

# **A Review of the Performance of Agricultural Finance in Ethiopia: Pre- and Post Reform Periods**

By Assefa Admassie

## **1. Background**

Rural development means nothing but the transformation of the subsistence agricultural production to a market oriented agricultural economy. Availability and access to financial resources is one of the key elements to this transition. Financial resource is a very important, if not the most important, factor in economic development.

Shortage of finance is one of the major problems facing small farmers. Farmers need financial resource to buy improved agricultural inputs and farm implements so that they can increase their output and income level and break the cycle of poverty. Farmer's investment in these technologies cannot be real without having in place organizations and systems that are capable of adequately providing rural financial services to farmers. So, the effort to develop agriculture could suffer in the absence of a strong financial base that aims at expanding access to credit for small farmers.

Unfortunately, the state of rural financial markets in developing countries is characterized by inadequate availability of financing for both agricultural and non-agricultural activities. Very few of the rural populations have access to financial services because commercial banks consider lending to small farmers as a risky business and because providing financial services to rural people is considered to be more costly and difficult. Lending to small farmers involves high transaction costs. They lack conventional collateral and the managerial skill and do not keep records.

Ethiopia is characterized by a vicious circle of poverty (low productivity, low income, low savings and consequently low productivity). In order to break this cycle of poverty and raise productivity injection of capital could play a major role. Credit is the only mechanism for small farmers to acquire the desired capital goods for production and to break the vicious cycle of poverty and raise their productivity and level of income.

Ethiopia should always give priority to the peasant agriculture in its national development efforts since development cannot take place without giving special considerations to the

majority of the rural population. In a country where agriculture accounts for a major proportion of economic activities and employs a large proportion of the population increased availability of credit to the sector would lead to increased production and growth. Therefore, in order for agriculture to effectively meet the challenge of being an engine of growth credit should be made available and accessible to small farmers in particular.

The purpose of this paper is to briefly review the operational performance of rural finance in Ethiopia both before and after the financial reform with the aim of drawing some lessons. The study is based entirely on literature review. The paper is organized into four sections. Section 2 deals with the review of the operation of agricultural finance before the liberalization. Section three discusses the situation after the financial liberalization while section four presents some concluding remarks.

## **2. Agricultural Finance in Ethiopia: Pre-Reform Period**

The development of the financial sector in Ethiopia has a long history and included an array of banking and non banking institutions. The financial system comprised of commercial banks, development banks, specialized financial institutions, cooperatives, insurance companies, etc. The organizational structure, management and ownership of these financial institutions as well as their performance have been changing under the different regimes.

### **2.1. The Imperial period**

The history of the formal financial sector development in the country can be traced back to 1942, when the State Bank of Ethiopia was created by an Imperial Charter. Until 1963 the bank had the dual function of a central bank and a commercial bank. In 1963, the bank was reorganized and two institutions were created: the National Bank of Ethiopia (NBE) as the central bank of the country, and the commercial Bank of Ethiopia (CBE), to

take overall banking business with the public, including mobilization of savings for short term purposes.

In addition, there were also other financial institutions that mobilized resources for medium and long term purposes. These included: (a) the development Bank of Ethiopia (DBE), a state owned institution, established by the Imperial Charter of 1951; (b) the Ethiopian investment Corporation (EIC) established as a fully government owned company in 1963; (c) the Addis Ababa Bank, established as a private share company in 1964, and (d) the Banco Di Roma established in 1967 as an Ethiopian share company.

Other financial institutions involved in the mobilization of financial resources during the period, were: The agricultural and Industrial Development Bank (AIDB), which was formed by merging DBE and EIC in 1970; the Ethiopian Tourism and Hotel Investment Corporation established in 1970; the Savings and Mortgage Corporation established in 1965; the Imperial Savings and Home Ownership Public Association established in 1962; the insurance industry established in 1971; the Addis Ababa Share Market established in 1965; Cooperatives established in 1966 and the Pension Fund which was established in 1965.

With respect to the development of financial institutions that cater for agricultural finance the establishment of the Agricultural Bank of Ethiopia in 1945 was a pioneer. Following the creation of the Ministry of Agriculture in 1943 the Agricultural Bank of Ethiopia was established to accelerate agricultural development by assisting small landholders whose farms had been devastated during the Italian occupation through loans for purchase of seeds, livestock and implements and to repair or reconstruct their homes and farm buildings (Assefa, 1987).

A close scrutiny of the Second Five years Development plan shows that the Government intervened in the allocation of financial resources in order to accelerate national development. The intervention took various forms including: allocation of credit according to coordinated investment plans, use of differential interest rates, establishment

of public commercial as well as specialized<sup>1</sup> banks (development, and investment banks), and giving priority to productive projects in the use of foreign credits. Public banks were supposed to mobilize resources and channel them in accordance with the Plan.

Flow of bank credit (both to private and public undertakings) was supposed to be in accordance with the priorities set in the Plan, which identified (i) agriculture as the leading<sup>2</sup> economic activity, and (ii) mining, manufacturing & power as “the most propulsive sectors”. The Plan made a distinction between credit for investment and current transactions and gave priority in investment credits to “directly productive” economic activities. The Plan also allowed for interest rate discrimination between borrowers favoring businesses that are in conformity with the Plan (Imperial Ethiopian Government, 1962: 333). Credit access was not to be discriminated by ownership. Instead, the Plan explicitly recognized the private and public sectors as equally important: “Neither the private nor the public sector will have priority; both of them should have equal rights, obligations, and facilities. There will be no limitation to the private sector either in kind of business or in the size of enterprises” (Imperial Ethiopian Government, 1962: 336).

Regarding agricultural finance, the share of agriculture reflected the importance attached to it in the Plan. Subsistence and large-scale & mechanized agriculture together were to receive about *half* of the bank credit. *Subsistence* agriculture was to be transformed through (a) the introduction of improved tools & implements, modern techniques, and better seeds; (b) credit, price and tax policies; and (c) land reform and agricultural services. Accordingly, farmers were to be assisted to produce more marketable surpluses, and thereby develop the subsistence agricultural sector into a monetized one. Credit for farm tools & implements was to be extended (by the Development Bank of Ethiopia) not

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<sup>1</sup> As articulated in the Plan, the main task of the Commercial Bank was local banking, promotion of current economic activity and mobilisation of savings; the Development Bank was to handle long-term credit while the Investment Bank (which, in 1965, became the Ethiopian Investment Corporation) was to engage in medium- and long-term credits for small and medium-scale undertakings (Imperial Ethiopian Government, 1962:334).

<sup>2</sup> Because of its perceived important role in the national economy in view of the existing natural conditions (climate, fertile soil, etc.) allowing it to provides “the largest production increment both in terms of food, raw material, and goods for export” and the “impact of such development on the political and social life of the country”.

directly but through the then Grain Corporation or Farmers' Cooperatives. These institutions were to receive credit funds and then buy the implements and supply them to farmers on credit (to be repaid in kind) or lease or sell them on credit if they are expensive - such as selectors, threshing machines, winnowers, etc. (to be repaid in cash). It was explicitly stated that credit was to be provided only in goods & services the reason being to ensure that it is used only for productive purposes. These practices were expected to raise production as a result of rapid application of efficient implements and lead to commercialization of peasant agriculture due to increased marketable agricultural output. Priority for credit among farmers was to be determined by the co-operatives (with advice from extension agents). However, this seems to ignore the well known problem of fungibility<sup>3</sup> of funds. An analysis of the total loans disbursed by the DBE shows that the most of the loan was directed towards the industrial sector (see Table 1). Between 1951 and 1969, of the total loan disbursed by the DBE, industrial loans absorbed about 58 percent of the loans while agriculture made up the balance.

Table 1: Loan disbursement by the DBE (1951 – 69) ('000 Birr)

Year	Agricultural loans	Industrial loans	Other loans	Share of agricultural loans
1951-1960	9,497.8	13,528.5	915.1	39.67
61	1,249.1	143.2	--	89.7
62	656.0	1410.0	24.0	31.4
63	851.0	2763.0	39.0	23.3
64	1,335.9	2334.4	80.5	35.6
65	1,353.5	2657.4	189.1	32.2
66	729.0	405.7	75.5	60.2
67	1,645.0	469.0	60.0	75.7
68	847.0	1657.0	172.0	31.7
69	1,748.0	1910.0	7.0	47.7

Source: Development Bank of Ethiopia, Annual Reports.

<sup>3</sup> Farmers receive in-kind credit for farm tools/implements which they would have bought anyway and use the cash thus released for non-productive purposes so that the selective credit policy may not guarantee the use of the resources for productive purposes only.

Banks were also to extend credit to commercial farms (for modern tools, fattening, etc.) and fishing co-operatives at favourable terms. The Plan also gave emphasis to the importance of promotion and mobilization of domestic savings. Co-operatives, in addition to marketing farmers' products and supplying [credit to] agriculture, were envisaged to be involved in collection of surplus funds from farmers (i.e. savings mobilization).

Pre-Five Year Development Plan (1945-1951<sup>4</sup>) efforts to support agriculture and small farmers through credit were not a success for a number of reasons including the collateral requirement involved, the landlord-tenant relationship which made it difficult to produce certificate of ownership, diversion of loans to non-agricultural uses, etc. (Assefa, 1987). Neither did the efforts under the Five Year Development Plans succeed. High collateral (as high as 200% of the loan), mainly in the form of real property and machinery, and guarantor requirements, in the face of widespread tenancy, land title problems (e.g. communal land, *rist* system), etc., proved effective hindrance. Of the total DBE loans disbursed during 1951-69, only 42 per cent went to agriculture, of which small farmers received only 7.5 per cent. Nor was most of this used for agricultural purposes<sup>5</sup>. In fact, the DBE which, according to the Plan, was supposed to extend credit for farm tools & implements to farmers, discontinued in 1961 mainly due to collection problems. The absence of success story is not, however, limited to small farmer credit. Similarly disappointing results hold with respect to DBE's credit to large-scale agriculture and co-operatives as well as the medium- and long-term agricultural loans of the IBE (later EIC<sup>6</sup>).

The successor of DBE, the AIDB<sup>7</sup> whose objective, among others, was to mobilize funds and extend medium- and long-term agricultural credit, did not do a better job in terms of reaching farmers with credit either. In fact, its credit policy disqualified peasant farmers

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<sup>4</sup> through the Agricultural Bank, and then latter through the Agricultural and Commercial Bank, which later became the Development Bank of Ethiopia (DBE).

<sup>5</sup> Loans went to "absentee landlords, merchants, town dwellers, government officials and other non-agriculturalists" which were mainly spent on house building, shops, cars, weddings, etc. (Assefa 1987).

<sup>6</sup> Shortage of skilled manpower and funds as well as reliance on collateral rather than repayment capacity were, according to Assefa 1987), the main factors.

<sup>7</sup> Established in 1970 by merging the DBE and the Ethiopian Investment Corporation.

in areas away from the main road, without many borrowers, etc.; required property collateral (which should be insured at the borrowers expense), ranging 100 to 200%<sup>8</sup>, and/or personal guarantor; and required borrower farmers to sell their output to its subsidiary at fixed prices as a means of enforcing repayment (see Assefa 1987). The implication of these on peasant farmers' credit access is clear. While the share of agriculture in AIDB total credit during 1970/71-74/75 was high, averaging about 65 per cent, peasant farmers did not benefit much. It mainly went to diary development projects, large farmers, co-operatives of commercial farmers, etc.

The comprehensive and minimum package<sup>9</sup> programmes, which were intended to support small farmers by, among other things, organizing them in a way that makes it easier and less costly for the AIDB to provide credit, did not achieve much in terms of reaching small farmers partly due to the stringent requirements involved such as high down payment (25 to 75%), two reputable guarantors (one of them the landlord in case of tenant borrowers), and signed lease agreement and partly due to incentive problems associated with the share cropping arrangement that prevailed and marketing problems. Just like what happened in most directed credit programmes of other countries<sup>10</sup>, benefits mainly accrued to the non-target groups (landlords, large landowners/big cultivators, merchants, etc.). Overall, the extent of exclusion was well recognized by the AIDB board so much so that in 1974 it decided to introduce a small farmers credit program on pilot basis but was not implemented as it was overtaken by events of the revolution (see Assefa, 1987).

## **2.2. The Derge Period**

Consequent to the 1974 revolution, the financial system in Ethiopia was nationalized and restructured on the basis of the 1976 Banking Law. As a result, the sector after 1976

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<sup>8</sup> 100-125% for special resident farmers and share companies; 125-150% for resident farmers; and 175-200% for non-resident farmers.

<sup>9</sup> Chilalo Agricultural Development Unit (CADU), Walamo Agricultural Development Unit (WADU), and Minimum Package Project I (MPP-I).

<sup>10</sup> In many countries that implemented directed credit programmes, benefits mainly went to those with connections and influence rather than the target beneficiaries (see Fry 1995).

comprised only of five institutions each with a specific and differentiated area of responsibility based on function. The institutions were (a) the NBE, the central bank with overall responsibility for monetary policy and financial sector supervision; (b) the CBE, the sole commercial bank undertaking both retail and wholesale banking, short term commercial credit and saving mobilization; (c) the AIDB, which concentrated on seasonal production credit, medium and long term credit for agriculture, industry and other sectors; (d) the Housing and Savings Bank (HSB), the main source for long term credit for building and housing construction and (e) the Ethiopian Insurance Corporation (EIC) which provided a full range of insurance cover. There has also been one pension authority, with a separate legal entity and management.

The credit policy after 1976 was geared towards the overall policy of the country's centralized economic management. The financial institutions were simple instruments of the state to channel resources mobilized by the financial sector towards the public sector (i.e. central government, public enterprises, cooperatives, and state farms). All elements of financial repression existed during this period in their severe form: controls on financial prices (i.e. interest rates and exchange rates) and restrictions/control on new entry into the sector as well as on the activities and portfolios existing financial institutions. Interest rates on loans to different economic and social sectors were administratively fixed. The rate structure bears little relationship with the opportunity cost of capital or the rate of inflation. Exchange rate control was in place. All financial institutions were publicly owned and entry was banned, thereby establishing a public monopoly of the financial sector. Moreover, financial institutions were assigned specialized functions each enjoying monopoly in its segment.

Credit policy gave absolute priority to the socialized sector (public enterprises, state farms and cooperatives). The public sector was the major user of bank credit. The share in domestic credit of the central government alone (excluding credit to public enterprises and state farmers) which was only 11% in 1974 averaged 47% between 1975 and 1990 and 50% between 1980 and 1990. The private sector was marginalized. The share in domestic

credit outstanding during 1986-90 of the private sector and cooperatives averaged 4.7 and 1.1 per cent, respectively (World Bank 1991).

Loans and advances by borrowing institutions over the ten year period between 1981 and 1990 show that on average the government sector took 36.4 percent of the total, while 50.3% went to public enterprises while the private sector's share was only 8.3% of the total loans and advances made by the banking system during the period as shown in Table 2.

Table 2: interest rates on long and short term loans and advances (per cent per annum)

Sector	Coops	Government owned undertakings	Individuals and private organizations	Financial institutions
Agriculture	5.0	6.0	7.0	--
Industry, mining, power & water resources	6.0	8.0	9.0	--
Domestic trade	6.0	8.0	9.5	--
Transport & communication	6.0	8.0	8.0	--
Export trade	6.0	6.0	6.0	--
Import trade fertilizers, seed and pesticides – all other imports	5.0	6.0	7.0	--
Hotel and tourism	6.0	8.0	9.0	--
Construction	6.0	8.0	9.0	--
Housing				
- construction	4.5	4.5	7.0	--
- purchase	6.0	6.0	8.0	--
Central government				
- Short term	--	3.0	--	--
- Long term	--	5.0	--	--
National bank of Ethiopia	--	--	--	2.5-4.0
Personal	--	--	--	--
Penalty	2.5-5.0	2.0-5.0	2.0-5.0	--

Source: National Bank of Ethiopia.

More than 89 per cent of AIDB agricultural loans went to state farms while the rest went to agricultural co-operatives, with the private peasant sector receiving negligible share. Discrimination against the private sector was not limited to credit access. The interest rate schedule explicitly discriminated against the private sector. The NBE set lending rates ranging between 4.5 – 9.5 %, depending on the type of ownership and sector (see Table

2). For instance, it had fixed the lending interest rates of 9% for private, compared to 8% for public industrial enterprises, and 8% for private as opposed to 6% for public enterprises in agriculture (NBE, 1986). Private enterprises faced further discrimination in credit since banks required them to insure their assets (this was not the case with public enterprises).

In many instances, banks have been directed by the NBE to lend for non viable investments in the public sector. As a result, most of the funds disbursed to the public enterprises, particularly state farms, have remained uncollected, leaving the banks with low rate of growth of capital and reserves. Among the financial institutions, the AIDB suffered serious capital depletion, with its net capital becoming negative by the end of the 1990 financial year. Repayment problem of the AIDB was so severe (highest 68% in 1988 and lowest of 11% in 1993) that it had to terminate its agricultural inputs loans to rural households (see Wolday 2004) just as its predecessor, the DBE, did in 1961. Therefore, the outcome with regard to reaching small rural borrowers with financial services was disappointing<sup>11</sup> both during the Imperial and Derge regimes.

Within the agricultural sector, registered service cooperatives and producers' cooperatives were eligible for bank credit except for agricultural input loans. Lack of registration of these cooperatives was the main impediment to the expansion of credit. For instance, as of May 1990, the percentage of registered SCs was only 48, while that of the producers' cooperatives was only 14. So, the chance of getting credit by small producers was very low. This is evident from the amount of rural credit that went to the peasant sector. Table 3 shows that out of the overall supply of rural credit through both AIDB and CBE during the period 1982 – 1992 only Birr 792 million or 9 percent went to the peasant sector. Considering the large number of rural population, the size of land under cultivation and the demand for credit, the volume of loan extended to this sector is insignificant. Credit delivery systems have been insufficient to serve the rural people.

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<sup>11</sup> benefits mainly accrued to the well connected and influential (rather than the target beneficiaries) or to ideologically favoured groups; large loan losses accumulated; and sustaining their services required frequent re-capitalisation; and domestic savings mobilization disregarded leading to heavy depends on donor support.

Table 3: Number of loans, volume of credit and proportion of rural credit (in million Birr)

Year	Rural credit				CBE	Total annual disbursement	AIDB	CBE	Total	Percent share of rural credit to total loan disbursed
	AIDB									
	Number of loans	Investment	Working capital	Total						
1981/82	226	0.9	50.5	51.4	1.0	52.4	336.7	704.4	1041.1	5
1982/83	303	0.4	50.9	51.3	1.0	52.3	255.6	1338.1	1593.7	3
1983/84	325	0.1	54.0	54.1	1.1	55.2	275.4	758.6	1034.0	5
1984/85	387	4.3	32.6	36.9	1.3	38.2	36.6	404.4	711.0	5
1985/86	636	8.5	57.3	65.8	2.7	68.5	374.8	353.7	728.5	9
1986/87	1013	16.9	38.2	55.1	29.8	84.9	289.9	411.3	701.2	12
1987/88	1321	29.7	49.2	78.9	45.2	124.1	382.9	438.8	821.7	15
1988/89	1478	26.5	61.2	87.7	33.1	120.8	307.6	423.5	731.1	17
1989/90	1346	11.7	7.70	84.4	5.3	89.8	308.5	337.9	646.4	14
1990/91	205	10.7	56.1	66.8	3.2	70.0	256.6	339.9	496.5	14
1991/92	260	1.7	34.0	35.7	0.5	36.2	167.7	364.3	532.0	7
Total	7500	111.4	556.7	668.1	124.1	792.3	3162.3	5874.9	9037.2	9
Average	602	10.1	50.6	60.7	11.3	72.0	287.5	534.1	821.6	9

Source: AIDB Annual Reports and CBE Annual Reports

### **3. Agricultural Finance after Financial Liberalization**

Financial liberalization is an extremely important component of a successful development strategy. Both economic theory and practical experience suggest that financial liberalization can stimulate economic development. It is advocated that financially repressed systems should abolish or relax interest rate controls; eliminate or greatly reduce controls on allocation of credit; switch to market based indirect methods of money supply control; and develop money and capital markets.

Following financial liberalization, market determination of the interest rates is expected to result in positive real interest rates. These in turn will increase the resources available to the financial system, since bank deposits offering competitive return will attract savings that were previously held outside the formal financial sector. Moreover, positive real interest rates will provide an incentive for borrowers to invest in more productive activities, thereby improving the productivity of the economy as a whole. Consequently, financial liberalization should lead to an increase in both the quantity and the quality of financial intermediation by the banking system.

Following the overthrow of the Derge regime, changes in economic policies as well as political, administrative and institutional structures began to be introduced by the new government. Hence, several policy, legal, regulatory, supervisory and institutional reforms have been undertaken by the new government. The government adopted a World Bank/IMF supported SAP. The policy reforms involved among other things, reducing budget deficits and government reliance on domestic bank borrowing, developing more flexible monetary policy instruments, liberalizing interest rates, and improving efficiency of financial intermediation by removing distortions in financial resources mobilization and allocation.

Financial liberalization in Ethiopia began at the end of 1992. The financial reform undertaken in Ethiopia include elimination of priority access to credit, interest rate

liberalization, restructuring and introduction of profitability criteria, reduced direct government control on financial intermediaries and limits bank loans to the government, enhancement of the supervisory, regulatory and legal infrastructure of the NBE, allowing private financial intermediaries through new entry of domestic private intermediaries (rather than privatization of the existing ones) and introduction of treasury bills auction markets.

As a result of the liberalization, nominal interest rates on deposits and loans were raised by 60 – 900% and 58-144% in 1992, respectively. Prior to 1992, the interest rate charged to farmers' cooperatives was 5 percent which is below the rate of savings deposit (6 percent). Financial institutions were obliged to pay interest margin on deposits from their own sources. Lending rates which were between 4.5 and 9.5 % were raised to 11-15% depending on the sector until September 1994. Deposit rates which ranged between 1-7.5 % for time deposit, and 6% for savings deposits were raised to 10-12%. Discrimination of credit access and interest rates by type of ownership (i.e. between state owned enterprises, cooperatives and private firms) were eliminated. Sectoral interest rates discrimination was reduced, and domestic establishment of private financial institutions was allowed and encouraged through proclamation number 29/1992 (NBE, 1992).

Further liberalization eliminated sectoral discrimination of lending rates, which had continued (favoring agriculture and housing construction with reduced rates). Since January 1995, the NBE switched to a policy of *floors* on deposits and *ceilings* on lending rates, allowing banks to set interest rates (NBE, 1995). These rates combined with low inflation resulted in positive real rates. Further interest rates liberalization was taken in 2001/02.

The government saw the need to review the interest rates to encourage savings through the banks and to create a disincentive to forestall speculation and uneconomic use of savings by borrowers. The interest rate policy was reviewed with the following objectives: (1) to keep the general level of interest rates positive in real terms in order to encourage savings and to contribute to the maintenance of financial stability; (2) to allow

greater flexibility and encourage greater competition among the banks and non-bank financial institutions to enhance efficient allocation of financial resources – in particular, the policy strove to ensure that funds flowed into those areas that are most productive. Hence, the NBE revised the floor for saving deposits downwards to 3% from 6% in 2001/02 with an intention of encouraging investment and boost economic activity. Lending rates quickly followed suit as the minimum lending rate changed by commercial banks went down from 10.5% to 7.5% in the same period.

The liberalization also raised nominal yields on treasury bills and bonds to 12% and 13% respectively, since 1992. Later a government securities market was established in January 1995 through the introduction of monthly (later biweekly) auction of 91 days treasury bills with 28 days and 182 days bills added in 1996. Treasury bills are now on offer to financial institution, business firms as well as the general public.

Interest rate liberalization was accompanied by other reforms including the floating of the exchange rate and trade liberalization. The government also sought to strengthen the legal and technical capacity of the central bank to carry out its regulatory and supervisory functions. The 1960 Civil Code with respect to sale of bank collateral has also been amended in 1997 by proclamation (FDRE, 1997). This amendment provides for an agreement with the borrower authorizing lending banks to sell directly and quickly collateral from delinquent borrowers. This contributed to the effectiveness of enforcement of credit contracts.

In addition, restructuring of the financial institutions was felt necessary to promote competition, reduce government ownership and control, balance the type of institutions (commercial banks, development and household savings banks), and upgrade services. The state owned banks were restructured financially and operationally. Changes in corporate governance have been introduced: banks have management autonomy and their own boards; management have been replaced and reorganized; new incentive schemes have been introduced; and banks are to operate in a competitive environment using commercial criteria. Banks are no longer required to specialize their credit services to

certain sectors of the economy. They also no longer face restrictions on the types and sources of deposits they accept. Banks are also decentralizing loan decision making in order to reduce transaction costs of borrowing and reducing screening hence transaction costs of lending. Entry restrictions into banking were lifted for domestic banks. Entry rules and guidelines have been drawn.

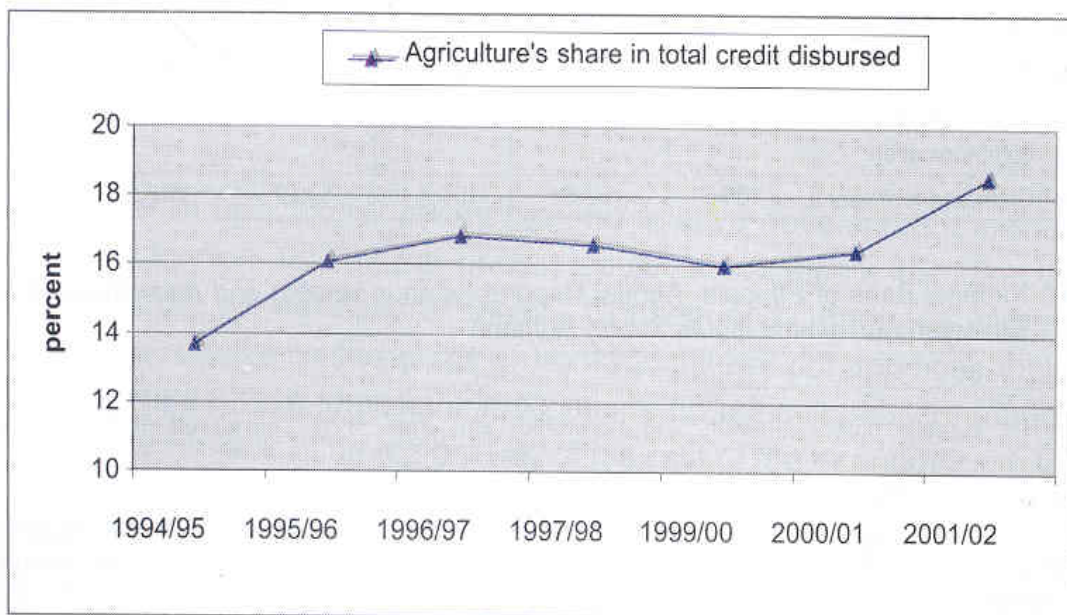
The lending approaches of banks to target beneficiaries could be both a direct type and a two tier system. The direct type is in which the Bank extends credit directly to the end user. This could be an individual person or organization such as cooperatives, government or private enterprises which have legal entity. In the two tier approach, the Bank transfers its financial resources to end users through other bodies such as cooperatives and peasant associations. In the case of the first type, the credit beneficiaries enter loan agreements with the bank and are responsible for repayment of the borrowed loan, whereas in the case of the latter other intermediaries such as cooperatives or associations sign a loan contract with the bank and channel the borrowed fund to their members or end users.

In the case of rural Ethiopia, regional governments act as intermediaries between banks and farmers. These governments use their federally allocated budget as collateral to borrow from banks and on lend these funds to farmers for the purchase of agricultural inputs. This procedure has enabled banks to lend a great deal of money to farmers. Nevertheless, there have been cases of default, which have necessitated repayment out of the budget allocations of the regional administrations.

However, the inability of the formal financial sector to provide adequate financial services to small farmers and the poor in general continued even after the reform. A study by the National Bank of Ethiopia (1996) concluded that “CBE and DBE have only catered for insignificant demand for credit of small farmers. The bulk of financial services provided to small and micro-enterprises in rural and urban areas, therefore, mostly originated from the informal sector such as Iqqub, money lenders and friends” (NBE, 1996).

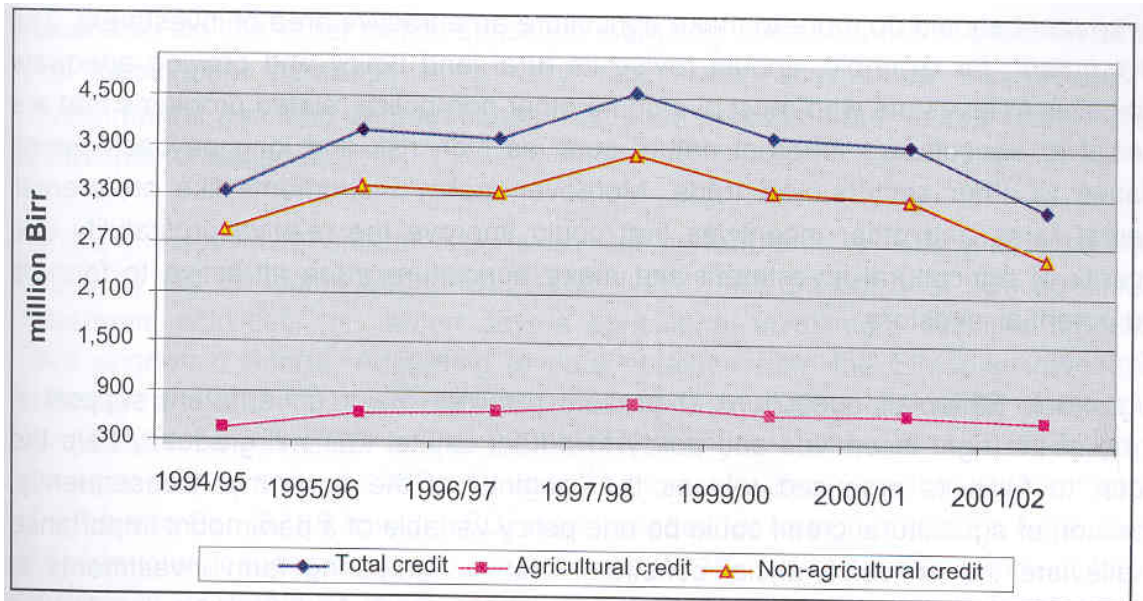
Despite some success of post liberalization policy in shifting the direction of the flow financial resources (mainly credit) from public enterprises to the private sector, the economic reforms have failed to make the agricultural sector more attractive and suitable for long term investments. As compared to other economic sectors the share of agricultural sector in the total credit disbursed by the banks has been marginal (see figure 1 and 2). For instance, the share of agriculture in the total credit disbursed between 1991/92 and 1997/98, has only been 14.7 percent, while domestic trade had 32.2% and industry 13.2%. Recently the share of agricultural credit stagnated at around 16% and never exceeded 19% of the total credit disbursed. In addition it is believed that almost all of the agricultural credit is of short term nature, which will have little impact on long term investment and transformation of agriculture. The financial resource that flows to the sector is in general low when compared to the sector's actual and expected contribution to the economy.

**Figure1:** Agricultural credit share in total credit disbursed in recent years.



Source: Computed based on data obtained from NBE's various annual reports.

**Figure 2:** growth in agricultural credit versus non agricultural credit.



Source: Computed based on data obtained from NBE's various annual reports.

Because of the inability of the banks to meet the credit needs of small farmers, the post-reform period also witnessed the establishment of MFIs. Both the government and foreign as well as local NGOs established (or supported the establishment of) such institutions. As at end of March 2004, there were 23 MFIs (with paid-up-capital of Birr 51.6 million) that registered with the NBE in accordance with Proc. No. 40/1996 and became operational.

## Concluding Remarks

Financial institutions in Ethiopia, both state and private owned ones first emerged with management autonomy during the imperial period. But, after the structural reorganizations and nationalizations of financial institutions in 1976, the sector has lost its institutional autonomy. The lack of autonomy has been an obstacle to the effective management of the institutions and had seriously hampered competition. The structure and behavior of the financial system during the Derge era exhibited that state enterprises and cooperatives were dominant borrowers. Lack of autonomy by the banks to decide on

credit allocation has eroded the capital of some financial institutions. The private sector has also been heavily discriminated in credit allocations.

Interest rate policy has been set by the National Bank prescribing in detail each instrument available to both borrowers and depositors in all sectors. Therefore, the overall policy in the financial system during the pre reform period did not encourage efficient and productive resource allocation. Financial sector reform in the areas of the regulatory and legal framework, interest rate, institutional restructuring and capacity building was thus, in order.

The financial sector reform that started in 1992 had far reaching implications on the performance of the system. The new rural financial market development approach assigned a different role to the government with less direct interventions in credit allocation and credit delivery. New actors and financial institutions have emerged after the reform. The role of the public sector in credit allocation has significantly declined. In spite of the significant financial reform substantial gaps continue to persist in the rural financial markets. These gaps relate to the scarce availability of deposit facilities in rural areas, the difficulties that small farmers face in accessing formal agricultural credit, and the paucity of medium- and long-term lending facilities. The absence of these financial services has major implications for efforts to modernize the agricultural sector and to increase the incomes of small farm and other rural households.

One strategy to be considered is fostering the creation of robust rural financial markets in rural areas to build sustainable financial institutions, to stimulate the full range of job creation activities, and to stimulate information, product and capital flows between rural and urban areas. The solutions to these obstacles will be more than just credit and more than just agriculture. A more efficient rural financial system would help accomplish the dual objectives of boosting agricultural production and alleviating rural poverty. Today's rural finance solutions require a combination of credible short-term solutions and a long-term integrated systems development approach.

Using regional governments as financial intermediaries has several problems and thus cannot continue in its present form. Several reasons could be forwarded. For instance, since regional administrations are not financial institutions; the banking services they render are confined to on lending and does not embrace savings or other banking services. It also has exerted a great deal of administrative pressure on regional administrations and to the extent of severely compromising development initiatives other than input credit management. This negatively affects the relationship between extension personnel and farmers.

It is recognized that there is an important need for a proactive role of the government in creating of a favourable macroeconomic environment with appropriate fiscal and monetary policies, formulating and implementing of sound market-led financial and agricultural sector policies, putting in place of a suitable legal framework for market transactions with well defined property rights, effective contract law and contract enforcement mechanisms, and an appropriate regulatory and supervisory framework for rural financial intermediary organizations and in supporting the capacity building efforts of rural financial institutions and to the development of cost and risk-reducing financial technologies and new financial products.

Moreover, today's rural finance solutions require a combination of credible short-term solutions and a long-term integrated systems development approach such as agricultural sector policy which supports agricultural sector income potential; financial sector policy which supports financial institution sustainability; infrastructure which breaks production bottlenecks, reduces production risk and bolsters the return to capital; human capital and management development and capital market development, for both external and internal sources of capital.

The creation of a strong relation with commercial banks and rural banks (inter-bank loaning, i.e., commercial bank lending to rural banks) will help to strengthen the rural financial system and to build an internally well integrated national financial structure.

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Annex Table 1: Loans and Advances by Economic Sectors (in Millions of Birr)

Sector	1994/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
Government deficit financing	2573.7	2847.2	2132.8	2203.1	3269.8	2865.8		
Agriculture	397.2	689.5	907.2	1078.1	1315.5	1431.6	650.5	588.9
Industry	1070.8	1530.5	1713.8	1789.0	2078.7	2224.6	533.1	353.5
Domestic trade	1245.7	1728.3	2143.4	2224.1	1901.8	2267.2	1129.5	938.7
International trade	1551.5	2028.4	2502.2	2905.5	3221.8	3157.8	838.0	767.8
Housing & construction	755.1	1130.7	1452.1	1976.5	1555.5	1640.7	183.9	52.4
Transport & communication	510.3	874.8	990.5	922.4	662.7	950.1	216.3	116.5
Hotels and Tourism	249.0	270.2	363.0	424.1	425.8	319.9	89.4	138.6
Mines, power and water res.	42.0	36.8	29.9	31.5	23.4	24.5	0.0	0.0
Personal	16.4	17.2	17.7	33.3	18.7	22.6	27.8	32.6
Others	486.5	503.4	579.3	1847.7	3249.9	4039.4	261.0	177.0
Total	8898.2	11658.0	12831.9	15435.1	17723.6	18944.2	3,929.5	3165.6