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# **FINANCING SMALL FARMER DEVELOPMENT IN ETHIOPIA**

**Haileleul Getahun**

## **1.1 Introduction and Background**

Agriculture in Ethiopia is the most important sector, as measured by its contribution to total output, employment, and export earnings. Small –scale peasant farming is the most predominant mode of cultivation, and it is the peasant farmer who has suffered the most from the lack of capital, lack of technology and deterioration of the soil. Although agriculture remains the backbone of the Ethiopian economy, production has been declining since the 1960s while the rate of population growth has been steadily rising. Thus Ethiopia, which could once feed itself, has been importing food on a large scale. The fall in agricultural output could be attributed to low productivity, archaic land tenure system, weak infrastructure, and the low level of technology, political instability, recurrent drought, and above all wrong- headed economic Policy. Particularly note worthy is the lack of resources directed at increasing productivity or provision of adequate rural finance. A significant example of neglect is the woefully inadequate amount of agricultural credit available to the peasant sector and the total neglect of encouraging savings mobilization. The result is that 70% - 80% of Ethiopian peasant farmers do not receive institutional credit today. That means the majority either do not borrow or depend on the private money lender. Since 80 to 90 percent of food production is from the small farm sector, credit, along with improved technology must be provided in a form that can serve these farmers. They in turn, must increase production to keep pace with the productivity of urban population This requires the application of expensive technology. While it is widely recognized that the poor need credit for basic consumption and to finance working capital, unfortunately, they are often discriminated by commercial financial institutions because they do not have the necessary collateral and are considered “high risk” Contrary to common belief , small farmers have demonstrated their ability not only to pay high rates of interest but also to repay on time<sup>1</sup>.

What is needed is vigorous competition in the provision of credit through multiplicity of lenders, both public and private. The lack of or denial of capital to peasants and poor farmers by financial institutions is denying the majority of producers full participation within the productive sector. In loan decisions, the emphasis should be the productive capacity of the farmer borrower rather than on collateral.

. On the other hand obtaining and processing documents substantially increases the cost of loans, delay their disbursement and discourages borrowing by small farmers and tenants. Small-scale farmers are usually penalized by the cumbersome and time –consuming procedures involved in applying for loans. Many lending agencies have rigid procedures for processing loans, whether large or small. These include the completion of complex forms and a pre -audit of the borrower who, if he is a small farmer, is often illiterate. Before the loan is issued, an official has to visit the farmer’s holding, and when the loan is eventually made, the funds and documents have to be collected at the lending institutions (which may be far from the holding). The repayment terms will often lack the flexibility needed to accommodate the natural hazards of farming.

## **1.2 Savings mobilization**

Credit allocation is only one facet of financial intermediaries. The other aspect is resource mobilization. The importance of (savings) mobilizations in credit schemes cannot be emphasized enough. Savings can be voluntary or compulsory where group members save a small amount every week and deposit it in a saving fund. Mobilized savings can be transformed into productive uses in the form of rural credit to assist in the adoption of technological innovations, expanding production and improving consumption<sup>2</sup> Some rural development experts argue that the rural population is poor and can not save given their limited subsistence income. However, it is now a well established fact that the rural poor can and do save provided they are given the

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necessary incentives. In other words rural households have a substantial capacity for voluntary savings and such savings need to be promoted and strengthened through national saving campaigns and education to this end<sup>3</sup> It should be noted that the propensity to save is more evident among the rural poor than among the urban poor and that rural dwellers are more inclined to invest their savings in productive assets than consumer goods.<sup>4</sup> Therefore, a developing country like Ethiopia needs to improve its efforts at saving mobilization and thereby increase its access to development finance. Increase in the savings is naturally expected to lead to a reduction in independence on foreign aid. Evidence of the success of financial institutions serving the rural areas can be found in the innovative approaches undertaken by the Grameen Bank in Bangladesh; the Rural Bank of Ghana and the National Bank of Kenya just to mention a few. These institutions represent well-documented case studies of successful lending and saving mobilization strategies in the rural areas. Savings may take many forms ranging from monetary assets such as cash, bank saving deposits and other liquid assets, to real assets such as crop inventories, land, and jewelry and labor services. Traditionally, savings mobilized in rural areas have been –relent primarily in urban areas, where higher interest rates prevailed. A well known FAO credit specialist argues that to make savings a more effective instrument for development, it must be linked to formal financial markets. For this to occur, he suggests the following incentive.

- The creation of convenient savings channels for beneficiaries
- Safety and accessibility of deposits
- Attempt to develop the best possible deposit and withdrawal arrangements at lowest possible cost to the saver
- An attractive yield or interest rates on those savings<sup>5</sup>

Higher rate of interest will induce people to increase savings further in the form of deposits and bonds rather than divert those savings toward the purchase of gold, jewelry, or hoards of

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foreign exchange. Low interest rates may also divert potential savings toward less useful investment. Increased mobilization of savings in the rural areas would necessarily entail having access to formal saving and lending institutions. However, as a result of an urban bias in development policy, most financial institutions are currently concentrated in the urban areas and centers of population much to the neglect of rural areas. Financial institutions need to branch out into the rural areas to allow rural residents access to such institutions. In other words, the rural money markets needs to be tapped, not only through the traditional local branch establishment, but also through offering appropriate savings and credit investments suited to the needs of rural population<sup>6</sup>

### **1.3.Major Problems confronted by small-scale farmers**

It is important to understand why lending to small farmers is so difficult and why they prefer borrowing from informal sources even though rate of interest for such borrowed capital may be higher. As pointed out in the beginning of this discussion, lending institutions refuse loans to poor farmers because they do not have the necessary collateral and are considered “high risk.” Financial institutions are discouraged because foreclosure is extremely difficult to implement and often politically unacceptable. Most lending agencies are urban- based and urban-biased. They prefer dealing with industrial and commercial enterprises in urban areas and center of population. They have rigid procedures for processing loans, whether large or small. There are usually delays in processing, and when the funds are finally disbursed the funds and corollary documents can be received only at the office of lending institutions that may be far from the borrower’s residence. Moreover, the repayment terms often lack the flexibility to accommodate the natural hazards of farming. Most financial institutions are afraid that there may be failures of farmers to repay their debts on time, or repay at all. Furthermore, the transaction costs of dispensing and supervising small loans are very high thus limiting the access of small cultivators to institutional source of credit.

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The plight of small Cameroonian farmers, described by Bouman and Hartevelt, is one that applies to other African countries, including Ethiopia:

“Obtaining institutional credit often implies, a day’s trip or more to a remote town in unfamiliar surroundings. Institutional credit, particularly where impressive looking banks are involved carries the aura of aloofness and foreboding .Its splendor, its impersonal approach, its complicated formal and legal procedures rouse the villager ‘s suspicion. The cool, sometimes hostile reception by a condescending clerkdom, makes the ordinary men feel and ill at ease. A rotating credit association, (informal source of lending such as djanggi in Western Cameroon), is home bound .The villager is amongst his equals in manner and speech. He understands what is going on and is familiar with its mechanism, his rights and obligations<sup>7</sup>

The statement above clearly explains the negative attitude of small farmers toward urban based financial institutions. On the other hand modernizing agriculture requires innovative approaches of production technology. Example of such technology include the introduction of yield - increasing crops, herbicides , fertilizer , machinery, crops that are resistant to drought and, heat or cold.. Agricultural productivity can be improved if financial institutions are willing to modify the rules and regulations that govern the requirements for collateral and the procedures involved for borrowing by small farmers.

#### **1.4 Group Lending**

Because a wide variety of borrowers are denied access to institutional credit, some developing countries have initiated innovative credit schemes based on group lending or group guarantee which have contributed to the reduction of both the risks and administrative costs. It began in Bangladesh as a modest grass-roots initiation by a young professor who

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organized small groups of villagers to enhance their income and employment. (lending as a means of solving the problems of rural credit by expanding the 'informal' or unconventional credit market that includes savings and loans associations, rotating funds, family-based lending and unconventional banks geared specifically, to the needs of the poor). Under the group guarantee approach several governments and non- governmental organizations (NGOs), have become active in providing financial services through organizing groups of persons to save and / or borrow together. This cohesive group serves as intermediary between its members and formal financial institutions by depositing savings, which serve as collateral with the latter. It then obtains group loans from the financial institutions for on- lending to its members. The loan is used for income generating activities of the group or the individual. To avoid loan delinquency and create mutual trust between farmer groups and financial institutions , emphasis is always placed on developing group responsibility for individual borrowing. This emphasis on group discipline and financial responsibility is instilled through training and strict enforcement. of the law.

Instead of concentrating largely in urban centers, lending agencies should open more Branches in the rural areas to facilitate the transformation of the rural subsistence sector, as well as promote the banking habit through the provision of credit and deposit facilities. In establishing saving/ credit programs, considerable emphasis should be placed on training credit program field staff and beneficiaries. Beneficiaries should be given high priority in training that should include " farmer –trains –farmer " methods with content based on group – identified needs. Additional skill training should be organized at national and /or sub-regional level for field staff, taking into account changing program requirement and using appropriate methodologies and training aids. The loan –savings scheme provide incentives for regular savings mobilization, credit allocation and effective financial intermediation of the rural subsistence sector. This innovative approach seems to be the most promising for reaching large numbers at low cost

The creation of a regular and minimum savings habit is indispensable for development at all levels, including that of the individual family. Rural people should, therefore, be encouraged to make regular savings in order to accelerate the saving process, to reinforce the saving habits, and to strengthen group commitment and solidarity.

### **1.5. Source of Rural Credit in Ethiopia**

***The informal financial Sector.*** Most of the credit that is available to the Ethiopian subsistence peasant sector comes from the informal financial sector. Some 70% - 80% percent of the small farmers in Ethiopia either do not borrow or depend on the private money lender. Though accurate data is difficult to find, it is estimated that about one percent of the total number of farmers use institutional credit. The bulk of the agricultural loans emanate from non-institutional sources such as the private money lender, other farmers, middlemen, neighbors, friends, relatives, and merchants. The interest rate on such loans are very high. In the Chilalo, Agricultural Development Unit for instance, before the launching of the project in 1967 the interest rate charged by the private money lender was 50 and 100 percent. However, after the project was operational, it declined to only 12 percent. Because of the collateral requirements, small farmers are forced to borrow from informal sources. The private money lender is not involved in saving mobilization efforts, concentrating in only providing credit. Informal sources of credit have the advantage of adaptability, organizational flexibility, popular participation, easy accessibility, and relatively low operational cost.<sup>7</sup> Most of the credit that is available to farmers in developing countries is short-term for one crop season or for one year or two years. Such loans are in cash or in kind. Collateral security for loans takes many forms, ranging from land mortgages, liens, on crops Personal guarantors, to formal promissory notes.

***Formal Financial Institution:*** Formal financial institutions operating in Ethiopia are

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largely urban – based and urban oriented, with their clientele almost exclusively in the domain of urban merchants and traders. These institutions include the National Bank of Ethiopia, the Commercial Bank of Ethiopia, and the Agricultural and Industrial Development Bank (AIDB). Since 1992, four privately owned banks with 33 branches have opened and become operational. These are the Bank of Abyssinia, the Awash International Bank, the Dashen Bank, and the Wegagen Bank. Information about these banks is very sketchy, but are characterized by the profit motives, little or no rural savings mobilization efforts and inadequate provision of credit to the rural subsistence sector. Their insistence on loans to individuals and physical collateral for securing agricultural loans has impeded the expansion of agricultural credit services to small farmer.<sup>8</sup> The major institution with rural outreach are:

**The Commercial Bank of Ethiopia**-- As noted previously the Commercial Bank of Ethiopia constitutes the core of the Ethiopian financial services system. This institution was Created with its only motive to make profit, and has had inadequate provision of credit and saving mobilization in the rural areas. The commercial Bank has traditionally channeled most of its loans to other sectors of the Ethiopian economy, and has been reluctant to deal with subsistence agriculture. It has a poor record in making loans available to agriculture because of its emphasis on collateral requirement rather than the productive capacity of small farmers. Land is the most acceptable form of security, and tenants have no land or other security to offer. Even after the 1975 Land Reform proclamation that made all rural lands the “collective Property” of Ethiopians land title remained in the hands of government. Since tenants have only a usufruct<sup>9</sup> right to the land, obtaining loans by using land as collateral was out of the question. The other problem was the high (25%) interest rate charged by the Commercial Bank. Credit worthiness was thus largely confined to those larger land owners or those who had a salary<sup>10</sup>. Since the Commercial Bank already has an extensive network of more than 100 rural branches, it

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has the potential to provide credit services to most rural Ethiopia without the cost and delay associated with building a new institution. Creating a more flexible set of rules and regulation under which credit can be granted and saving mobilized is a necessary first step in realizing that potential. Providing access to credit further encourages private investment. The Commercial Bank should therefore be encouraged to innovate and to move away from the traditional orientation. The best way of achieving this is through preferential rediscount rates, used on temporary basis to familiarize it with agricultural lending.

*The Agricultural and Industrial Development Bank (AIDB)*- The Agricultural and Industrial Development bank (AIDB) – The Agricultural and Industrial Development Bank of Ethiopia was established more than half a century ago by merging the Development Bank of Ethiopia and the Ethiopian Investment Corporation. It was intended to act as the major government instrument to mobilize and channel funds for accelerated development of Ethiopia’s agriculture and industry<sup>11</sup> Since the majority of peasants had too small incomes to spend on agricultural improvements, the Development Bank of Ethiopia did initiate a small agricultural loan program in the 1950s. The benefit went to those who could afford the collateral necessary to guarantee their loans. Those who did not own land could not benefit from the program<sup>12</sup> Still, the project failed due to high service costs and default rates, and was discontinued by the mid –1960s. The AIDB was established as a specialized credit institution for lending to agriculture. Yet, before 1974 no more than 20 percent of agricultural credit was provided by the AIDB and only 25 percent of peasant crop land treated with fertilizer provided by the government agencies, such as the Agricultural Marketing Corporation<sup>13</sup>

The World Bank study of Chile, Colombia, Ethiopia and Honduras indicated that at the time of the survey, larger farmers were the main beneficiaries of institutional credit<sup>14</sup> Another study

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revealed that in 1971-1972, only 7 percent of the loan granted in this period could be classified as being directed toward those who need them<sup>15</sup> Like other financial institutions, AIDB demanded security in land or cash for credit thus restricting its clientele to the wealthy. The poor and most vulnerable group of farmers was deprived of access to an institutional source of lending. The bank's insistence at lending at commercial rates obviously reduced greatly the number of small farmers who could receive loans. The AIDB also operated as a highly centralized bureaucratic structure, which tended to make it ill -suited for lending to large numbers of highly dispersed small farms. Excessive centralization, when dealing with small farmers, often results in increased administrative costs and an inability to adjust programs to local conditions because of political interference.

In order to minimize costs of credit and to enhance credit delivery to the rural community, the Use of service cooperatives as intermediary organization between the AIDB and peasant should not be underestimated. In the early years after the Ethiopian revolution, the AIDB channeled short- term loans through service cooperatives to reach small farmers via their peasant associations. On average, about five peasant associations formed a service cooperative. Service Cooperatives would be the most appropriate body to implement a saving and credit program in the rural areas of Ethiopia. Another advantage is that Service Cooperatives have the potential to mobilize resources, including finance and labor, for the development of the peasant sector, and crop marketing and distribution of inputs. Given sufficient freedom and legal support, the Service Cooperatives would be the most appropriate institution for self –sustaining development in the rural areas of Ethiopia. Sufficient freedom and legal support means less government regulation and interference, as well as legal status and legal protection.

#### **conclusion and suggestion**

The percentage of small farmers receiving institutional credit are very small. Large farmers have

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thus far been the main beneficiaries of institutional credit. Financial lending institutions have rigid policies and are reluctant to deal with subsistent farmers. They have always required that small borrowers pledge some collateral, usually land, as loan security, and small farmers have no security to offer. Excluding the majority of peasant farmers from participating in the saving/ credit program simply because they do not have physical collateral is quite illogical.

On the other hand small farmers have to buy current inputs, such as seed, fertilizer and herbicide .in order to produce a marketable surplus and thereby contribute to the development process of the country. Equally important is mobilization of savings. One method of increasing the flow of funds within the agricultural sector is to tap the surplus funds of those who have successfully adopted the new technology. Savings is, of course a relatively new concept in Ethiopia and for that matter in Africa, nevertheless even those farmers who have not successfully adopted the new technology should be encouraged to save. The Federal government of Ethiopia, along with the financial institutions of the country need to develop a more rational lending/ saving policy where poor farmers and peasants would have relatively greater access to loans. Loan -saving scheme between informal groups and formal institution should be promoted .in other words there must be some form of group responsibility for individual borrowings –an approach which has yet to be developed on a large scale.

Ronald Hope offers the following strategy for successful lending and saving mobilization in the rural areas: “lending agencies, whether public or private should establish their office at convenient location, lending should be to like- minded individuals and groups of similar economic circumstances, lending based on the borrower’s project and reputation rather than collateral requirements and the negotiations of loans in the familiar surroundings of potential borrowers, rather than at the desk bank officers . Also there are requirements of minimum savings to help develop a saving habit and, as well the sense of responsibility and repayment morale of

borrowers are strengthened by tying lending to savings mobilizations.<sup>16</sup> Banking practices on agricultural credit and resource allocation should be improved and reformed to include application and loan approval procedures, collateral security requirements, personnel policies and a focus on-small- scale, peasant farmers. More banking personnel should be trained and located in rural branches, and recruitment is needed of more qualified agricultural staff for viable farming projects

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