FINANCING MICRO AND SMALL SCALE ENTERPRISES: AN EMPERICAL SURVEY IN URBAN ETHIOPIA*

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Abstract

Using simple descriptive analysis of the data from the Ethiopian Urban Household Socio-economic Survey, the paper found out that micro and small enterprises are financed from own savings. However, these forms of savings have been found to finance businesses that require small amount of capital and mostly service-oriented activities. Investments in larger businesses call for external resources. But the only external finance available to micro and small enterprises is borrowing from friends and relatives, which have again a number of drawbacks. Existence of asymmetric information and lack of bankable collateral might explain lack of access to formal credit to this sector. Given the significance of bank credit to the sector, the paper suggests two possibilities for micro and small enterprises' access to formal credit, namely, group lending scheme through the provision of package program and effective risk sharing among creditors, borrowers, and the government.

1. INTRODUCTION

The role of small enterprises in developing countries is significant in terms of their employment generation capacity, quick production response and their adaptation to weak infrastructure and use of local resources, and as a means of developing indigenous entrepreneurial and managerial skills for sustained industrialisation (Aryeetey, 1994). However, their significant role in developing countries such as Ethiopia has been constrained by a number of factors including finance (Sonko, 1994).

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In Ethiopia, there were legal restrictions on entry and exit into the formal financial system for about seventeen years from 1974 to 1991. The nominal deposit and lending rates were also administratively fixed. Consequently, the real interest rates became negative or very low with the rise in the rate of inflation. During the same period, lending policies were set in favour of the socialised and priority sectors. Until the 1990 economic reform there had been a fixed asset ceiling on investment made by the private sector due to the 1975 economic policy; and yet this sector was required to provide collateral at the ratio of 2:1 (the ratio of security to loan) (CBE, 1977). What is more stringent is that most people with several immovable properties had lost them by the 1975 nationalisation, but the properties that were registered as collateral were only immovable ones. For instance Trucks, Cars, and Trailers were not considered as collateral. All these discouraged the private sector from participating in the credit market. On the other hand, the central government and all publicly owned organisations together with co-operatives enjoyed cheap and easily accessible credit. Unlike the private sector, disbursement of credit to the socialised sector did not need any collateral.

In view of the detrimental effects on growth and investment and the need to create a more conducive economic environment for the private sector, all those discriminatory policies and regulations have been reformed since October 1992. Given the nature and requirements of money markets in developing countries such as Ethiopia, financial liberalisation alone may not, however, solve the severe financing constraints faced by micro and small-scale enterprises. Hence, policy making in the financial sector in general and the micro and small-scale enterprises in particular needs an investigation. This paper attempts to look at the sources of start-up capital (patterns of enterprise financing in Urban Ethiopia), type of businesses with respect to source of start-up capital to examine quality of investment, and forms of savings (such as bank account, 'Iqub'[1] and credit association). The paper is based on data[2] of the Ethiopian Urban Socio-economic Survey undertaken by the Departments of Economics, Addis Ababa University (AAU) and University of Gothenburg with the institutional support of the Institute of Development Research (IDR), AAU.

2. THEORETICAL BACKGROUND

It is widely asserted that the rate of physical capital formation is one of the fundamental determinants of long-term economic growth of a nation. The role of money in this process has, however, remained controversial. Prior to the 1930's, money was generally thought to have a neutral effect on output and investment (Hyuha, 1982). Later in 1936, Keynes argued for non-neutrality of money. According to Keynes (1936), liquidity preference has historically tended to push the real interest rate above its full-employment equilibrium and hence income falls to equate savings and investment plans. With this argument, he suggested to repress liquidity preferences and hence the real interest rate by financial repression in the form of nominal interest rate ceilings or a Gesellian stamp tax on money holdings. The same

policy suggestion is further supported in Tobin's (1965) model of money and economic growth where households are assumed to allocate their wealth either in money or productive capital assets. Based on these theoretical backgrounds, many developing countries prior to 1973 adopted repressive financial policies, which included interest rate ceilings, the imposition of reserve requirements on commercial banks and compulsory credit ceilings with or without subsidised interest rates. The results of these policy measures were, however, disappointing. Many economies of developing countries were highly constrained by financial resources or savings. Moreover, these repressive measures indeed persuaded financial intermediaries to concentrate on lending to low-risk, large-scale, corporate borrowers. On the other hand, a large number of efficient small-scale activities, which employ the majority of the labour force in most developing countries, do not have access to institutional finance. To fill in this gap, most governments in these countries set up special financing schemes for small-scale industry and agriculture so as to finance these sectors on concessionary basis. These schemes have, however, led to a number of practical problems. First, the concessionary finance has naturally attracted, and for the most part has been absorbed by, influential borrowers of good standing who already have access to institutional finance on 'commercial' terms. Second, though again the picture varies, the default rates have been high in most cases. Thirdly, programs of lending at concessionary rates have often been associated with the misuse and diversion of funds thereby worsening the risks of non-repayment and have thus been resisted or implemented reluctantly (Anderson, 1985). Lastly, low returns on financial assets have also encouraged capital flights from many countries notably in Latin America.

Contrary to the above theoretical models, McKinnon (1973) and Shaw (1973) came up with models[3] of economic development in which financial liberalisation could accelerate the rate of economic growth. The main argument of the McKinnon-Shaw model is that financial liberalisation through a policy of positive real interest rates will encourage more savings and, in turn, leads to more investment and growth, on the assumption that prior savings are necessary for investment. Thus, it is argued that a relaxation of administrative controls on interest rates would provide an incentive for financial intermediaries to lend more widely, to small as well as to large-scale activities. It is also argued that financial liberalisation will result in a more efficient allocation of the funds. This, therefore, stands against the fundamental Keynesian argument that investment determines savings, not the other way round, and that high interest rates may stifle investment and economic growth. This is because of the fact that the effective constraint on the real capital formation in developing countries is the supply of real savings and not the inadequate willingness to invest on the assumption that investment opportunities in developing countries are abound (Mckinnon, 1973).

With an upward adjustment in the real interest rate from its low or negative level, the McKinnon-Shaw model primarily predicts an increase in the investible resources and hence an increase in investment which was constrained by low savings. The main argument behind this transmission mechanism is based on two assumptions. First,

capital markets in developing countries are very fragmented. As a result, most investments in these economies rely on self-finance. Second, indivisibility or lumpiness of investment is of considerable importance. This assumption again forces each potential investor to accumulate money balances prior to his investment. In this context, a higher real return on money balances is likely to raise physical capital formation because it enables potential investors to accumulate equity faster and also because this equity makes them more eligible for any limited institutional financing that may be available.[4] This argument implies that deposits serve as a conduit for capital formation by making deposits (or money) and capital complementary assets as long as the real interest rate does not exceed the real rate of return on investment.

3. CLASSIFICATION OF ENTERPRISES

The classification of enterprises (businesses) into different categories, namely, micro, small, medium and large-scale, requires subjective and qualitative judgements. Consequently, there is no standard definition of small-scale or any other type of enterprises as different countries use different measures (Admit, 1994:7). Some of the criteria used by many countries include annual turnover, paid-up capital and number of paid employees.

In Ethiopia, there is no clear-cut definition that helps to distinguish different scales of enterprises. Handicraft and Small Scale Industries Development Agency (HASIDA), in its report on the survey of private small-scale manufacturing and repair service establishments (HASIDA, 1989), defined small scale manufacturing and engineering services as any manufacturing activity which uses either manually operated or motive-power-driven machinery and equipment with a total value of fixed assets not exceeding Birr 1 million for sole proprietorship and Birr 2 million for partnership excluding investments on land improvement and building and which employs at least one person other than the owner/owners, unpaid family workers and/or apprentices. This definition is not, however, applicable to small enterprises other than manufacturing and engineering and has very little relevance for this study. As a result, this study resorts to the classification of Aryeetey et al. (1994), as applied in their analysis of supply and demand for finance of small enterprises in Ghana. They used total number of workers engaged in the business to differentiate enterprises into different groups. Accordingly, businesses with 1 to 4 workers termed 'microenterprises'; 5 to 29 workers, termed 'small' and 30 to 140 workers, termed 'medium'.

The distribution of the businesses by employment size, from the survey data, is given in Table 1. Accordingly, 386 businesses are categorised under microenterprises group with 1-4 workers while only 38 businesses are in the small-scale group. Hence, one can safely conclude that most of the businesses are operated by one man assisted by his family members. Therefore, the term 'micro and small scale enterprises' is used to refer generally all the businesses covered in the survey.

Table 1. Businesses Classified by Number of Persons Engaged

Workers	Number	Percentage
1	288	68.0
2-4	98	23.1
5-9	22	5.2
10 or more	16	3.8
Total	424	100

Source: Computed from the Data on the Ethiopian Urban Household Socio-economic Survey.

4. PATTERNS OF ENTERPRISE FINANCING

The growth and development of small enterprises is constrained by inadequate access to finance. It can be argued that lack of access to formal credit is one of the major impairments to small enterprises and entrepreneurs to flourish. This constraint is, however, mainly determined by policies and institutions external to the enterprises (Admit, 1994:4). Hence, the financing and saving patterns of individuals and households are briefly discussed in this section in order to draw appropriate intervention schemes in the sector.

4.1. Financing of Start-up Capital

The important sources of start-up capital open to micro and small-scale enterprises in developing countries are: (i) personal (own) savings; (ii) formal financial institutions; and (iii) informal financial institutions which include loans from friends and relatives, the system of rotating savings, local money lenders, and credit unions which could be described as semi-formal financial institution.

In Africa, small enterprises often use own savings, loans from friends and relatives and occasionally informal sector loans to start a new business that have gravely limited the scale of activities and investment (Nissanke, 1991). This study, thus, seeks to investigate the sources of finance for start-up capital used by specific enterprises covered in the survey. We found out that personal savings, borrowing from friends and relatives, bank loans, inheritance and suppliers' loan are identified as sources of start-up capital by various types of enterprises located in the seven major urban centres. A more detailed analysis is given below.

Micro and small enterprises from the seven major urban centres followed the general pattern in financing their start-up capital. Personal savings were the main source of finance to start a new business, followed by borrowing from friends and relatives. Table 2 shows that own savings were the principal source for about 68 percent and among the top two for about 73 percent of the businesses covered in the survey. The table also shows that almost all the businesses that used own savings as a source of finance except one rank it among the main two sources. In addition, the number of

businesses steadily increases as the percentage share of personal savings from the initial or start-up capital increases (see Table 3). The table depicts that about 82 percent of the enterprises in this category generated 75 or more percent of their initial capital from own savings, while only 7.4 percent reported less than 50 percent from own funds. On the average, this source accounted for about 88 percent of the initial capital for the entire population under this category (Table 4).

The most important alternative source of finance to own savings is borrowing from friends and relatives used by nearly 25 percent of all businesses. Close to 18 percent of the micro and small enterprises in the study were established principally from loans from friends and relatives (Table 2). The percent increases to about a quarter if our reference point is the top two sources. About 48 percent of those reported to have borrowed from friends and relatives obtained 75 or more percent of their start-up capital from this source (Table 3). This source, on the average, comprised of 66.7 percent of start-up capital for those who had access to borrowing from friends and relatives in establishing new businesses (Table 4).

Inheritance ranked third as a source of start-up capital next to private savings and borrowing from friends and relatives. This indicates the relative importance of bequest to that of formal finance, specifically bank loans, to start a business. Over 9 percent of all enterprises used inheritance as a source of start-up capital; of which it is a primary source for about 7 percent of the sample (Table 2).

The contribution of bank and suppliers' loans in financing the initial investment of micro and small-scale enterprises is insignificant as compared to the other sources. Only 2 percent and slightly greater than 1 percent of all firms used bank loans and suppliers' credit respectively, as a primary source of start-up capital (Table 2). This confirms the general consensus that micro and small-scale entrepreneurs in developing countries and particularly in Africa have little access to formal finance in order to start their businesses. Most of the enterprises depend upon own savings and borrowing from friends and relatives as an alternative source of financing start-up capital. This shows the relative importance of the informal sector in financing micro and small enterprises in urban Ethiopia.

The other important issue, which needs to be addressed with respect to source of finance, is the relationship between firms' access to formal and informal finance to start a business and their respective size. The argument here is that firms that borrow from friends and relatives are unlikely to be big. In contrast, access to formal external finance at the time of starting the business is highly associated with larger size firms (Aryeetey, 1994). However, it is difficult to reach a conclusive result as the number of enterprises that used bank loans to finance their start-up capital are too few for the analysis to provide meaningful generalisation. Hence, we only look into the relationship between size of firms and loans from friends and relatives.

For this purpose, enterprises are categorised under six groups based on their initial investment. Table 4 portrays that for relatively small investors with start-up capital less than or equal to 100 Birr, borrowing from friends and relatives was the main alternative form of financing to personal savings. In this group the mean percentage share of borrowing from friends and relatives in start-up capital was 90 percent which is comparable to that of own savings (around 95 percent). For relatively bigger businesses (with start-up capital above 50,000), the mean percentage share of borrowing from friends and relatives (14 percent) was by far lower than own savings (73 percent). Moreover, the mean percentage share of the former steadily declines as the size of firms increases except in the case of group four. In general, there is a declining tendency in the percentage share of loans from friends and relatives in start-up capital. These differences in the group means are statistically significant. An analysis of variance (ANOVA) is conducted to test the null hypothesis that the means in all the groups are equal. This null hypothesis is, however, rejected at zero level of significance with an F-statistic of 7.1332. These results indicate that the role of the informal sector, more specifically, borrowing from friends and relatives, decreases as the size of micro and small-scale enterprises increases.

Table 2. Sources of Start-up Capital

	Principal Source		Top Two Sources (Cumulative)[b]		Total Responses (Cumulative)[b]	
Sources	Number	Percent	Number	Percent	Number	Percent
Personal Savings	289	68.2	310	73.2	311	73.4
Borrowing, Friends and Relatives	74	17.5	103	24.3	104	24.5
Inheritance	31	7.3	36	8.6	39	9.3
Bank Loan	8	1.9	12	2.8	12	2.8
Suppliers' Loan	6	1.4	8	1.9	8	1.9
Other	20	4.7	28	6.6	36	7.5
Total	424[a]					

Source: ibid.

a. The sum of the column is 428 which is greater than the number of enterprises. This is owing to double counting as individuals reported more than one source as principal sources of finance.

b. Cumulative refers to the cumulated frequencies for a particular source of finance ranked as first or second most important source in the case of the top two sources and irrespective of its rank in the case of total responses.

Table 3. Percentage Share of Personal Savings and Borrowing from Friends and Relatives in Start-up Capital

Percentage Share	Personal Savings		Borrowing from Friends and Relatives	
	Number	Percent	Number	Percent
Less than 25	5	1.6	12	11.5
25 – 49	18	5.8	18	17.3
50 – 74	34	10.9	24	23.1
75 or more	254	81.7	50	48.1
Total	311	100.0	104	100.0

Source: ibid.

Table 4: Percentage Share of Personal Savings and Borrowing from Friends and Relatives in Start-up Capital by Business Size

Start-up Capital in Birr	Personal Savings		Borrowing from Friends and Relatives	
	Number	Mean Percentage Share	Number	Mean Percentage Share
100 or less	77	94.6	31	90.0
101 – 1000	117	87.5	32	60.9
1001 - 5000	46	80.5	25	57.6
5001 - 10000	16	93.4	4	68.8
10001 - 50000	20	81.0	9	43.9
50001 or more	11	73.0	2	14.0
Mean for the Entire Population		**88.2**		**66.7**

Source: ibid.

4.2. Characteristics of Enterprises

So far we have seen how enterprises finance their start-up capital. We found that enterprises predominantly rely on internal source of finance. This type of financing is, however, argued to encourage low quality investment and the retention of traditional technology (Laumas, 1990). Hence, type of businesses and the magnitude of start-up capital are examined in this section to get an insight on the quality of investment in micro and small-scale enterprises.

Type of Businesses

A report by ACORD (1996) pointed out that the most striking feature of small towns in Ethiopia is the predominance of service functions, mainly retail trades and 'buna bets' (bars) and complete absence of production related activities. This is confirmed by our results from the survey data which indicate that most of the individuals in the sample with their own businesses are engaged in two major activities: retail trade (32.8 percent) and food and beverages preparation (20.3 percent) (Table 5). In the latter group, bars, hotels and restaurants account for about 35 percent. The dominance of service-oriented enterprises highly limits the desired forward and backward linkages of micro and small enterprises with that of medium and large-scale enterprises. In addition, their contribution in creating rural urban linkages will be restricted.

Table 5. Type of Businesses and their Percentage Distribution

Type of Business	Number	Percent
Food and Beverages Preparing	86	20.3
Textile and Leather Products	57	13.4
Furniture Making and Handicrafts	47	11.1
Transport/communication Services	25	5.9
Retail Trade	139	32.8
Professional and Other Services	33	7.8
Other	37	8.7
Total	**424**	**100.0**

Source: ibid.

The concentration of enterprises in certain areas may, however, be attributed to lack of entrepreneurial skills. The Policy Framework Paper prepared by the Transitional Government of Ethiopia (TGE) underscored the limited knowledge of investment opportunities in the country as one of the impediments for the development of the private sector. Businessmen/women are, thus, supposed to find their own way to assess the viability of their proposed investment, as there is no agency which can provide advice on investment opportunities or carry out feasibility studies. As a result, they 'simply replicate the latest businesses considered to be profitable' (TGE, 1995: 18-19). Furthermore, mismatch between capital holding and entrepreneurial skills poses problems to the development of the sector. This exacerbates the weakness of self-financed investment while investment requires a relatively more entrepreneurial skills and start-up capital (TGE, 1995). Hence availability of external finance as source of credit may instigate the endeavour of potential entrepreneurs.

Capital Base

As indicated in Table 6, over 68 percent of enterprises covered in this study had an initial capital less than 1000 Birr. Only 3.4 percent of them had a start-up capital of more than 50,000 Birr. The maximum amount of start-up capital was 100,000 Birr with a minimum of 4 Birr. The average start-up capital for the entire population was around 5,540 Birr. The summary statistics in Table 6 indicate the dominance of enterprises that require very small capital base, which may be due to the predominance of personal savings in financing new enterprises.

Table 6. Start-up Capital

Start-up Capital in Birr	Number	Percent
100 or less	116	30.2
101 – 1000	146	38.0
1001 – 5000	64	16.7
5001 – 10000	18	4.7
10001 – 50000	27	7.0
50001 or more	13	3.4

Source: ibid.

The important implication that can be derived from the predominance of self-finance is that investments will be undertaken in service-oriented type of activities that require small start-up capital and turnover.

5. FORMS OF SAVINGS

It is difficult to thoroughly investigate the form and nature of savings by micro and small entrepreneurs using the survey data. Despite lack of comprehensive data on this issue, the available information can provide an insight on financial arrangements

or connections of households. In the survey, households were asked if at least one member has a bank account, belong to 'Iqub' (a form of rotating savings club) and/or credit association.

Table 7: Households Membership of 'Iqub' and Credit Association and Bank Connection (In Percentages)

	Total Sample	Households with Businesses
Bank Account	21.9	30.0
'Iqub'	24.1	33.9
Credit Association	8.9	5.7
(Number of Households)	(1494)	(369)

Source: ibid.

Table 7 shows that 'Iqub' is relatively the most widely used form of savings for both the households and households with at least one member running a business. Around 24 percent of the surveyed households and 34 percent of the households having business/es reported that at least one member of the household belong to an 'Iqub'. Next to this, almost 22 percent of the surveyed households and 30 percent of households having business/es have bank accounts. In both cases, the proportions of households having business/es are greater than that of the total households covered in the survey. However, the connection of micro and small enterprises with the banking system is not satisfactory especially when compared to other developing countries. In Ghana, for example, 74 percent of small entrepreneurs accumulated their investment funds in banks (Aryeetey, 1994).

6. IMPLICATIONS FOR INTERVENTION

The data of the Ethiopian Urban Household Survey supports the idea that small businesses in developing countries such as Ethiopia are financed from own funds. The share of credit from any source for start-up capital is relatively small. Thus, efforts to promote micro and small enterprises should pay attention to savings. One policy recommendation to this end is financial liberalisation in the form of interest rate adjustment that is expected to encourage investment by increasing savings and by making the accumulation of equity faster. But positive real interest rate by itself may not enable the economy to achieve the above objective given the major structural problem of the inaccessibility of financial institutions to most people in rural areas and small towns. As discussed in the previous section, only 30 percent of the surveyed households, having business in the seven major towns, have bank accounts. Further, self-finance has a number of major drawbacks. It is widely argued that individual investment opportunities may not match available resources or may be inefficiently limited by them (WB, 1989:29). The problem becomes more serious when there is a need to invest in larger businesses and/or when faster growth through more investment is needed. This, therefore, indicates that lack of external

financing curtails the exploitation of highly profitable opportunities, and growth of the sector could be accelerated if credit were more readily available. Survey results in many developing countries reveal the existence of high rates of application for loans among small and medium enterprises (SMEs) and also their willingness to pay above market rates of interest indicating strong excess demand for credit (Aryeetey, 1994:1).

In developing countries, most of the external finance for the non-corporate sector comes from the informal sector such as moneylenders, suppliers' loans and friends and relatives especially in the early stages of financial development. This source of external finance has, however, a number of limitations. The scale of lending is small, the range of services is limited, markets are fragmented, and interest rates are sometimes usurious (WB, 1989:4); no deposit mobilisation[5] and no provision of term finance. All these shortcomings work against the long-term planning and investment necessary for an increase in productivity and growth of the economy (WB, 1989:116).

In the absence of well-developed domestic equity market, the only sources of external finance left are bank loans and foreign debt though the latter is not available to SMEs. Financial liberalisation, which is expected to increase bank credit due to an increase in deposits or loanable fund, has had little effect on improving SMEs' access to bank credit in a number of developing countries. The main reasons behind this may be the existence of asymmetric information and lack of bankable collateral among micro and SMEs in most developing countries deterring creditors from providing long-term funds. The weakness of accounting, auditing and disclosure regulations in these economies limit the information available to lenders about borrowers. The Urban Household survey for instance reveals that only 28 percent of the businesses keep accounts. Legal procedures for collateral, foreclosure and enforcement are poorly specified making repayment very difficult. Experience from Philippines reveal that a large proportion of the borrowers were not repaying loans because of their perception of weak reaction by the institution and legal authorities to default and lack of incentives to repay (Anderson *et al., 1985*:356-357). Related to this, Stickey and Tapsoba in their 1978 survey in Upper Volta, as reviewed in Anderson and Khambata (1985), found that of the 31% of the accounts in default, three-quarters of the borrowers (farmers) did not pay due to various failings of the institutions implementing the credit program and to borrowers 'feeling no obligation to repay their loans'. Experiences in a number of countries suggest that a policy of simply letting interest rates float in itself is unlikely to induce banks to lend to small businesses. Higher interest rates as argued by Stiglitiz and Weiss (1981) may instead attract the riskier borrowers, deter the more conservative, and induce others to undertake yet riskier projects in the expectation of higher returns (Anderson *et al., 1985:354).*

In general, the problems of information and collateral result in high costs and risks. This may entail government intervention in a number of ways. A report by the World Bank suggested that governments can intervene in the credit market by modernising

legal systems and making contracts more easily enforceable; by clarifying property rights and improving title transfer and loan security; by improving bank regulation and supervision; by training accountants and auditors; and by ensuring adequate disclosure of information (WB, 1989:5).

Currently, most governments in developing countries have also recognised the relative low cost of information and operation, and risks associated with informal institutions. Thus most of them have established programs to link informal markets more closely with formal markets as one means to overcome the above problems. In this regard, the Ethiopian government currently has started to introduce a new scheme for microenterprise development through group lending. In doing so, care must, however, be taken because of the widespread problems of entrepreneurship and lack of effective demand for the products of micro and small-scale enterprises (see Solomon, 1995) for the application and disbursement of loans through this scheme in the town of Debre Berhan). Related to this, Sonko (1994) pointed out that around 73 percent and 58 percent of the surveyed small-scale enterprises in Addis Ababa have reported difficulty in marketing their products and in getting skilled personnel, respectively. These, therefore, call for the provision of a package program instead of simply making credit available. The package may include effective project identification by looking at the supply and demand balance with the consideration of the marketing constraints, information provision, technical and managerial training, effective monitoring and regulation of projects financed through the scheme.

On top of group-lending scheme, the Korean experience tells us that in the absence of well functioning domestic equity market, the huge investment requirements for rapid industrial expansion calls for an effective risk sharing among creditors, borrowers and the government. In doing so, the government primarily has to have a clear focus to target narrowly on certain sectors deemed essential for development. Moreover, the government has to ensure the successful operations of the supported firms and projects by monitoring and consulting them closely. Like Korea, credit policies might need to be well co-ordinated with other economic policies, consistent with long-term economic development plans. The implementation of this has to be subjected to less political abuse as to overcome the problem of political abuse which is common in many other developing countries where credit programs are often used for political ends, and, as such, their sheer size and the heavy subsidies they provide, simply open opportunities for rent-seeking (Cho *et al.*, 1995:8). In Korea, this indirect impact of government credit policies is thought to have a more important effect than the credit subsidies *per se* for its rapid industrialisation (Cho *et al.*, 1995:7).

Experiences from other countries again reveal that care must be taken in such schemes because the government risk sharing may aggravate the moral hazard issues for firms and banks. This is because firms may be encouraged to depend on the government for support without giving enough attention to their project identification and feasibility study. Moreover, with government risk sharing, banks will have little incentive for serious credit evaluation and monitoring (Cho *et al.*, 1995:65).

7. CONCLUSIONS

Based on the data from the Ethiopian Urban Household Socio-economic Survey, the paper found out that most micro and small enterprises are financed from own savings. However, this form of savings has been found to finance businesses that require small amount of capital and mostly service-oriented activities. This, therefore, implies that investments in larger businesses call for external resources. The survey results, however, reveal that the only external finance available to micro and small enterprises is from the informal sector mainly from friends and relatives, which is found to have a number of drawbacks. Existence of asymmetric information and lack of bankable collateral might explain lack of access to formal credit to this sector. Given the significance of bank credit to the sector, the paper suggests two possibilities through which micro and small enterprises could access formal credit, namely, group-lending scheme through the provision of package program and effective risk sharing among creditors, borrowers, and the government.

In both cases, more attention has to be given to credit availability instead of interest rate subsidies. Thus, all costs related to lending to these activities have to be covered with the corresponding interest charges by letting interest rates reflect the opportunity costs of raising and administering resources, including a premium to reflect risks. In developing countries like Ethiopia, absence of interest subsidies may have a number of advantages including:

First, as means to increase financial savings in the banking sector and hence the availability of more loanable funds. By this, most firms that are illegible to bank credit could become legible. Moreover, an increase in savings could lead to an increase in self-financed investment.

Second, positive real interest rates could increase the average efficiency of investment. Instead of direct investment, inefficient households and firms put their money in the banking sector to be lent to more efficient investors. Market determined interest rates ration out inefficient investors from borrowing in the banking sector and give guarantee against the misuse and diversion of credit from the targeted sector. Further, a number of authors 'unanimously agree on the point that concessionary finance leads to unprofessional and unseemly collusion between the borrowers and those involved in lending decisions' (Anderson *et al.*, 1985:365).

Finally, all the regulated credit-programs mentioned above would be sustainable as long as their costs are covered by the interest charged from the borrowers. With regard to this, experiences and information must be shared among financial staff members so as to reduce costs and risks by using the information to improve screening and supervision procedures.

Notes

[1] 'Iqub' is a kind of rotating credit and savings association (ROSCAs).

[2] The data set used in this study is from the first round survey of the Ethiopian Urban Socio-economic Survey jointly undertaken by the Departments of Economics of Addis Ababa University and Gothenburg University in 1994. The survey consists of a sample of 1500 households in seven major urban centres of the country. The urban centres, namely, Addis Ababa in the centre, Mekele and Dessie in the North, Bahir Dar in the Northwest, Dire Dawa in the East, Awassa in the South and Jimma in the Southwest were selected to reflect the different socio-economic characteristics of the urban centres in the country (for the details see the Report on the 1994 Socio-economic Survey of Major Urban Centres in Ethiopia). Systematic sampling technique was used in selecting the sample households in each urban centre. The sample size in each town was proportional to the population of the respective urban centre based on the Central Statistics Authority 1992 projections. Correspondingly, 900 households in Addis Ababa, 125 in Dire Dawa, 75 in Awasa and 100 in each of the other four towns were selected. The survey was not specifically designed to produce extensive data on the financing of small-scale enterprises. As a result, it is not possible to get detailed information in some important aspects of micro and small-scale enterprises found in the major urban centres in the country. In spite of this, the survey provides a wide range of data on household demographics, rural-urban migration, employment and income, consumption and expenditures, health status and other welfare indicators. However, some findings are appearing from this study based on 369 households from all the seven urban centres that are involved in business activities. A total of 424 persons from 369 households are engaged in business activities as employer or own account workers.

[3] Although both models suggest financial liberalisation as a possible policy measure, they have a clear distinction in terms of the transmission mechanism of savings into investment. McKinnon (1973) emphasises the importance of higher real interest rate in increasing self-financed investment while Shaw's (1973) analysis is based on the debt-intermediation hypothesis which focuses on the role of deposit accumulation in expanding the lending potential of financial intermediaries through higher real interest rate. But both are viewed to be complementary since it is unlikely (in developing countries) that a project is fully bank financed. Rather, in the limiting case, projects are financed in part with own funds and in part with borrowing.

[4] Repressed financial markets impede efficient allocation of the available resources, compel enterprises to depend on internal sources of investment and consequently promote the use of traditional technologies. As a result, positive real interest rate is also expected to enhance the efficiency of investment (Laumas, 1990).

[5] Nissanke (1991) pointed out that any fund mobilised by one informal group is hardly used to finance other groups. This, therefore, implies that the importance of the informal sector for economy wide diversification is negligible.

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