

Financing gap for micro, small and medium enterprises (MSMEs) in Ethiopia

A Demand-side diagnostic study



This BRIDGES research insight aimed at quantifying the gap between the demand and supply of credit to medium, small and micro enterprises in Ethiopia. We calculated the average loan size acquired by these enterprises, and their potential demand for credit. We found there is a huge unmet demand that requires the collaboration and coordination of multiple stakeholders to address.

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Background

There are many reasons for the poor performance of medium, small and micro enterprises (MSMEs) in Ethiopia. These include lack of access to finance and market linkages; inability to obtain work premises; poor governance and tax administration; unreliable water and electricity supply; and inadequately educated workforce.¹ But the biggest obstacle for Ethiopian enterprises is related to access to finance, according to the World Bank 2015 Enterprise Survey. Over 40% of survey respondents identified it as a significant challenge. This finding is a striking contrast to the Sub-Saharan Africa and low-income countries' average, which stands at 30% and 20%, respectively.

In this paper, we estimate the financing gap of MSMEs in Ethiopia by calculating the demand and supply of credit to them.

MSME Financing in Ethiopia

1. What are MSMEs?

There is little argument that MSMEs demand finance for their businesses at start-up, and for working capital.

According to Ethiopia's 2011 Micro and Small Enterprises Development Strategy, the working definition of micro and small enterprises (MSEs) in Ethiopia is based on the following criteria: capital, number of employees, and the

¹ PDRI, 2020; ADA, 2017. Small and Growing Businesses in Ethiopia; BRIDGES, 2020. Typical Journey of MSMEs: A systematic analysis.

business sector. Compared to the definition provided by multilateral organizations, the definition by the Ethiopian government does not consider annual sales or turnover.

The federal-level agencies mandated to define and categorize enterprises have evolved and restructured over time. Changes have been introduced to emphasize priority sectors and establish boundaries between medium and small enterprises (MSEs), and small and micro enterprises (SMEs).

Table 1: Definition of MSMEs

	Sectors	Capital (ETB)	Jobs
Micro	Services	<50,000	< 6
	Industry	<100,000	
Small	Services	50,000-500,000	6-30
	Industry	100,000-1,500,000	
Medium		500,000-7,500,000	31-100

The definitions in the above table are from the Federal Micro and Small Enterprises Development Agency (FeMSEDA), which has now been separated into two: the Federal Urban Job Creation and Food Security Agency (FUJCFSA), and the Federal Small and Medium Manufacturing Enterprises Promotion Authority (FeSMMIPA).

Similarly, the total number of existing MSMEs in Ethiopia is unclear due to discrepancies between numbers reported by various government organizations and institutions.

We gathered the number of MSMEs reported by different government organizations (such as Ministry of Trade and Industry, FUJCSFA, and FeSMMIPA) at both the national and Addis Ababa levels, as well as by development organizations such as the Entrepreneurship Development Centre (EDC). However, we soon identified challenges such as poor-quality data, and discrepancies in records calculating the number of MSMEs operating in the country.

Data from the Federal Urban Job Creation and Food Security Agency shows that there were 800,000 micro, 12,000 small, and 8,000 medium-sized enterprises in the country by the end of 2019. The Federal Small and Medium Manufacturing Enterprises Promotion Authority, on its part, lists 15,282 small and 3,777 medium

i. The Average MSME Loan Size

In 2020, we assessed the average loan size from a list of 5,000 micro-enterprises with outstanding credit at four microfinance institutions (MFIs): Metemamen, Meklit, Dynamic, and Aggar. The four institutions were selected due to their typicality of microfinance institutions in Ethiopia.

The average loan amount given to a micro enterprise was found to be about ETB 75,000 (USD 1,500). This assumption is substantiated by the estimates of what MSMEs of different sizes and maturity levels operating in particular sectors would typically borrow.

Regarding the demand for finance by small and medium enterprises (SMEs), our research utilized the monthly

Causes for the limited access to finance by enterprises were found to be, in decreasing order:

High collateral requirements: Both banks and MFIs require collateral, mainly physical assets, to provide credit.

High cost of borrowing: The interest rates levied by MFIs are remarkably high, particularly considering enterprises' financial capabilities.

Enterprise characteristics: MSMEs established with support from the government are more likely to access credit, at the very least from government-affiliated MFIs. On the other hand, as the enterprises' size and age increases, their chances of obtaining credit also increase. This is mainly associated with the increased ability to provide collateral as firms grow.

manufacturing enterprises in its database by the end of 2019. The Entrepreneurship Development Center (EDC) maintains the assumption that there are an additional 660,941 enterprises in the country that are not accounted for by both FUJCSFA and FeSMMIPA, because the two government agencies primarily count enterprises established with support from the government.

Considering the indicated figures, the total number of existing MSMEs in the country reaches 1.5 million. 1.2 (80%) million are micro enterprises while small and medium-sized enterprises comprise the remaining 300,000 (20%).

Our research also sought to assess the number of MSMEs through trend analysis over a number of years. However, sufficient data was unavailable from the aforementioned sources.

Additionally, since informal enterprises are not eligible to access finance from formal sources, they are not considered in the estimates on the number of enterprises in Ethiopia. Since the first requirement to access finance from any financial institution mandates the enterprises' legal status, this directly excludes all informal businesses.

insights of Enterprise Partners' SME Finance Project of 2018, 2019, and 2020. The monthly average was found to be close to ETB 1.3 million (USD 26,000).²

For the purposes of this paper, the average loan size demanded by micro enterprises and small and medium enterprises is thus ETB 50,000 and ETB 1.3 million respectively.

Our research team held discussions with four financial sector experts from various financial institutions to validate these estimates. Based on the sector experts' feedback, this estimation closely matches current market trends.

ii. Potential MSMEs' Demand for Loans

We multiplied the average loan size by the number of MSMEs in Ethiopia to estimate the potential demand for finance by MSMEs. Since the demand for finance by medium, small and micro enterprises vary, we separated the numbers for micro enterprises, and small and medium enterprises.

² One USD = 1USD= 49.6 ETB, NBE report (2022)

Table 2: Estimated Finance Demand by MSMEs

	Finance Demand Per Enterprise (\$)	Number of MSMEs	Total(\$)
Micro	1,500	1,200,000	1,800,000,000
SMEs	26,000	300,000	7,800,000,000
Total (\$)		1,500,000	9,600,000,000
	Exchange Rate		49.60
Total (ETB)			476,160,000,000

The potential demand for finance by MSMEs is estimated at ETB 476 billion (USD 9.6 billion).



Compared with IFC estimates in 2017 of USD 5.9 billion, the demand for finance by MSMEs has increased by \$3.7 billion.³ This difference can be attributed to the number of MSMEs in Ethiopia estimated by IFC, which is only 136,633.

iii. MSME Financing Gap

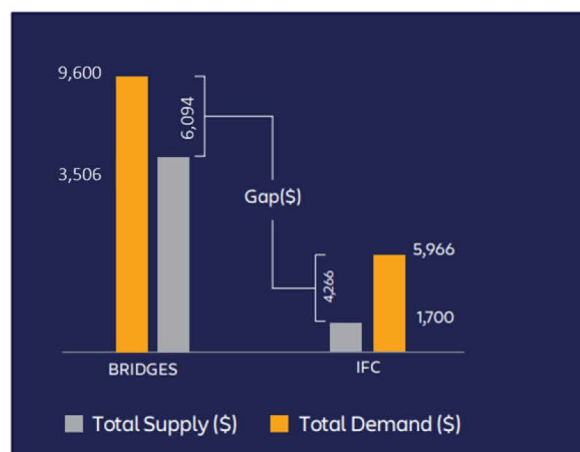
The total outstanding loan in the economy by the end of 2020/21 is ETB 1.3 trillion (nearly USD 27 billion). Assuming MSMEs take 13% of this outstanding loan, the current supply of loan to MSMEs is estimated at USD 3.5 billion. Thus, deducting this current supply of loan from the total demand, the financing gap of MSMEs is estimated at 300 billion (USD 6.1 billion).



³ IFC (2017). MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets. Washington, D.C., USA

Compared with IFC estimates in 2017, the gap has increased but not significantly. This shows that even though the number of MSMEs has increased, and hence the potential demand, the supply amount has also increased together.

Figure 1: MSME Financing Gap (IFC and BRIDGES)



II. Conclusion

It is said that MSMEs can contribute greatly to Ethiopia's economy both in employment creation and income generation. But MSMEs are not making these contributions due to various obstacles. One of the greatest challenges in this regard is access to finance as proven by many studies.

Our research found that access to finance is a challenge for more than half of Ethiopia's enterprises with their potential demand for finance estimated at \$9.6 billion. The main reasons are:

- ✓ Collateral required by financial institutions
- ✓ High cost of borrowing
- ✓ Differences based on the characteristics of enterprises

Based on the survey we conducted, we found that MSMEs demand finance for purposes such as market linkages and working premises. This means that some of the demand for finance by MSMEs can be satisfied by providing support on market linkages, working premises, and other areas.

Taking into account the above findings, the following recommendations are suggested:

- ✓ There should be clear distinctions made between micro, small, and medium enterprises regarding access to finance. This is essential since their demands are vastly different.

- ✓ Alternative sources of financing should be encouraged.
- ✓ Awareness creation about the business environment for new start-ups might help enterprises understand issues beforehand and plan how to tackle them.

The financing gap is significant in that it calls for the involvement and coordination of various stakeholders to bridge, while also highlighting the role a regulatory framework can have in easing MSMEs' access to finance. Overall, access to finance is not an end in and of itself, unless it is complemented by the resolution of other critical challenges identified to be affecting the sector.

BRIDGES is a Mastercard Foundation - Young Africa Works programme implemented by First Consult. We are working to support and create jobs and medium, small and micro enterprises by unlocking the job-creation potential of industrial parks and other big enterprises in Ethiopia.

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