RESEARCH BRIEF
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Monetary policy and firm size in South Africa

Monetary policy affects the real economy through various channels, including the interest rate, exchange rate, credit, and asset price channels. The credit channel has recently received considerable attention.

Monetary policy changes that lead to increased interest expenses on outstanding debts bearing a floating interest rate affect firms' cash flow, liquidity position, and net worth. As a result, firms with a weaker balance sheet or net worth will face unfavourable cost of credit. Tighter monetary policy will result in firms that face a higher cost of credit or external financing premium to cut their investment spending and hiring, which in the absence of offsetting counter-effects will result in a negative aggregate impact on economic growth.

What then are the distributional impacts of monetary policy on firm balance sheets? And given that firms are heterogeneous, is it the case that monetary policy effects are not uniform across them?

How does firm size matter?

Small firms generally face greater credit access constraints compared with larger firms. They are also reliant on banks for financing, whereas larger firms can alternatively issue equity or debt to raise capital. It is therefore expected that the impact of monetary policy will be greater on small firms.

Small firms are more sensitive to changes in interest rates. Those small firms which are financially constrained, and have relatively lower net worth and idiosyncratic risks, face a higher cost of capital from external finance sources. A one percentage point increase in interest rates will see the debt service burden of small firms rise by on average 35.7%.

FINDINGS

Small firms are more sensitive to changes in interest rates. Small firms which are financially constrained, and have relatively weaker balance sheets and idiosyncratic risks, also face a higher cost of capital from external sources

On average, a one percentage point increase in interest rates will see the debt service burden of small firms rise by 35.7% measured by the interest coverage ratio

Monetary policy that weakens the balance sheet position of small firms — which also face a higher premium on external financing and are financially constrained — may force the firms to cut investment spending and hiring to avoid default

For medium and large firms there is no statistically significant relationship between monetary policy and the interest coverage ratio

Photo: Dominic Chavez/World Bank

Photo: Spencer Davis

For medium and large firms there is no statistically significant relationship between monetary policy and the interest coverage ratio. Medium and large firms with larger balance sheets have relatively larger collateral to provide against borrowing and as a result face relatively lower external financing premium.

Why are small firms more vulnerable?

There are a number of reasons why small firms are more vulnerable to monetary policy changes. For one, profitable firms, and those with higher credit worthiness or a higher market value of assets, are considered less risky and face a relatively lower cost of capital from external financing sources. However, smaller firms tend not to benefit from this.

Further, firms that use more debt finance will be burdened by higher interest expenses if interest rates rise and therefore be more sensitive to monetary policy changes. This is especially true for smaller firms.

In addition, small firms are largely dependent on intermediated or bank financing to overcome informational frictions. Large firms have access to other sources of funding and, therefore, are not reliant on intermediated funding because the market generally has information about this category of firms. Moreover, large firms have a relatively higher net worth and as a result greater collateral value as security when borrowing, which reduces their premium or cost on external funding.

Policy implications

Monetary policy that weakens the balance sheet position of small, financially constrained firms with limited access to external finance may force them to cut investment spending and hiring to avoid default. In aggregate, this will have implications for domestic investment, employment, and growth in the economy. Therefore, domestic monetary authorities should consider the impact of their policy decisions on small firms in South Africa when making decisions on interest rate changes.

Monetary policy can be supportive of small firms through a flexible inflation targeting framework. Importantly, the expansion of the role and capacity of state institutions which provide funding is also critical for increasing access to affordable funding for small firms.

This brief is based on WIDER Working Paper 2019/32 '**The size distribution of monetary policy effects among South African manufacturing firms: Firm-level evidence from administrative tax data**', by Keagile Lesame.

IMPLICATIONS

Domestic monetary authorities should consider the impact of their policy decisions on small firms in South Africa when making decisions on interest rate changes

In order to be supportive to small firms the monetary policy needs to be flexible

The expansion of the role and capacity of state institutions which provide funding to small firms is also critical