenience of entrepreneurs. The interest rate charged by the bank; the business production cycle are some important factors which led to their businesses default.

9. The findings regarding the raw material showed that the raw materials were available in places located far away from the place of production. It increased the cost of production which ultimately affected the prices of products, hence, reduced the profit margin. Moreover, the seasonal variations also affected the prices of raw materials and its availability, which indirectly affected the cost of the final product. Furthermore, the warehouses were albeit, fulfilled the requirements, however, not built and maintained according to the standards set for the entrepreneurs. All these factors led to the profit reduction, resultantly, default of the businesses occurred.

10. The findings regarding the production process revealed the following information:

- Each of the weavers owned 1 to 20 hand looms and on average it came three business units per person. It implied that each weaver had to operate three production units, which were quite difficult to maintain and operate with efficiency and effectiveness, hence, required output was unachievable. Resultantly, they had to produce below their production capacity which affected the sale and required profit. Consequently, they were unable to pay back the interest in stipulated time frame. Hence, businesses led to default.

- Quality Control Management plays a vital role in the thriving of a business. However, in that case the weavers were not acquainted with such term and were lacking the TQM (Total Quality Management) Techniques. They maintained poor quality of their products which directly affected their products' quality. Resultantly, their products could not capture the required market share, Owing to the reason their sale could not boost up, which greatly affected the profit and caused the default of their businesses.
- The weavers were, owing to the lack of technical education, not using the general accepted accounting principles (GAAP). That greatly affected their productions' efficiency which indirectly led to their businesses default.
- The ratio of production per annum was varied from weavers to weavers. It ranged form 1400 pieces per annum to 2400 pieces per annum. That implied that owing to lack of resources, proper training and planning the production capacity could not improve. Since production below the capacity affected their production sale and profit. Resultantly their businesses led to default.
- The seasonal variation in their products' demands and supplies was an important issue which could not be tackled aptly owing to the lack of planning. That also indirectly led to businesses default.

11. Findings with regards to the performance of the packaging section are:

- Packaging has a direct link with the sale of a product and plays a vital role in its sale and capturing of market share. However, in that case such an essential factor was ignored. The entrepreneurs, almost, overlooked the packaging of their products and used only polyethylene bags as packaging. Resultantly, they could not boost up their sale.
- The packaging used were substandard and of poor quality hence, unable to attract the customers which it could be. Consequently, the products did not capture the required market share. That affected their business sale and profit; hence, they were unable to pay the interest and led to business default.
- Lack of mechanization in the field of packaging greatly affected the efficiency of the entrepreneurs. The packaging was done manually; hence, the factor of human error was there. That practice consumed a lot of valuable time, energy and money, which ate up excess of financial resources including profit and, some times, working capital. Resultantly, unable to pay back the interest and faced business default.

12. The findings Related to the Supply Section:

- Goods manufactured by the hand loom weavers were exported and sold out across the country, however, these were not sold out on a large scale, similarly were not exported to a large number of countries. The reason were obvious; no such arrangements were done to achieve economy of scale so that to compete the local and international markets. That impeded the profit maximization, resultantly, caused their failure to pay the interest rate.
- The value chain distribution used for the goods was mainly personal selling. It implied that in order to save the wastage of the profit margin by the hands of middlemen, weavers were personally sold their products. However, owing to the lack of marketing expertise they were unable to sell out the products to new markets and customers.
- It took almost five days to supply goods or products from warehouses to the markets owing to the following reasons.
- Due to the unavailability of personal transport.
- Lack of use of modern means of communication and business transaction such as e-mail, banking transaction and online dealing etc.
- Moreover, lack of viable communication system and resources mobilization is another reason for delay.
- It implied that lack of infrastructure such as means of communications, lack of mobilization hampered the weavers to supply their products and goods to the market in the stipulated time frame. Resultantly, they were unable to complete their production cycle on time. Hence, could not generate the required income to pay back the interest to the bank and faced business default.

RECOMMENDATIONS

Following are the proposed recommendations which, if implemented, can solve the problems faced by the entrepreneurs of the Matta Mughal Khail particularly and Pakistan, generally.

These recommendations are too divided into two sub-categories-recommendations on the part of government and the bank.

Recommendations for Government:

1. Government should support the SME sector by investing in infrastructure, technical education, extending subsidized loans, etc.

2. Export Promotion Bureau (EPB) under the Government umbrella, ought to arrange special seminars and orientation sessions for the entrepreneurs regarding the exports of indigenous products. Moreover, facilitation should be provided for exports.

3. Government should have to provide wear-housing facilities to the entrepreneurs according to the international standards. Furthermore, communication and transportation facilities ought to be provided so that final products may easily be transported and mobilized to the markets.

4. SME sector must be exempted from tax network, at least for three to five years, if not completely. Besides, tax rebate should also be given to encourage the entrepreneurs.

5. Being the back bone of the economy, Government should pay special attention to SMEs; hence, legislation should be done in this regard.

6. The SME' Models, being practiced in the South Korea, Singapore, China and Japan should be implemented. Moreover, the existing model practiced in Pakistan ought to be revised, modified and brought at par to the above mentioned countries.

7. A special budget should be allocated to the SMEs on provincial level in Annual Development Program (ADP) and on Federal level in Public Sector Development Program (PSDP).

8. The tax ratio on locally produced raw materials should be reduced to minimum since it would help in decreasing cost of production and increasing profit margin.

9. Rebate should be given on the exports of locally manufactured SMEs product in order to provide an extra boost to the exports and indirectly to the national economy.

Recommendations for Banks/ Financial Institutions:

3. Banks/ Financial institutions should properly train, guide and educate the entrepreneurs prior to extending finances or loans.
4. Booths should be installed by the banks at the place of production in order to guide and facilitate the entrepreneurs in the services such as book keeping, accounts maintenance, etc. Moreover, banks besides financing should have to monitor and care after the business activities coupled with guidance in the business activities.
5. Entrepreneurs should be indulged in he financial matters and the mode of financing should be made with accordance to their convenience.
6. Financial institutions should extend soft and affordable loans to the SMEs also; interest holidays should be given to entrepreneurs.
7. Banks/ Financial institutions should charge the interest rate according to the business financial and operational position.

8. Banks/ Financial institutions should also consider the social status of the entrepreneurs before deciding about the terms of the credit.

CONCLUSION

Advanced countries of the world are being burning up the track of economic development by virtue of robust development in their SME sector. SME sector, in fact, plays a vital role in the development of a country's economy, by providing employment to a large section of the society. However, unlikely, the south Asian countries have not so far given the due importance to its development. Same is the case with Pakistan, where the SME sector plays the role of back bone in its economy by providing 65-70% employment to its skilled and unskilled youth and billions of rupees as revenue. However, owing to the lack of Government interest it is deprived of modernization and progress. Similarly, lack of technically educated human resource and non-utilization of human and financial resources have added to the agonies of this sector. Resultantly, SME sector is taking a nose dive by each passing day, instead of thriving and flourishing.

The urge for playing the due role of the government is indispensable. Government should devise a long term, sustainable industrial policy by underscoring the importance of SME sector. A sustainable policy should be chalked out for the betterment of the SME sector. The main problem, the SME sector is facing, is the lack of financial resources coupled with technically skillful human resources. The ramifications of these two problems further multiply the effect. The above mentioned problems of grave concern can be cured by a proper, planned and systematic investment by the government in the sector. A bail out package should be announced to build up infrastructure, to provide electricity and gas uninterrupted and on subsidized rates. Besides government, financial institutions, lending finances to the SME sector, should also review their existing policies regarding the SME sector. They should take the entrepreneurs into confidence by joint cooperation prior to extend the loan. Technical facilities such as accounting and book keeping should also be provided to the entrepreneurs. SME sector requires relatively less investment as compared to the large entrepreneurship and in return gives greater benefits to the economy. To conclude banks and financial institutions should keep their mark-up rate as low as possible and should be friendly to creditors so that it can be easily paid back. Furthermore, the government should chalk out a viable strategy for the infrastructure and development of the SME sector.

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