Banking reform and SME financing in Ethiopia: Evidence from the manufacturing sector

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This study investigates the effect of banking reform on Small and Medium Enterprise (henceforth SMEs) access to bank credit during post-liberalization period 1994 to 2007. Aiming at casting light on the changes in the country’s banking sector, bank concentration, competition, efficiency, and liquidity have been assessed. In addition, survey of 102 randomly selected manufacturing SME has been conducted to examine changes in SME access to bank loan. Assessment of changes in the banking sector reveals that the sector has become less concentrated. However, competition among banks is weak, which is manifested through operational inefficiency and accumulation of large stock of liquidity. This led to persistence of lack of access to bank loan even after the reform. The study also finds that access to loan is limited across firms of different age groups, ownership forms, and at different stages of SME development. In general, despite the introduction of banking sector reform in 1994 that led to expansion of the banking industry, SMEs’ problem of credit access has persisted. This implies that changes in the banking sector structure per se are not sufficient to introduce competition in the banking industry and an improvement in SME credit access. Policy makers should therefore devise mechanisms that enhance competition in the banking sector and establish a policy framework that encourages them to lend to the SME sector.

Keywords: Ethiopian financial sector, Banking reform, SME financing, manufacturing sector, credit Access.

INTRODUCTION

The effect of banking sector liberalization on SMEs access to loan is one of the most interesting areas in the study of financial liberalization and credit access. Extant literature on financial liberalization documents that liberalization boosts economic growth through fostering the development of the SME sector by easing their access to external finance (Laeven, 2000; Beck et al., 2004). This is further supported by country case studies that brought to light the positive effect of liberalization on SME credit access. For instance, financial liberalization in Korea led to a narrower interest spread and a lesser reliance of banks on collateral (Hübler et al., 2008), easing of the access to credit of hitherto financially constrained firms (Koo and Shin, 2004). However, studies focused more on emerging economies in Asia, South America and Central and Eastern Europe, while only a few on SSA countries. Besides, owing to the fact that countries pursued different paths in liberalizing their financial sector, more country case studies are needed to help in establishing the theoretical framework useful in understanding the nexus between banking liberalization and SME credit access. Ethiopia undertook a banking reform program in 1994 three years after the centrally planned economy was scrapped, and a market economy was launched by the new government. The reform, ardently supported by the World Bank and International Monetary Fund (IMF), brought about changes to the financial platform. Opening the financial sector to private investment was the first step in liberalizing the market. The banking sector liberalization policy, however, inhibits foreign bank entry in any form and does not allow purchase of shares by foreign nationals. Besides, despite proliferation of domestic private banks, state owned banks still lead the banking sector with a considerable share of the market. This prompts a legitimate question as to whether banking sector liberalization eases SME credit access under a
condition where the sector is dominated by state owned banks and where it remains closed against foreign entry. This study is therefore needed to answer this vital question, thereby bringing the experience of a developing country in the SSA region into the extant body of literature. To the best of my knowledge, this is the first ever piece of study shedding light on the link between banking liberalization and SME credit access in Ethiopia.

Thus, the study investigates performance of the banking sector over the period from 1994 to 2007, focusing on concentration, competition, efficiency, and liquidity. Aiming at examining changes in SME access to bank loan, survey of 102 randomly selected manufacturing SME was conducted and access to credit is evaluated in relation to form of ownership, age, and possession of fixed assets; and at three stages of development: startup, operation, and growth. Assessment of changes in the banking sector reveals that the sector has become less concentrated, concentration declining at a much faster rate in the loan market than in the deposit market. However, the results suggest that there is no significant change in competition and efficiency, and the sector has been continuously accumulating liquidity. In general, the financial reform did not bring a robust change in the banking sector that can enhance SME access to credit.

Survey result also shows that there is no improvement in SME credit access during the post-reform period. No significant variation is observed in access \textit{vis-à-vis} age and ownership form. It has been found that firms that own fixed assets have a relatively better access to loan compared to those that do not, signifying the importance of collateral in the credit market. Assessment of access at different stages of business life cycle also shows that SMEs are constrained at all stages of their life cycle. In general, it has been found that a change in the structure of a banking sector \textit{per se} does not enhance credit access. Hence unless the banking sector becomes so competitive as to compel the incumbent institutions to design schemes that help in reaching out to the hitherto financially constrained firms, SME exclusion from the credit market will persist. The policy and theoretical implication of this finding are two folds. First, it brings a lesson that a mere change in the structure of the banking sector does not boost credit access. Second, SME financial constraints may stay unresolved unless banks make a shift from collateral-based lending toward schemes that recognize such important attributes as profitability, degree of business risk and management quality.

The rest of the paper is organized as follows. Subsequently, the study reviews related literature, after which the financial liberalization in Ethiopia was described by tracing back the origins and evolution of banking in the country. The data and research methodology are described, and the change in the Ethiopian Banking sector from the dimension of concentration, competition, liquidity and efficiency was presented. This was followed by a report on the results of the survey of manufacturing SMEs, shedding light on their access to loan during the post reform period, after which the study was concluded.

**LITERATURE REVIEW**

In their seminal papers, McKinnon (1973) and Shaw (1973) postulated that financial liberalization, narrowly defined as interest rate decontrol, promotes saving and investment, leading to economic growth by improving efficiency of capital allocation. They argue that the interest rate that equates demand for and supply of deposit encourages savings, and makes more funds available for investment. This has been confirmed through empirical studies in developing countries that shows that keeping interest rate at a moderate level boosts growth (see Ghatak, 1997, Ang and McKibbin, 2007; Levchenko et al., 2009).

Despite successful implementation of financial liberalization program and attainment of financial deepening and economic growth in some countries, there are indeed nations that did not reap the desired benefits. Even worse, some dived into a deep financial crisis following liberalization. For example, Mexico liberalized its financial system in the 1990 only to see serious banking crises afterwards, costing the government quite a large sum of money in bailing out insolvent banks. Similarly, Korea had a financial crisis in 1997 triggered by financial liberalization, resulting in financial insolvencies and closure of many of its banks. In SSA countries such as Kenya and Nigeria, financial liberalization played no discernible role in achieving financial deepening and economic growth (Ayadi and Hyman, 2006). In their paper that investigates the causes of financial crises in selected SSA countries in the 1980s and 1990s, Daumont et al. (2004), also find that the financial liberalization program gave rise to banking crisis that swept across countries in the region.

Following unfruitful liberalization efforts in some countries and a banking crisis in others, scholars started to doubt the role of financial liberalization in enhancing economic development. Studies revealed that, for financial liberalization to succeed, macroeconomic stability and institutional framework are prerequisites. Explaining why bank efficiency has dropped following liberalization of Turkish financial sector, Denizer et al. (2007), blame macroeconomic instability and existence of scale problems. According to Levine et al. (1999) legal and accounting reforms must precede financial reform in order for it to bear fruit. Similarly, Tornell et al. (2003) discovered that countries with contract enforcement fared better in their financial reform program than those that launched a liberalization program without legal and institutional framework in place. Explaining the causes of financial system collapse following liberalization in SSA countries,
Daumont et al. (2004), hold the macroeconomic instability and heavy hands of the government as the chief culprits. However, both theoretical and empirical studies mutually agree that, despite the fact that liberalization in some countries was followed by banking crisis and decline in national output, it pays off, especially when the economic cost of a repressed system is taken into account. That is why researchers and policy makers, including the two Breton woods institutions, ardently advocate it. As discovered by Wyplosz (2001), compared with industrialized nations, developing countries have a strong economic boom following financial liberalization. There is a strong empirical support that a cautiously laid out plan of liberalization brings about financial deepening, credit access to hitherto marginalized enterprises, cut in unemployment, and growth in national output. The adverse economic conditions that followed liberalization are not its inherent consequences but simply outcomes of mismanagement. Reinforcing the foregoing claim, Hagen and Zhang (2006) warn that a drastic move towards financial liberalization is counterproductive, and firmly advocate a gradual and careful move. The failure of both Mexico and Korea in their liberalization effort lies in the fact that both undertook liberalization without putting in place institutional and legal framework beforehand. It is therefore indisputable that a wisely implemented liberalization program may enhance financial development and economic growth.

Although, literature converges to the view that financial liberalization leads to efficient allocation of resources, the channel through which its effects are revealed is subject to debate. Some scholars, following the same line of argument as McKinnon (1973) and Shaw (1973), show that interest decontrol encourages saving and hence makes more funds available for investment, boosting up investment activities leading to a higher national output (Koo and Shin, 2004). Others, on the other hand, present evidence that the affirmative effect of financial liberalization is revealed through its enhancement of SME credit access (see Berger et al., 2004). Consistent with the latter group Laeven (2000), using a panel data on a large number of firms in 13 developing countries, finds that liberalization affects small and large firms differently. His findings are consistent with earlier literature that a repressed financial system harms smaller firms much more than larger ones, and a financial reform therefore benefits SMEs much more than large and well established firms.

The move to date by governments around the world towards financial liberalization shows that some have drastically launched liberalization program by entirely relinquishing state ownership of banks and allowing foreign investors in the sector, while others opted for an overly cautious move with continued state control. The two being extremes in the continuum, there are quite a lot of different models. For instance, in Ethiopia, state owned banks run in tandem with domestic private banks. Although, literature does not provide a clear cut view as to which particular mode of liberalization leads to an optimum result, scholars heavily criticize government control of financial institutions. While the efficacy of privatization of state owned banks is an ongoing matter of scholarly debate, many share the view that relinquishment of ownership control of banks by the state is a signal of a more efficient financial sector (Berger et al., 2004). Studying the effect of bank privatization, Clarke et al. (2005) show that benefit of bank privatization is maximized when the state fully relinquishes control interest. State ownership of banks is often associated with inefficient credit market characterized by politically motivated lending. Equally debatable is the real effect of foreign bank entry in fostering competition in the banking sector and in enhancing credit access. Empirical evidence has a mixed result, fueling further debate in the area. Cull et al. (1999) , in their study on the Argentinean banking sector, find that foreign banks compete in sectors where they have a comparative advantage, and domestic banks face a stiffer competition in areas where foreign banks enter. It follows that market segments less attractive to foreign banks would see no discernible change in access to bank loan. This has been confirmed by Gormley (2009) who, drawing the post-liberalization experience of India, finds that foreign banks engage in “skimming the cream”, focusing on the most profitable segment of the market, disregarding lending to SMEs. Moreover, firms reported a fall in loan accessibility following foreign bank entry, due to a drop in domestic bank loan, and the decline was significant among SMEs. Supporting the earlier view, Sengupta (2007) posits that foreign banks lend more to large firms thereby disregarding SMEs.

In contrast, Haas and Naaborg (2005) find that acquisition of local banks by foreign banks has not led to a persistent bias in the credit supply towards large multinational corporations. Instead, increased competition and the improvement of subsidiaries’ lending technologies have led foreign banks to gradually expand into the SME and retail markets. Using data from 35 developing and transition economies, Clarke et al. (2006) find that all enterprises, including SMEs, face lower financing obstacles in countries with higher levels of foreign bank presence. Foreign bank entry is followed by a drop in margin and profit caused by increased competition in the market. Using data from 80 countries, Claessens et al. (2001) also find that in developing countries, foreign banks win a significant share of market from domestic banks using their excellence in competition. This leads to domestic banks engaging in lending to firms hitherto considered not commercially viable to compensate for market surrendered to more efficient foreign banks. This is consistent with Unite and Sullivan (2003) who find that foreign entry corresponds with improvement in operating efficiency. In general, under a well functioning bank regulatory and supervisory system and institutional and
Financial services in Ethiopia dates back to the onset of the 20th Century, when Bank of Abyssinia, the first bank in the country, was established in 1905 as a branch of Bank of Egypt by the courageous move of Emperor Menilik II, based on a 50 years concession with the British authorities. Bank of Ethiopia was established in 1931, replacing Bank of Abyssinia after agreement was reached among stakeholders to liquidate the latter. However, it too was liquidated following the Italian invasion in 1936, and was re-established in 1942 bearing the name State Bank of Ethiopia. Three specialized banks were also established during the same period: Development Bank of Ethiopia in 1951, the Imperial Saving and House Ownership Public Association (ISHOPA) and the Housing and Saving Bank in 1962, and the Investment Bank of Ethiopia in 1963. In addition to state owned banks, there were private banks operating in the country in which foreigners as well had ownership equity. The Agricultural and Industrial Development Bank (AIDB) was set up in 1970, taking over two earlier development banks: the Development Bank of Ethiopia and the Ethiopian Investment Corporation. The Housing and Savings Bank was created in 1975 out of a merger between two earlier housing finance institutions (see Mauri, 2003).

The socialist regime that took power in 1974 redesigned the banking platform of the country through its nationalization policy. All the private banks operating at that time were brought into state ownership and merged with Commercial Bank of Ethiopia. The state owned banks were designed to serve as a tool in materializing the government’s economic policy, built on the socialist ideology. Nationalization of the financial and non-financial firms led to a significant fall in private sector loan. Credit to the private sector fell to 40% of outstanding loans during the socialist regime, from 100% during the Imperial period (Addison and Geda, 2001).

The banks focused on serving the public sector, and private sector investment was marginal. Substantial portion of the loans were channeled to state owned farms and public enterprises. The credit market disenfranchised the private sector as evidenced by average private sector credit of 14% over a period from 1985 to 1989 compared with loan to the central government of 60% of outstanding loans (Addison and Gada, 2001).

The 1991 revolution brought with it market economy, compelling the government to gradually relinquish control of the economy, and promote economic growth through private sector development. The new government placed financial liberalization at the top of its Economic policy and allowed participation of the private sector through banking business proclamation of 1994. The reform did not, however, take privatization of state owned banks as a necessary step. The private sector expanded driven by denationalization of state owned enterprises and opening of large parts of the economic sector to private investment. It was thus, expedient that the financial sector is redesigned to satisfy the increasing demand for financial services. Banking sector reform has been undertaken giving rise to the reemergence of private banks that brought change in the face of the financial platform.

Following licensing of private banks, state owned banks gradually relinquished market share to a bit more efficient new banks. The sector had three players in the field in 1994, all state owned, with CBE alone controlling above 90% of the market share, while there are ten more banks in 2007, all private owned, controlling nearly one half of the market. Bank branch network has increased from 192 in 1994 to 458 in 2007 of which 44% belong to private banks. CBE alone mobilized 95% of deposits in 1994 while its share in the deposit market has plummeted to 60% in 2007, surrendering a third of its deposit market to private banks. Outstanding loans stood at ETB 3.8 billion in 1994, while it rose to ETB 24.8 billion in 2007, of which more than 60% represents that of private banks. Assets of the banking sector has also grown from ETB 12 billion in 1994 to ETB 65 billion in 2007, and bank capital increased over seventeen folds from ETB 275 million to ETB 4.7 billion. Taken at face value, the foregoing Figures 1 to 8 suggest that there is change in the banking sector, serving as a primary motivation for this study that investigates (1) whether there are changes in concentration, competition, liquidity, and efficiency and (2) impacts of the changes, if any, on SME credit access.

DATA AND METHODOLOGY

Data
This study uses combination of primary and secondary data. The primary data involves survey of manufacturing SMEs, while the secondary data is collected from two state owned banks and six
Figure 1. Loan to deposit ratio; based on data from Annual Reports.

Figure 2. Net Interest Margin; based on data from Annual Reports.

Figure 3. Overhead cost; based on data from Annual Reports.
private commercial banks operating in the country. The survey was conducted covering a randomly selected sample of 102 manufacturing SMEs operating in Addis Ababa, the capital that hosts nearly one half of manufacturing SMEs. The sample represents 13% of manufacturing SMEs operating in the country. The firms are stratified into 10 industrial classes: Food products and beverages (31.4%), wearing apparel (5%), Tanning and dressing of leather; manufacture of footwear, luggage and handbags (7.8%), Paper products and printing (15.7%), Chemical and chemical products (5%), Rubber and plastic products (6.9%), Non-metallic mineral products (5.9%), Fabricated metal products (2.9%), Machinery and equipment (7.8%), and Furniture (11.8%). In terms of age, the sample includes firms with varying age groups ranging from those established during the present regime (58%) to those set up during the socialist regime (21%) and imperial regime (21%). The survey is conducted using a door-to-door interview. The secondary data includes key financial figures acquired from audited annual financial statements of two state owned banks (Commercial Bank of Ethiopia (CBE) and Construction and Business Bank (CBB)) and six private banks (Awash International Bank Sc.(AIB), Dashen Bank Sc.(DB), Bank of Abyssinia Sc.(BoA), United Bank Sc.(UB), Wegagen Bank Sc.(WB), and Nib International Bank Sc.(NIB)) over a period that stretches from 1994 to 2007.

**Methods**

Changes in the commercial banking sector have been evaluated using concentration, competition, liquidity, and efficiency indicators. **Dominant bank’s market share**, **n-concentration ratio**, and **Herfindhal Hischerman Index (HHI)** are used to measure structural concentration. Lerner (1934) index an indicator of market power is used to determine the extent of competition. Banking sector efficiency is measured using net interest margin and overhead cost, following the work of (Beck et al., 1999). The net interest margin is measured as the ratio of accounting value of a bank’s net interest revenue to its total assets. Overhead cost ratio is measured by computing the accounting value of a bank’s overhead costs by total assets. Bank liquidity is measured using the ratio of loans to deposits.
IMPACT OF THE REFORM ON THE BANKING SECTOR

Prior to the reform, the Ethiopian banking sector comprised three state owned banks. CBE was the market leader mobilizing over 95% of deposits, 85% of loans, and with branch net work of around 76% of bank branches in the country. It would also act as a financier for the other two specialized state owned banks, by extending long-term loans and also by keeping a time deposit to satisfy their demand for fund. The financial reform, marked by opening of the sector for domestic private investment through Licensing and Supervision of Banking Business Proclamation No. 84/1994, has brought changes into the state-bank-dominated banking market of the country. One new bank popped up in the banking market every year till 1999, bringing the number of private banks to six by the end of 2007.

A cursory look at the CBEs gradual loss of predominance shows the changing face of the banking sector. CBE, the industrial giant that assumed a market leading position with a quasi-monopoly power, is now sharing the market with the private banks. Its branch net work now represents only 38% of bank branches, falling from 90% in 1994; mobilizes 61% of deposits compared with 95% in 1994; originated 35% of bank loans outstanding in 2007 compared with 87% in 1994; and its net worth represents only 33% of banking sector capital diving from 84% in 1994. To paint a better picture of the trend of changes in the banking market, we look at
structural concentration, competition, liquidity and efficiency.

Concentration and competition

Concentration is measured using dominant bank’s market share and n-concentration ratio, and HHI. The market share of CBE is used to compute the dominant bank’s market share; CR-3 includes three biggest banks namely the CBE, AIB, and DB. The HHI includes all banks in the study.

As shown in Table 1, Dominant bank’s share, CR-3, and HHI have all been generally declining. One can note that the decline in concentration in the loan market is faster than that in the deposit market, implying a more vigorous penetration of private banks into the credit market. Decline in the deposit market at a slower pace manifests the government’s long standing directive that obligates government agencies to keep their account at the state owned Commercial Bank of Ethiopia. This directive helps the bank to cling to large share of the market, losing only a small portion of it over the years. Consequently, the private banks could not penetrate into the entire deposit market, but managed to narrow the gap in the loan market significantly, as evidenced by a fall in CBEs share in loans to 35% from 87% compared to a fall in the share in deposits to only 61% from 95%.

Despite the use of concentration as a signal for degree of competition, recent literature casts doubt over its propriety in serving as a proxy for competition. Berger et al. (2004) suggest that concentration may not be an appropriate measure of competition because it may not prohibit competition in a market with less regulation and more possibility for foreign bank entry. Schaeck and Čihák (2007) and Casu and Girardone (2009) also find that concentration as a measure of market structure is unlikely to capture competition. Instead, Lerner (1934) index as shown in Table 2 commonly used as an indicator of the degree of market power, is considered more robust in capturing competition. The index denotes the extent to which firms fix a price (p) above marginal cost (mc) using their market power. A value of the index close to zero indicates perfect competition, while a value of one indicates monopoly. Analysis of competitiveness in the banking market is confined to the period 2000 to 2007, over which data for all banks under study is available.

A Lerner index that hovers around 0.50 suggests that the banking market is neither perfectly competitive nor monopolistic; it is moderately competitive with a certain degree of monopolistic power. Although, volatile, there seems to be an increase in market power of each bank, suggesting that there is a room for banks to exercise such power. As indicated by the average, CBE is still predominant in the banking industry. Virtually all the private banks have gained a lot of market power, but they could not emulate the industrial giant. Despite a persistent decline in bank concentration in Ethiopia since 1994, competitiveness in the banking sector has not improved so well. This is because for one thing interest is not fully decontrolled as the minimum deposit rate a bank can pay is still dictated by the National Bank of Ethiopia. Secondly, a boundary has been set for private banks to compete in the deposit market by requiring all governmental agencies to keep their demand deposit at the Commercial Bank of Ethiopia, this gives the state-owned bank an exclusive advantage over private banks. Thirdly, with the lowest bank-branch to population ratio, demand for financial services still exceeds the supply, leaving little incentive for banks to aggressively compete for market. The divergence in our conclusion using measures of concentration and competition might be due to inability of concentration to serve as a proxy for

![Figure 8. Source of working capital; Field Survey.](image-url)
Liquidity

Liquidity of banks measures the extent to which they extend loan out of the funds they acquire from depositors. Too low liquidity, represented by a high loan to deposit ratio, may signal a lax lending policy and excessive credit risk, while too much liquidity may signal a stringent lending policy and hence a credit restraint. Consistent with the findings of Sacerdoti (2005) for selected countries in SSA region, the Ethiopian banks too have excess liquidity. The average ratio for the period 1997-2007 ranges from the minimum of 44% for CBE and maximum of 93% for NIB. The industrial average is 77% and CBEs loan to deposit ratio represents a little more than one half the industrial average, implying that compared with the private banks, the state owned bank lags in mobilizing deposits. The foregoing ratios show that banks follow an overly conservative lending policy, which is testified by a huge collateral requirement. For instance, 96.3% of loans in the country are backed by collateral compared with average of 73.6% for SSA, and value of collateral as a percentage of loan is 173.6%, by far greater than the regional average of 109.1%. Besides, collateral burden of 178% for SME loan compared with 165% for large firms signifies that the burden is heavier on smaller firms.

As depicted in Figure 1, the industrial average follows a declining trend, despite private banks share exhibiting no significant change over the study period as the ratio stayed at slightly the same level in 2007 relative to 1997. A continuous decline in CBE’s loan to deposit ratio implies that the bank has been continually tightening its credit policy. Although by far better, even the private banks did not maintain their original pace in giving out loans; as revealed by a lower ratio since 2002. The industrial average rose only momentarily over two years, receding to its previous position afterwards. The implication one can draw is that overall, lending has not been growing in tandem with the growth in deposits. Although there was a rise in the industrial average in the first few years, compared with its 1997 position, the ratio did not change much over the period, manifesting “no collateral no loan” policy of the banks that led to rejection of possibly commercially viable projects.

Efficiency

As depicted in Figure 2, the net interest margin stayed almost unchanged till 2005 after which it started to rise. This can be explained by the fact that private banks that have been relying more on time deposit (a more expensive source of funds) started attracting deposits (relatively cheaper money) by expanding their branch networks. Private Banks has had a better margin than state owned banks since 2000 because the former charge a higher interest on loans than the latter. Overhead cost of the banking industry has been fluctuating over the entire period. Most notable is the upsurge in 2002 and a fall afterwards. The rise in overhead cost in 2002 is driven by increase in the provision for doubtful loans following issuance of a more stringent doubtful loans provision by the National Bank of Ethiopia through directive Number SBB/32/2002. State owned banks have a lower overhead compared with private banks, implying that the former, through its long years of experience might have managed to cut costs. An
alternative explanation may be that state owned banks have excessive investment in fixed assets while private banks’ investment in fixed assets is smaller, bringing the ratio down. Assessment of both net interest margin and overhead cost however shows that, overall, the change in efficiency of the banking sector is unremarkable.

SME financing during the post reform period

Here, the reports survey result in two segments; the first segment presents access to bank credit in relation to firm characteristics, that is, ownership form, age, and possession of tangible asset. This is followed by findings on SME’s access to credit upon startup, in raising working capital, and in financing growth.

Credit access related to characteristics of the firms

Form of ownership

Form of ownership of firms is heterogeneous. It takes sole proprietorship, cooperatives, partnership or privately limited companies (PLCs). As depicted in Figures 4 and 5, 48% of the manufacturing SMEs are owned by a sole proprietor and 42% are PLCs; the two alone constituting 90% of the ownership form of SMEs in the sample. Of the PLCs, majority are owned within a family group.

Analysis of access to credit based on ownership form reveals that compared with sole proprietors, PLCs had a relatively better access to bank loan. Of the firms that ever had a bank loan, sole proprietors constitute only 25% while 68% are PLCs. The figure for both partnerships and cooperative is even lower at 4% each, suggesting that these two forms have the worst access to bank credit. Only 30% of SMEs reported to have had a bank loan in their lifetime, of which 26% constitute sole proprietors, 4% partnerships, and 70% PLCs. Despite a marginal variation in access to loan among different forms, the overall picture is that irrespective of ownership, firms are seriously constrained in raising bank credit. This is consistent with the findings of Berkowitz and White (2004) that lenders disregard small firms’ organizational status in making loan decisions, because bankruptcy of the business entails foreclosure of the personal property of the owners. Where the personal property of owners is legally protected against foreclosure, lenders hesitate to extend loan in the absence of security backed by collateral. Consequently, even the incorporated SMEs have no significant advantage over the unincorporated in accessing bank loans.

Age

Country case studies document that age is also among the factors that influence firms’ access to bank loan. The influential role of age in explaining disparities in financial access of firms is accentuated when the financial system accommodates relationship lending. In countries where banks attach recognition to the length of their relationship with borrowers, older firms with a longer relationship with lenders have an upper-hand in accessing loans. This has been confirmed by Abor and Biekpe (2007) who find that older firms have a stronger relation with their bank and hence a better access to bank credit compared with younger firms that have no or lesser ties with their financier.

SMEs included in our study have ages ranging from 3 to 52 years, classified into three age groups: those set up during the imperial regime, socialist regime and the current regime. As depicted in Figure 5, 20% were established during the imperial regime, 20% during the socialist regime, and 60% during the current regime, showing that majority of the firms were set up during the post reform period in response to the private sector development strategy the government has pursued.

Disparity in access to bank loan is observed among firms set up in all the three regimes. A vertical analysis of firms across the three age groups reveals that, of those that succeeded in acquiring a bank loan, 36% are imperial regime, 15% socialist regime, and 49% current regime firms. The above figures, without prejudice to any

<table>
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<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
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<th>2005</th>
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<td>0.145</td>
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<td>0.196</td>
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<td>0.472</td>
<td>0.469</td>
<td>32</td>
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<tr>
<td>DB</td>
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<td>0.345</td>
<td>0.319</td>
<td>0.274</td>
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<td>0.416</td>
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<td>0.091</td>
<td>0.095</td>
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</table>

Own calculation based on data from annual financial statements.
additional probe, imply that post reform firms are exceptionally better in accessing bank credit. A horizontal analysis, however, tells a different story. Over 50% of imperial regime firms had access to bank loan, compared with only 26% of socialist regime firms and 23% of post reform firms. Taken at face value, this later figures may imply that imperial regime firms are better positioned in accessing credit than the younger firms.

But the reality is, those established during the imperial period might be survivors of restrained financial markets of the past and have enough collateral to pledge to secure a bank loan, whereas included in the post-reform firms are those that may not survive the existing financial famine. This weakens the effect of age in the lending decision of banks.

Ownership of collateralizable assets

SMEs were inquired on the status of the building they presently occupy to carry out business. Only 30% own the property in which they carry out business while 70% use rented building or acquired in some other way. Ownership of property varies based on size, as evidenced by 63% of medium firms have their own property while the figure for smaller one is 37%. As depicted in Figure 6, firms that own a non-residential building fared relatively better in getting a bank loan compared with those that do not have one. While 38% of firms with non-residential building had a bank loan in the past, only 16% of those without non-residential building managed to get a bank credit. It can be noted that a bank credit is not automatic even for firms that own a property. This might be due to the possibility that owing to existence of legal issues not all properties owned by SMEs are eligible to be accepted by banks as collateral.

As explained in the analysis of the credit market, collateral plays a vital role in accessing bank loan. Many SME owners complain that they are denied loan despite a strong earning capacity and future growth prospect.

Access to bank credit at different stages of development

A firm’s access to fund is often evaluated based on its ability to raise money upon startup, during operation, for business expansion, and also to meet unprecedented requirements driven by some exogenous events. Our discussion in this section is confined to the first three, namely, financing startup, operation, and expansion.

Source of seed money (financing start-up)

And add the (see Table 3) As reported by SME owners, the most serious challenge in setting up a business concern is securing funds; 76% believe raising seed money is the most daunting challenge. One of the impediments to development of a vibrant SME sector in developing countries like Ethiopia is entrepreneurs’ inability to raise start up money due to lack of willingness on the bank’s side to extend loan on a non-collateral basis. Survey result shows that establishing a business concern is difficult in Ethiopia. As reported by SME owners, the most serious challenge in setting up a business concern is securing funds; 76% believe raising seed money is the most daunting challenge.

Survey result also shows that more than 50% of the SMEs use their own saving to set up their business, while only 2% succeed in obtaining a bank loan. Using own saving is the most accessible source of financing but it is meager in most cases and hence does not cover all their start up costs. Consequently, new firms oftentimes limit their capital investment to the most essential ones that in turn restrains them from achieving the desired size upon start up.

Financing operation

Financing working capital is as challenging as financing startup for most SMEs in developing countries. Many startups die out few years after establishment due to inability to raise funds for working capital. Ismail and Razak (2003) find that firms in general prefer debt financing to equity financing, and this tendency is higher among smaller firms because of lesser desire of owners to sale ownership interest. Heavy reliance of SME on bank loan exposes them to a serious financing constraint in markets where banks follow a conservative lending policy. Survey evidences that only 4% managed to

Table 3. The most serious challenge in establishing a business.

<table>
<thead>
<tr>
<th>What is the most serious challenge in setting up a new business?</th>
<th>No. of firms</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>78</td>
<td>76</td>
</tr>
<tr>
<td>Premise</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Others</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100</td>
</tr>
</tbody>
</table>

Field Survey.
access bank credit in the form of overdraft and a short-term loan. More than 45% of the SMEs use retained profit and 33% use “Iqqub” to finance operation. The popularity of retained earnings as a means of financing operation is consistent with the findings of Abor and Biekpe (2007) that SMEs tend to retain profit to finance operation instead of seeking a bank loan.

Financing growth

As shown in Table 4 Quite a lot of the SMEs ardently desire to expand business; as evidenced by the survey result that shows 98% of them having a growth plan. The overwhelming majority of Ethiopian SMEs plan to expand operation, with more than 85% of them want to raise production capacity, the major driver behind their capacity expansion plan being existence of market. While 83% of the firms believe they have enough market to serve, 10% believe they have an edge over competitors in producing and distributing the main product. Profit retention is the predominant means of financing planned expansion, with 75% of SMEs opting it.

As a choice of 15% of the firms, “Iqqub” is the next most important source of financing growth. Only 9% of SME hope to get a bank loan to finance their planned expansion, signifying inaccessibility of bank loan. Reliance on retained profit as a source of financing growth has two problems. First, profit is less predictable and expansion plan is jeopardized when earning fails to measure up to expectation, hence hindering growth. Second, retained profit is not big enough to allow scaling up of operation by raising capacity or penetrating into a new market.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>77</td>
<td>75.49</td>
</tr>
<tr>
<td>Credit from friends</td>
<td>1</td>
<td>0.98</td>
</tr>
<tr>
<td>“Iqqub”</td>
<td>15</td>
<td>2.94</td>
</tr>
<tr>
<td>Bank loan</td>
<td>9</td>
<td>11.76</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td></td>
</tr>
</tbody>
</table>

Table 4. Primary means of financing business expansion.

Field Survey.

shows that a well laid out program of financial reform enhances economic development via different channels, one among which is improving financial access. However, studies considered countries that have taken long strides in reforming the sector, disregarding those that are gradually moving towards full scale liberalization. Besides, studies of this kind in SSA countries are so scant that the region is almost precluded from the literature. This study is set out to fill the void, shedding light on the impact of financial liberalization in Ethiopia on its SME sector.

This study covers the Ethiopian banking sector over a period from 1994 to 2007, focusing on the most important parameters: structural concentration, competition, efficiency, and liquidity. To examine changes in SME access to bank loan, survey of 102 randomly selected manufacturing SME is conducted, and access was evaluated in relation to form of ownership, age, and possession of fixed assets, and also at three stages of development including startup, operation, and growth. Assessment of changes in the banking sector reveals that the sector has become less concentrated. Concentration has been declining at a much faster rate in the loan market than in the deposit market. However, the results suggest that there is no significant change in competition and efficiency, and the sector has been continuously accumulating liquidity. In general, no robust change is found in the banking sector that enhances access to SMEs.

Survey result also shows that there has been no improvement in SME access during the post-reform period. Also no significant variation is found in access in relation to age and ownership form. However, firms that own assets for collateral are found to have a relatively better access, signifying the importance of collateral in the credit market. Assessment of access at different stages of business life cycle also shows that SMEs are financially constrained at all the stages. In general, the banking reform that changed structure of the banking sector did not succeed in igniting competition among the banks. Consequently, SMEs continue to be disen-franchised by the credit market limiting the vital role the sector can play in the economic development of the country.

Our policy recommendation comes in two packages. First and most critical is that the government should promote competition in the banking sector by lifting its heavy hands but without compromising safety and stability of the financial system. Secondly, government should step in to the rescue of the SME sector using combination of schemes. This includes initiating establishment of credit bureaus that maintain borrower information in a systematic manner useful in extending credit by employing credit scoring techniques. Besides, the state needs to launch credit guarantee programs that can run without subsidy targeting SMEs in selected industries because efficiently managed guarantee schemes can robustly enhance credit access with little distortion to the market.
REFERENCES


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