Promoting Financial Sector Dialogue: Making Finance Work for Africa

Financing Agricultural Value Chains in Africa

Focus on Coffee and Sesame in Ethiopia

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List of Abbreviations and Acronyms

ATM	Automated Teller Machine
CBE	Commercial Bank of Ethiopia
CPIA	Country Policy and Institutional Assessment
DBE	Development Bank of Ethiopia
EARI	Ethiopian Agricultural Research Institute
ECX	Ethiopian Commodity Exchange
EDS	Enterprise Development Services
IEC	Ethiopian Insurance Corporation
ETB	Ethiopian Birr
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GIZ	Deutsche Gesellschaft fuer Internationale Zusammenarbeit
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFTC	Integrated Tamale Fruit Company (Ghana)
KfW	German Development Bank
MFIs	Microfinance Institutions
MoARD	Ministry of Agriculture and Rural Development
MoFED	Ministry of Finance and Economic Development
MRLs	Maximum Residue Levels
NBE	National Bank of Ethiopia
NGO	Non-Governmental Organisation

OECD	Organisation for Economic Co-operation and Development
POS	Point of Sale
RAG	Red-Amber-Green
RUFIP	Rural Finance Intermediation Programme
SACCOs	Savings and Credit Co-operatives
SME	Small and Medium Enterprise
TA	Technical Assistance
UK	United Kingdom
US	United States
USAUD	US Agency for International Development
US$	United States Dollars
VAT	Value Added Tax
VC	Venture Capital

1 Executive Summary

This study is part of a series on agricultural finance in Africa, sponsored by GIZ and executed by Maxwell Stamp PLC. The aim is to examine access to finance for agriculture, with a view to identifying strategies and tactics which will improve that access for commercially-oriented agriculture. These recommendations will be used to inform policy development by government and development agencies, both at country level but also for the continent overall. To ensure the success of the studies, it is crucial that they draw lessons from each other, and become a sum greater than their parts.

The countries studied are Kenya, Ghana, Burkina Faso and Ethiopia. In each country, the reports also include analysis of a small number of agricultural sub-sectors. By referencing the analysis against specific value chains, we hope that we can illustrate how different agricultural markets work, and highlight the features which make them more or less attractive to financiers. A synthesis report that aggregates and analyses the findings from all the studies, and makes recommendations that can be considered by other countries in Africa trying to address similar challenges, will also be produced.

This study reviews the agricultural finance environment in Ethiopia, with particular reference to the coffee and sesame value chains. Accompanying the value-chain analysis is a review of both the agricultural and financial sectors in Ethiopia, with a performance dashboard for each. We hope these dashboards will be useful in highlighting the relative performance in certain key indicators between each of the countries under study and drawing the attention of policymakers to examples of particularly good (or bad) practice.

Ethiopia was unique among the countries studied for the degree of state sector involvement in both the agricultural and financial sectors. The government's philosophy is not to emulate the market-led, private sector development approach adopted by Kenya and Ghana in particular. It wishes to forge its own path, underpinned by admiration of the state-sponsored agricultural revolutions engineered by governments in countries like Vietnam, China and India. Like some of these countries, Ethiopia had a communist revolution which stripped the nascent private sector of its power. However, unlike some of these countries, it has yet to find an effective balance between entrepreneurship and central planning.

While it has the interests of small farmers at heart, the public sector is generally pretty ineffective at substituting for the private sector in a whole range of positions in agricultural value chains. Also, the country's inexperience and distrust of international finance means the local financial sector needs more extensive remedial action compared to Kenya and Ghana. Ethiopia also suffers from a chronic shortage of foreign exchange, a legacy of long-standing macroeconomic mismanagement, an issue which distorts policymaking in a series of contradictory ways.

However, Ethiopia is super-charging overall agricultural production in the country by leasing large tracts of land at very low prices to large commercial and industrial farmers and agricultural companies from the Middle East, and Asia in particular. The government seems to have little patience for the incremental, market-led development approaches promoted by the Organisation for Economic Co-operation and Development (OECD) partners, and is keen to build relationships with other bilateral partners.

At present there seems to be limited opportunity to significantly upscale debt finance for any agricultural value chain, as the National Bank of Ethiopia (NBE) has credit caps in place to control inflation. Indeed, even if these caps were lifted, the financial sector in Ethiopia is so limited and repressed, that it is difficult to see how transformative levels of debt finance can be generated for agriculture. The business environment is much more conducive to equity investments, and the biggest impact would be felt in the agriprocessing sector as virtually no value addition takes place in Ethiopian value chains at all.

The report is structured as follows:

- **Section 2 Agriculture,** includes a high-level review of the agricultural sector, together with sub-headings which break the analysis into the macro-, meso- and micro-level factors which we feel have the most impact in enabling access to finance for agriculture. A RAG (Red-Amber-Green) flag has been assigned against each factor, which reflects our subjective view of the current status of that factor in terms of having a relatively negative (red) or positive (green) impact on agricultural finance. It should be stressed that this is a device to draw the attention of the reader to areas of most interest, particularly where remedial action is most required, or where there are notable examples of good practice. It is not intended to be a rigorous quantitative tool.

- **Section 3 Business Environment**, is a short section with some cross-cutting factors which do not fit easily into either Section 2 or Section 4. Again, each factor has been assigned a RAG flag.

- **Section 4 Financial Sector**, is in the same format as Sections 2 and 3 but is focused on the financial sector.

- **Section 5 Value Chains**, is an overview of the structure of the coffee and sesame agricultural sub-sectors, the current role of financial services within these value chains, and some suggestions for practical interventions.

- **Section 6 Recommendations and Critical Success Factors**, is a high-level articulation of some key strategies and policies which we feel would have a major beneficial impact on access to finance for commercially-oriented agriculture, based on the information and expert opinion we have assimilated.

The key recommendations are as follows:

➲ To continue the policy dialogue with the government about the benefits of liberalising the financial sector;

➲ To work closely with the NBE to continue its financial sector reform programme, to improve its institutional capacity, and to adopt new approaches to both monetary policy and financial sector regulation and supervision;

➲ To strengthen the co-operative movement, including both producer co-operatives and financial services co-operatives, and particularly the introduction of strong apex structures to lead the sector;

➲ Focus development finance on equity investments, at least for the time being, and to support foreign and domestic capital with co-financing arrangements;

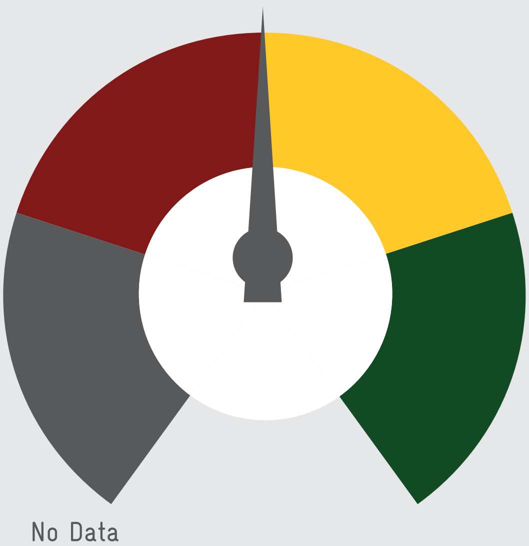
➲ Work with agribusiness to establish or deepen outgrower schemes and contract farming, and facilitate access to supplier finance in due course;

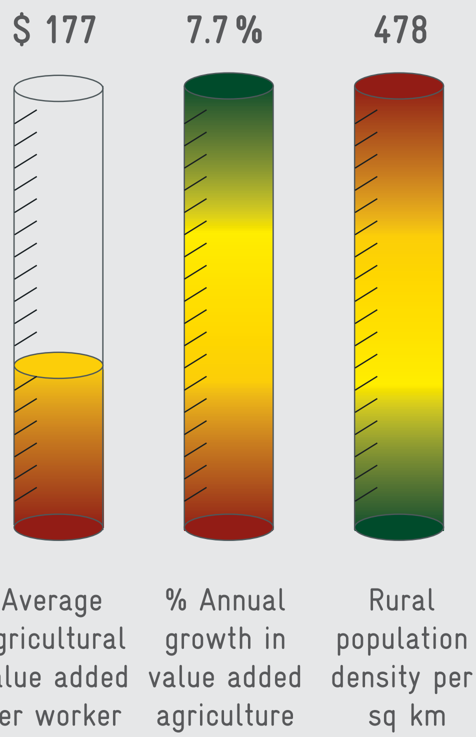
➲ Strengthen the business and financial skills of high-potential producers and processors through a programme of Enterprise Development Services (EDS);

➲ Work with the Ethiopian Commodity Exchange (ECX) to build on its operations and support the use of commodities as security for short-term finance; and

➲ Develop the commercial banking sector, and particularly the Commercial Bank of Ethiopia.

2 Analysis of Agricultural Sector





Ethiopia has vast agricultural resources constrained by a political consensus that effectively represses market-led agricultural development. Rules are tailored, however, for major international investors which are granted access to large tracts of cheap land in return for capital and expertise.

Figure 1: Performance Dashboard for Agricultural Sector

Macro-Level

The government is certainly demonstrating its commitment to agricultural development through budget allocations, but effectiveness is undermined by poor implementation. Policy development, public sector co-ordination and fiscal responsibility all needed drastic improvement.

Leadership	Ministries do not seem well co-ordinated in Ethiopia and there appear to be competing agendas and contradictory policies in relation to agriculture.
Strategy Development	Ethiopia takes agriculture very seriously and has developed comprehensive policies to address the sector. The path for implementation is not so clearly mapped out.
Legislative and Policy Development	The political environment is very poor, marked by considerable and violent divisions between factions. Policy development is put behind rivalry and power struggles.
Budget Allocation	Ethiopia´s decent budget allocation is let down by poor control of public finances, exacerbated by the country´s federalised system.

Meso-Level

Ethiopia is strikingly weak at the meso-level, and particular disappointing were the lack of producer organisation and the almost complete absence of agribusiness. This is a legacy and symptom of the state's inability to release responsibility to the private sector.

Parastatal Organisations	The parastatal sector is undertaking major initiatives to improve, but is crowding out the private sector where it would be better placed to deliver in the long run.
Producer Organisations	Farmer organisation is typically very weak, though the co-operative movement is experiencing something of a revival.
The Development Community	There are a wide range of players but there could be more emphasis on market-led initiatives.
Agribusiness	Agribusiness in Ethiopia is very weak and private sector development is constrained. The government is encouraging large-scale FDI in commercial farming.

Micro-Level

The competitiveness of value chains vary from one sub-sector to another, though generally farmers in Ethiopia have relatively low productivity.

Producer Viability	Most Ethiopian agricultural production is by small-scale producers, many of which lack economies of scales as well as the required technical and business skills.
Access to Inputs	Producers use relatively low levels of inputs due to lack of finance, and the absence of a robust private sector to meet demand.
Water and Irrigation	Ethiopia has recognised the vast potential of its water resources and is beginning to bring major programmes on line.
Agricultural Extension Services	There has been a considerable improvement in extension services though uptake is relatively low.
Agricultural Standards, Pests and Disease	Performance in this area seems to be weak, but the development of the Ethiopian Commodity Exchange could lead to improvements for some key value chains.

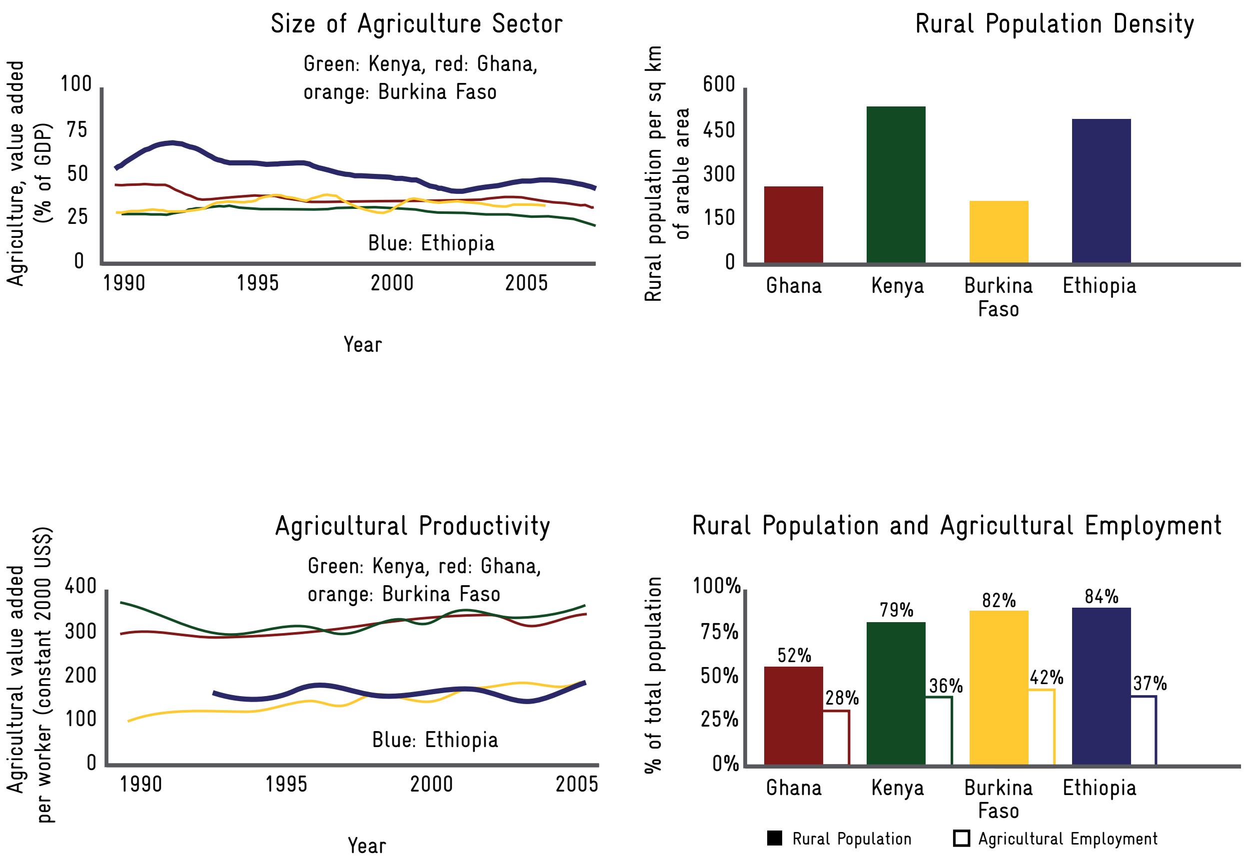


Figure 2: Comparison of Key Agricultural Statistics

Macro

LEADERSHIP

The strength of both the leadership structures and the qualities of the individuals who make up the cadre is vital. The ability to influence stakeholders and manage change is more important than technical experience.

*

STRATEGY

Strategic objectives are the straight forward part. Generally plans are missing specific and robust monitoring and control frameworks, to ensure deliverables are achieved. They also fail to assign accountability, and also how to incentivise staff.

**

BUDGET

Budgets generally need to increase but, most importantly, demonstrate stability. Allocation and measurement of the impact of funds should be integrated into a holistic monitoring and control framework.

LEGISLATION/ POLICY

Good and stable government works with both the public and private sector to develop robust and unambiguous legislation affecting the agricultural sector, and enacts it in a timely manner. It is not subject to partisan interests.

*It is vital that the strategy and leadership are a good fit and well alligned. Leadership should be accountable for development and delivery of the strategy according to agreed measures.

Meso

PARASTATAL ORGANISATIONS

The sector should be supported with a range of well-funded expert agencies to promote development. Where possible, strong links should be formed with the private sector. Research and development, and depth and outreach of extension services are key.

PRODUCER ORGANISATIONS

Well-funded and well-organized producer organisations are a vital component in linking small farmers with other stakeholders and the rest of the economy. Ideally these are organised from the ground up by farmers.

DEVELOPMENT AGENCIES

Development agencies have, and will continue to have a role in supporting agricultural development, both in terms of funding and expertise. They should be aligned where possible with the agricultural sector strategy.

AGRIBUSINESS

A strong agribusiness sector is important both for value addition (including input supply), but also to provide a stable domestic off-take market. Agriprocessors are particularly adept at intermediating with the producers.

BUSINESS ENVIRONMENT

**It is difficult for leadership to stipulate the available budgets and to specify the precise government policy and legislative plan. Alignment between politicians and civil servants on these issues is vital.

Micro

INPUTS

Access to a wide market of competitive input supplies is a key ingredient. Suppliers need to have scale and outreach, and a business model capable of reaching small producers. Like agriprocessors, input suppliers can intermediate finance and expertise.

NATURAL RESOURCES

The natural resources of the country in relation to agriculture are generally static, aside from the unique ability to better harness and manage vital water resources. Investment in water security is difficult to finance but has long-term pay-offs.

KNOWLEDGE

Producers need the requisite to execute their enterprise effectively, exemplified in the provision of extension services. The outreach and depth of extension services is an asset, and can also be used to facilitate access to finance.

RISK MANAGEMENT

The ability to manage key agricultural risks is very important for maintaining yield quantities and qualities. Aside from water, pest and disease management are the major themes. The policies and processes to address this are important.

COMPETITIVENESS

The commercial ability of farmers and the underlying viability of their farm enterprise is crucial. In the longer term, most farms need to be larger and better managed. Focus should be on those with high-growth potential.

Figure 3: Key Factors Affecting Agricultural Markets

2.1 Overview

Red/Amber status:

Ethiopia has an incongruous set of agricultural policies. The lack of land tenure and state intervention in the market greatly inhibit the development of a class of domestic commercial farmers. However, Foreign Direct Investment (FDI), by international commercial farming enterprises is actively encouraged, with generous concessions issued.

Ethiopia is an overwhelmingly agrarian economy, with agriculture accounting for about 50 % of Gross Domestic Product (GDP), 60 % of exports, and 80 % of total employment. The largest sub-sector in Ethiopian agriculture is cereal production, making up about 32 % of agricultural GDP, and Ethiopia is Africa's second biggest maize producer.

However, cash crops such as coffee and oilseed dominate export markets, and the Ethiopian government is prioritising these two sub-sectors (as well as cereals), mainly as a direct result of its chronic shortage of foreign exchange. Ethiopia is also believed to have Africa's largest livestock herd, with meat and other animal products (e.g. leather) making up nearly 10 % of export income. Livestock rearing and fattening, and related meat and leather processing, is a solid and growing industry in Ethiopia. Experts in private sector development are enthused by the plethora of value-adding opportunities that relate to this sector, much more so than the processing of commodities.

Ethiopia is a large country with a huge range of geographic and climatic zones. These range from highly arable, rain-fed belts in the forested and highland areas to zones of more-or-less permanent drought. The country has a total area of about 1.13 million km2, with estimated arable land resources of potentially of 55 million hectares, or about 50 % of its land mass. Despite the huge arable land resources potential, only 14 % of the country's total land mass is being used for crop cultivation. Inaccessibility, water shortages and infestations of disease-causing insects, mainly mosquitoes, prevent the use of large parcels of potentially productive land.

Ironically, parts of Ethiopia are extremely densely populated, with some arable areas coming under considerable pressure. Dealing with land degradation is a major government priority as small farmers push into increasingly marginal areas. Ethiopian farms tend to be very small and many crop farmers do not have viable farms. However, there is also a large population of medium-sized and even large commercial farmers who dominate national agricultural output, of which the smallest 40 % of farms contribute only 10 %.
Over the last 20 years the area under cultivation has increased steadily. However, the impact was negated in the first decade by declining yields. Yields have begun to improve over the last 10 years though. It is still estimated by sources that cereal yields could double (even applying current agri-technology) if agronomic practices and the use of inputs was optimised.

Ethiopia is very much forging its own path in terms of agricultural development, heavily influenced by the agricultural revolutions that have taken place in other centrally planned economies, especially in Asia. It will continue to maintain and develop its public sector support of small farmers, while simultaneously developing large tracts of land by inviting in foreign investors.

2.2 Macro-Level

Red/Amber status:

There is little doubt that agriculture is at the heart of the Ethiopian government's economic development strategy. Considerable focus has been put on strategy development and budget allocation. Strategies fail in implementation, however, largely due to ineffective financial analysis, and poor monitoring and control.

2.2.1 Leadership

Red/Amber status:

Policy development and implementation for agriculture in Ethiopia seems to be characterised by competing political agendas. Furthermore, the government, in its ambition to emulate other centrally planned economies (e.g. in Asia), probably overestimates its ability to effectively implement change. The result is a slightly confusing mix of pro-market initiatives and ineffective state-sector engagement.

Agricultural development falls under the stewardship of the Ministry of Agriculture and Rural Development (MoARD). That said, the Ethiopian public sector is populated by a number of powerful players, which are often capable of implementing conflicting policies that have a major impact on the separate agendas.

Notably, the Ethiopian banking sector is effectively state-controlled, and the NBE is a major force, not only in the setting of interest rate policy and establishing financial stability, but also in the allocation of credit. This is complicated further by the role of the major state-owned commercial and development banks, the CBE and Development Bank of Ethiopia (DBE), which are subject to political direction.

The Ministries of Finance and Economic Development have been amalgamated, which some feel is an error, with the new ministry (MoFED) focused on fiscal matters at the expense of improving the business environment.

Cross ministerial co-ordination appears to be limited, though MoARD highlighted the establishment of a monthly steering committee with the Ministry of Trade and Industry to help align their strategies.

The ministries are generally characterised by weak capacity and inexperience, and their ability to effectively implement change is highly questionable. These waters are muddied again when policy reaches the regional level, where regional governments have considerable latitude in the interpretation and implementation of policy, and in the development of parallel or even alternative approaches.

2.2.2 Strategy Development

Amber status:

The policy is comprehensive and far-reaching and, on the face of it, makes sense. The policy demarcates a role for government in the financing and implementation of major investments, while also encouraging private enterprise to fill gaps in the value chain. In relation to the former, the government's capacity to emulate its mentors in Asia with the effective execution of large projects is not yet proven. In relation to the latter objective, it is not clear to us how the private sector is expected to fill this void given the unfriendly business environment and strict credit controls. A detailed implementation or master plan in English has apparently been prepared for the agricultural sector but we were not allowed sight of this as apparently it has not been approved.

The Ethiopian government takes agriculture seriously and has put it at the heart of its development plans. In 2007 it developed the Agriculture Development Led Industrialization policy to supplement other policy documents such as the Sustainable Development and Poverty Reduction Programme and the Plan for Accelerated and Sustained Development to End Poverty.

The policy is comprehensive and ambitious, encompassing infrastructure investment, especially in roads, telecommunications and electricity, improved access to finance, encouragement of agro-investment, enhanced research and development, and implementation of health and livelihoods measures for rural populations.

The government makes no secret that its policy is a hybrid of market-oriented measures as well as clearly marking out a major role for the state. There is substantial admiration for the agricultural revolutions in some centrally-planned economies in Asia in particular.

At producer level, the policy emphasises two angles: first, promoting small-scale agriculture through incremental development and diversification, and second, attracting large-scale investment (particularly from overseas) to develop very large commercial farms. These pair off against the government's key priorities of improving food security and rural livelihoods generally, and its desperation to improve its foreign exchange earnings. To this end, the strategy also concentrates on several key commodities such as cereal production, and high export-earning value chains including coffee and edible oil.

2.2.3 Legislative and Policy Development

Red/Amber status:

The legal and policy environment in Ethiopia is poor, and improvements seem to be slow in coming. The political situation, while more stable recently, is still unpredictable, with parliament becoming a battleground between competing regional, ethnic, and business interests.

Effective policy development and legislation are undermined by the fragile political environment. There were severe disruptions and violence in disputed elections as recently as 2005. Much of the government's (and indeed opposition parties') time is spent in harassing and attacking each other, rather than the questioning and probing which underpins effective development.

Policy development and the passing of legislative acts are slow, and tend to be on an ad hoc basis. Much of the law is subject to interpretation, and interest groups close to the ruling party are allowed latitude not given to others. Also, the regions are given considerable autonomy to make their own laws, as are specific ethnic groups and religions.

2.2.4 Budget Allocation

Red/Amber status:

Ethiopia clearly gives agricultural spending a high priority, but this is undermined by poor budget planning, project analysis, and monitoring and control. The system is very much complicated by Ethiopia's federal structure and, at regional level, accountability is low and capacity very weak.

Under the Maputo Declaration of 2003, Ethiopia, along with other African countries committed itself to the Comprehensive Africa Agricultural Development Programme and the allocation of 10 % of the national budget to agriculture. According to 2005 data, it is one of six African countries to achieve this along with Niger, Burkina Faso, Chad, Mali and Malawi. Levels have risen radically from the neglect of the Imperial period, when allocations were typically less than 2 %.

While allocations have improved to meet stated objectives, there are considerable concerns about the effectiveness of public spending on agriculture. These include:

- A lack of strategy in budget allocations with changes generally made on an incremental basis depending on the proposals of independent ministries;
- Very little co-ordination of budget proposals, and little evidence of a thorough rationalisation by MoFED;
- An almost complete absence of cost-benefit analysis during the process, and an inability to undertake basic project appraisal;
- A focus on activities and tasks rather than benefits and outcomes, and little monitoring and control; and
- A lack of accountability and professionalism at the regional level, where much of the expenditure occurs.

2.3 Meso-Level

Red/Amber status:

Ethiopia has made a major effort to improve the performance of its parastatal sector, and to some extent its relatively centralised structure makes this easier to manage. The parastatal sector, however, continues to crowd out the private sector, though the private sector's ability to respond to market gaps is severely inhibited. Few of the fundamentals required to support market-led growth are in place.

2.3.1 Parastatal Organisations

Amber status:

The parastatal sector is markedly different from that in other markets studied, characterised by fewer and larger institutions. Perhaps this will provide the momentum they require to improve, though they are starting from a low base. Clearly we are very concerned about the intervention of government in some markets, however.

Improving and integrating the existing research institutions is a fundamental component of the strategy. One of the major players on the agricultural side is the Ethiopian Agricultural Research Institution (EARI), under which a plethora of individual institutions were merged. Compared to other countries under study, this centralised structure may be perceived as a strength (resulting in better co-ordination) or a weakness (a lack of diversity). Agricultural research has been noted as a comparative weakness in Ethiopia, exemplified by the lack of progress in developing and distributing improved seed varieties. It has been highlighted that, for various historical reasons, compared to other African research institutions, EARI has relatively weak links with international institutions. These relationships are vital in catalysing development and facilitating the transfer of best practice.

EARI has traditionally been underfunded with low levels of expertise. Ethiopia is making a real effort to transform agricultural research, as it begins to realise the competitive benefits. A particularly good example is the efforts to better manage and secure the substantial genetic resources of the country's indigenous coffee varieties.

State-owned companies are major players in the agricultural market, outside of the sphere of research as well. The Ethiopian Input Supply Corporation dominates the fertiliser trade, the Ethiopian Seed Enterprise controls access to new and improved varieties of seeds, and the Ethiopian Grain Trading Enterprise monopolises the international marketing of cereals. In addition, there are large numbers of »private« sector agribusinesses with strong connections to ruling elites, which are accused of receiving preferential treatment. This is worrying, as the record of state enterprises in effectively servicing these markets is not good.

Another major difference, of course, is the involvement of the government in the financial sector. This is not only demonstrated through the interventionist approach of the central bank, but also the domination of the commercial banking sector and even microfinance institutions (MFIs) by state-owned or funded institutions. Recently the government sponsored the development of the ECX, though it has expressed an intention to fully privatise the operation in due course. The role of the state in the financial sector is covered in much greater detail in Section 4.

2.3.2 Producer Organisations

Red/Amber status:

Producer organisation in Ethiopia is very weak in most areas. The co-operative movement has literally being built from scratch over the last 15 years, after its almost total destruction at the hands of the Derg regime. Industry associations vary but most do not seem to have a particularly active role. The levels of private sector solidarity seem to be low in the face of a very strong government.

The dominant form of producer organisation in Ethiopia is the agricultural co-operative. As movement was effectively destroyed through the process of nationalisation under the communist regime, it is undergoing a revival. This revival is tainted, however, by an underlying distrust and disillusionment with the movement, a legacy of the corruption and ineptitude which characterised the communist period.

That said, the movement has been recovering rapidly over the last 15 years, with recent statistics suggesting that there are as many as 15 000 co-operatives. Data is at odds, but it appears that a relatively small proportion of farmers, perhaps between 5 %-10 %, are currently members of co-operatives. Many of these co-operatives are chronically weak, and are rarely organised into regional or national structures.

The absence of apex institutions is notable. Only recently have co-operative unions begun to form, represented most strongly in the coffee industry. There is a government body, the Federal Cooperative Agency, which is tasked with developing the sector but it appears institutionally weak.

Some of the larger co-operative unions have access to finance through the commercial banking system, which they often on-lend to member primary co-operatives. Repayment histories have varied, and some of the primary co-operatives are saddled with long outstanding debts.

Some small credit unions have been formed, though these are not strong in rural areas, and even one (and shortly to become two), co-operative banks. There is no grand plan for developing co-operative financial services in Ethiopia, and certainly no apex or support structures.

In addition to co-operatives, there are also a number of agricultural industry associations, largely dominated by commercial farmers and agribusiness. These effectively form hubs of knowledge and expertise, marketing information and promotion, and also lobby government on the behalf of the sector. Some appear to be quite dynamic institutions with an active and vocal membership, while others appear to be far less so. It is regrettable that, given its pedigree, little seems to be done to promote the »Ethiopian brand« in the coffee industry internationally.

2.3.3 The Development Community

Amber status:

There are a wide range of players in the development of agriculture in Ethiopia, but compared to some other markets, there appears to less emphasis on pro-growth, value-chain development.

The development community has a major interest in the Ethiopian agricultural sector. However, a general comment would be that there appears to be markedly less pro-market and growth programmes in relation to other countries under study, and the focus tends to be on livelihoods development. This is probably symptomatic of the political and economic realities of working in Ethiopian agriculture. The notable exceptions include:

- The US Agency for International Development (USAID) has awarded Fintrac the market-led Ethiopia Agribusiness and Trade Expansion Activity, a technical assistance contract to improve competitiveness in four agroindustry sectors: coffee; hides, skins and leather; oilseeds; and horticulture;

- The GIZ Engineering Capacity Building Programme covers a wide range of value-chain development including coffee, sesame, passion fruit, meat and leather, ginger and bamboo;

- SNV (Netherlands Development Organisation) is working on a number of agricultural value chains including milk and milk products, honey and beeswax, oilseeds (sesame, niger, safflower), and horticulture (apple, mango and pineapple); and

- TechnoServe are active in promoting and developing the coffee value chain.

Other major players include the International Fund for Agricultural Development (IFAD), whose strategy in Ethiopia focuses on supporting investment programmes with the greatest potential impact on sustainable household food security and on the incomes of rural poor people, particularly small-scale farmers and herders, and women in all categories. The objectives of the strategy are to enhance the access of rural poor people to:

- Natural resources such as land and water;

- Improved agricultural and livestock production technologies and support services; and

- Reliable financial services.

2.3.4 Agribusiness

Red status:

Agribusiness in Ethiopia is extremely weak and, if one takes a pessimistic view, it is currently difficult to see how the sector will take off domestically given the extremely tight credit environment. Rather, the government is adopting an approach to invite large amounts of foreign finance focused on boosting production.

There is a small amount of agriprocessing around the coffee, sugar and edible oil industries. This is of very minor scale, however, and the vast majority of Ethiopian produce is exported raw. The technology required to make these industries competitive is often of industrial scale, expensive, and requires skilled maintenance and operation. The domestic private sector is extremely undeveloped, starved of finance and expertise, and this is particularly the case in agriprocessing.

Ancillary sectors such as input supply for production are also dominated by the state. The major private agribusinesses in Ethiopia are commodities brokers and traders, particularly in coffee and sesame. These are a mix of domestic (some of whom have strong political connections) and foreign firms (though there are claims that foreign firms face discrimination), which act in the local market on behalf of parent companies or international buyers.

However, commercial agriculture is growing rapidly as the government embarks on a series of major land deals with international investors, particularly from India, Asia, and the Middle East. The deals entice investors with the promise of long-term leases at very low rates. In return, the investors are expected to invest heavily in agricultural infrastructure required for international competitiveness. It is expected that by 2013 nearly three million hectares of land will be leased to large foreign industrial farmers, equivalent to roughly one-fifth of the entire area currently under cultivation.

2.4 Micro-Level

Amber status:

At the micro-level we are looking at the discrete factors which impact on agricultural value chains at both a producer and processor level. These vary wildly from one sub-sector to another, however, some common themes are outlined in this section.

2.4.1 Producer Viability

Red/Amber status:

The vast majority of Ethiopia's agricultural production comes from small-scale farmers, and their productivity is generally much lower than it should be. This is the result of a range of factors related to social and cultural values and behaviours (e.g. attitudes to enterprise, risk, property, advice etc), technical and financial skills, and the availability and quality of land. That said, the government is making a major effort to develop large commercial farms by leasing large tracts of land to major international farming enterprises.

Ultimately, to access agricultural finance, a farm would need to be a viable commercial enterprise. This requires some tangible components such as:

- The farm needs to generate at least some retained cash which can be used to repay loans and/or reinvest in growth and improvements;
- To achieve this, the farm needs to be of sufficient size and/or scale;
- It also needs access to a market which will off-take this production; and
- The farm needs access to a minimum level of inputs and infrastructure required to enable production.

There are many people whose livelihood, while it is wholly or partially dependent on the land, does not meet this definition. This does not necessarily mean that they are excluded from access to finance, but rather that specific agricultural finance solutions are not appropriate. These include circumstances when:

- Small-scale production is used to supplement the diet and/or income of a household where the primary source of income is from another source (i. e. another job);
- Subsistence agriculture, where most of the production is used for household consumption rather than cash generation;
- Absentee farmers, for example those who have moved to cities from rural areas whose landholdings are not really actively managed, tend to be harvested by others in line with established custom, and the resulting cash payment generally considered a supplement to other income streams; and
- Those rural poor who have a small patch of land, used for very small-scale subsistence, to the extent that the landholding is so small that it cannot even be improved on a full-time basis.

Most counterparts in the field of private sector development, agribusiness, and the financial sector were also keen to stress the intangible factors which make for a successful farmer, and therefore bankable proposition. These include:

- Farmers must be full-time entrepreneurs in pursuit of generating surplus cash from the farm »enterprise« (this includes off-farm income);

- They must be experienced and have an enthusiasm for developing their expertise;
- They need to be capable of thinking long term about their business, and open to receiving advice and adopting new ideas; and
- Capable of working well with others where there is demonstrable mutual benefit, and of understanding their rights and responsibilities in a group structure, and to external stakeholders.

These criteria further restrict the scope of agricultural finance and, while the extent to which ingrained values and behaviours can be changed, it is certain that a significant group of farmers would not be able to adapt to these requirements.

2.4.2 Access to Inputs

Red/Amber status:

The market for input supply is very weak. The government has yet to recognise the gains that can be realised by engaging the private sector in input supply. Rather than looking at creative ways to subsidise inputs for the most needy, it has opted to subsume the private sector, and the resulting enterprises suffer the expected levels of inefficiency, corruption, and poor service.

The government supports many smallholders with access to inputs with a very limited role for the private sector. This was not always the case, however. For example, following the collapse of the Derg regime in the 1990s, the state monopoly on fertiliser was lifted. A thriving market of wholesalers and retailers flourished, which has since been squeezed by the re-entry of the state-owned Agricultural Input Supply Corporation and a number of other companies with quite obvious political connections. Ostensibly this was part of a government policy to integrate and co-ordinate a range of different input supplies and extension services, though it is regrettable that it happened to the detriment of what could have been a flourishing private sector. While inputs are competitively priced (as a result of hidden subsidies) compared to other markets, service levels are a source of major frustration. Delays in the delivery of fertiliser and inadequate supplies have a detrimental effect on their impact.

Nevertheless, fertiliser use in Ethiopia has increased at a rate of around 5% a year until in 2008 it stood at 400 000 tons. It should be noted that increased fertiliser use alone is not a remedy. In Ethiopia, many small-scale farmers use similar ratios as large commercial farmers with much smaller yields. Fertiliser use must be aligned with improved seed stock and better agronomic practices.

One of the main issues highlighted during the study was the relatively poor genetic make-up of Ethiopian seed stock. Again, it is a government priority to address this through improved research and development. A role for the private sector in production and distribution should be identified. Also, the use of appropriate pesticides and herbicides is very limited at present.

Agricultural co-operatives also play a leading role in the procurement and distribution of inputs to members. They are constrained in their ability to upscale, however, due to low institutional capacity and limited access to finance. Most farmers obtain credit from the large state-affiliated MFIs and the CBE to fund purchases. The tight repayment schedules are a source of stress for small farmers and a major reason for low uptake.

2.4.3 Water and Irrigation

Amber status:

Ethiopia has abundant natural water resources and major irrigation potential. Substantial progress has been made but much remains to be achieved. The government is implementing major projects to enhance irrigation but it would be beneficial to continue to facilitate access to private finance for these schemes.

Nascent irrigation development by private sector commercial farmers was ended with land nationalisation. The Derg regime instigated a number of major schemes attached to state-owned farms. Since the regime's downfall, the government has effectively renounced responsibility for irrigation infrastructure – development has halted, and existing schemes have fallen into disrepair.

While the government sponsored small schemes under the Regional Water, Mines and Energy Bureaus, the Federal Government has had little involvement until recently. Currently, Ethiopia irrigates about 250 000 ha out of a potential 2.5 million ha, and now has some major schemes nearly completed and well advanced in the planning and delivery phases.

The private sector is also beginning to invest, where schemes are attached to major commercial farms. Ethiopia's abundant water resources are a major draw for industrial farmers.

2.4.4 Agricultural Extension Services

Amber status:

Ethiopia has greatly improved access to extension services for farmers, but uptake and implementation of recommendations by farmers has been inhibited by the lack of a demand-driven approach. There is little diversity or flexibility in the market.

Extension services aim to increase the productivity of farmers through a structured programme of skills and technology transfer. They are delivered by a mix of the public sector, development agencies, private and co-operative marketing groups, and non-governmental organisations (NGOs). Typically, they are aligned along specific agricultural sub-sectors, and a specialist extension officer is assigned to a group of farmers (maybe a few hundred) in a given locality to develop their expertise in this sub-sector.

The availability of extension services in Ethiopia has improved markedly in recent years; however, provision is dominated by the public sector. The new strategy continues to support expansion in these as fundamental to growth. The model, however, is very much a top-down approach. MoARD has developed a series of packages it deems to be appropriate to particular segments, and these cannot be tailored to the needs of individual farmers. Nor do they often have other options in the provision of these services from NGOs and the private sector.

2.4.5 Agricultural Standards, Pests and Disease

Amber status:

This has become a high priority recently as the country's coffee industry reels from an import ban imposed by the Japanese for breaching maximum residue levels (MRLs). In general, agricultural quality standards are very weak, though the integration of value chains (currently coffee and soon sesame), into the Ethiopian Commodity Exchange testing framework may bring benefits.

Export markets in particular are becoming increasingly concerned about making sure the produce that they import meets the required traceability, safety, sanitary and phytosanitary standards and MRLs. MRLs are standards on the maximum safe levels of input chemicals which are left on the produce. This is particularly noticeable in industries such as cocoa and coffee, where international standards (notably Organic, Fairtrade, Rainforest Alliance, UTZ, and other major certifications) are a major differentiator in terms of the desirability of produce. Crop disease is also a major factor in pre- and post-harvest losses for farmers, with much of this attributable to poor handling and storage.

This was brought into stark relief recently for Ethiopia, as Japan banned coffee imports from the country after failing MRLs tests for pesticides. It will be interesting to see how the ECX can improve standards through its testing regime. Considerable work still needs to be done to improve traceability down through the value chain, however. Contamination need not occur at producer level, and can easily happen through inadequate transport and storage arrangements.

3 Analysis of Business Environment

This section addresses a few cross-cutting issues in the general business environment, which affect the performance of both the financial and agricultural sector. We have not broken them down into the macro-, meso- and micro- levels, arguing that to fully review the business environment for Ethiopia is beyond the scope of this study.

Rather, we have largely assumed for the purposes of this study that the business environment is a static feature of the Burkina Faso environment (it is not), in order to draw attention to some of those areas which may be deserving of the highest priority in relation to agricultural finance.

3.1 Land Tenure

Red status:

Land in Ethiopia is owned by the government and distributed to individuals, who are granted only usufruct rights. The lack of property rights is a major constraint to the financing of business, and also leads to poor agricultural productivity and environmental degradation by encouraging intensive production and discouraging investment in improving the quality of land. The government seems more flexible on allowing land to be used as lending collateral in situations where default would cause the land to be returned to a government entity.

Land in Ethiopia was traditionally administered under a feudal system, a situation that contributed to Ethiopia's revolution in 1974 and the country's consequent 17-year long military dictatorship.

The military dictatorship introduced a system of land tenure, which was maintained by the succeeding administration and is still in place today. Under this system, all property is owned by the state and distributed equally to farmers, who are granted only usufruct rights: they cannot sell, transfer, or pledge their land as collateral.

There is fierce debate between supporters of the current system and proponents of land reform. Donor agencies have made various attempts to encourage land tenure reform; however, such initiatives have invariably met stiff resistance early on. The political sensitivities surrounding land reform arise largely as a result of the government's deeply rooted philosophy that every Ethiopian should have a plot of land if they require one for a livelihood.

To further the difficulties in implementing land reform in Ethiopia, the country is unique among African countries in that, with the exception of a brief period of Italian occupation during the 1930s and 1940s, the country has not been subjected to any real colonialisation. Consequently, Ethiopia has not had imposed on it a Western-style system of land tenure and private property rights, from which it could model its own system, tailored to fit the country's idiosyncrasies, as is the case in most other countries across Africa. Furthermore, critics of land reform proposals in Ethiopia point to the experiences of neighbouring Kenya, where a large-scale land privatisation programme is widely believed to have resulted in large numbers of landless poor living in shanty towns on the edges of urban centres.

The inability to pledge their land as collateral clearly constrains the financing of business activity. In addition, the land tenure system causes a number of specific agricultural problems. The land tenure system requires farmers to not allow land to go unused, which causes loss in soil fertility and other environmental degradation, which in turn constrains crop yields. Without full ownership rights, the farmers have little incentive to invest to improve soil fertility and prevent soil erosion.

An additional complication is that the government has entered into long-term contracts to lease large areas of prime farming land to other sovereign nations, which limits the supply available to domestic farmers.

These problems are compounded by a growing population and by the inheritance provisions of the land tenure system, both of which result in the existing stock of land being divided into increasingly smaller plots.

Despite the extensive problems, however, there are some signs that the government is starting to become more flexible. It has started to allow land to be pledged as collateral for loans issued by the state-owned commercial bank or for loans guaranteed by local governments. The guaranteeing of loans by local government takes place only in certain regions of the country, whereby the local governments can guarantee loans against their annual budget, taking land as collateral, which can be sold back to the Federal Government to offset losses incurred.

3.2 Legal System

Amber status:

Ethiopia has a well-developed commercial legal code, but the effectiveness of this code is undermined by deficiencies in the judicial and enforcement system. Contracts are not always honoured and there is little effective recourse that the inconvenienced party to the contract can take. This situation acts as a constraint to business lending, as well as business itself. There are some signs that contract enforcement is becoming easier in Ethiopia.

Ethiopia has a well-developed legal framework for business, commerce and finance, including definition of the rights of lenders, financial reporting and auditing requirements, and provisions for bankruptcy proceedings. The most widely applicable piece of business legislation in Ethiopia is the 1960 Commercial Code of Ethiopia, but the legislation also covers constitution, public administration, criminal law, civil law, company law, labour, mining, tax, banking, communications and media, transport, environment, intellectual property, energy, agriculture, and construction.

While the country has comprehensive legislation, difficulties remain in enforcing certain aspects of the legislation. Contract enforcement is a particular problem, especially towards the smaller end of the business size spectrum. Even when formal contracts can be established, they are not always honoured, and in many such cases, there is little effective recourse for the inconvenienced party. This is particularly so in remote rural areas, where access to justice is limited.

Specifically relating to agricultural finance, weak contractual enforcement is a major challenge to the success of value-chain finance. Agribusiness (in the form of processors, buyers and commercial farmers) and small-scale farmers often team up with each other and make agreements on the purchase of produce and provision of finance. A common complaint among providers of agricultural value-chain finance in Ethiopia is that contracts are not honoured. Even when written contracts are established, buyers claim that side-selling by producers is rampant.

Overall, the situation in Ethiopia is by no means disastrous. Contract enforcement in Ethiopia is not as big a problem as in some other African countries and there are signs that this is improving. The World Bank's 2010 Doing Business Report suggests that it has become easier to enforce contracts in Ethiopia, with Ethiopia's rank in the indicator rising from 66 to 57 in the Enforcing Contracts indicator.

3.3 Infrastructure

Amber status:

There is currently a large amount of infrastructure development happening in Ethiopia; however the true costs of this new infrastructure are unclear. This situation is particularly true for energy infrastructure and roads.

Transport infrastructure in Ethiopia is generally fairly poor, however, a lot of infrastructure is under construction with further development planned in the pipeline.

A significant amount of Ethiopia's road building is being funded by the Chinese government. Much of this is in rural areas, aimed at improving access to local markets for agricultural produce, so that it can be easily shipped to China. It is not clear what concessions the Ethiopian Government are giving the Chinese in return, although it is unlikely that the Chinese are building infrastructure for free.

While the Chinese government is a large contributor to Ethiopia's road-building programme, it is not the only organisation funding this in Ethiopia. The African Development Bank Group has approved a US$326m loan to finance the second phase of the Mombasa-Nairobi-Addis Ababa Road Corridor Project. It involves the construction of 438km of road, including a 193km section in Ethiopia.

The newly formed Ethiopia Railway Corporation has been charged with the task of building a 5 000km rail network across the country, including a rail link between Addis Ababa and the Port of Djibouti. While the programme is in its early stages, the network is expected to link Ethiopia's urban centres, as well as enabling farmers to supply their produce to local and international markets and expanding access to commodities produced in remote areas.

Ethiopia's telecommunications infra-structure is generally good and the Ethiopian Telecommunications Corporation has announced plans to invest in further infrastructure that aims to improve the delivery of broadband internet and to extend its telecommunication services to the country's more remote areas.

Hydroelectricity is a major source of power in Ethiopia. However, as with the Chinese-built roads, the true cost of hydroelectricity in Ethiopia is unclear. The government is currently building a dam – the Gibe III dam – on the Omo river in the south of the country to provide the local area with electricity, as well as to generate electricity to export. However, the project is not without controversy: critics of the dam claim that interference with the flow of the river will upset the balance of agriculture in the Omo valley, cause armed conflict between different ethnic groups over water resources, and cause about 500 000 Ethiopians to be displaced from their homes, not to mention the potential problems caused downriver in Northern Kenya.

The recently completed Takeze dam project in Ethiopia illustrates the difficulties of conducting even a summary cost-benefit assessment of Ethiopian infrastructure projects. Unforeseen environmental impacts of the dam are now making themselves known, and the dam is costing large sums of money to remedy landslides caused by it. It is unclear how the dam was financed and who is bearing the financial burden of these losses.

In summary, while there is plenty of infrastructure development currently taking place in Ethiopia, the costs of these projects is unclear and it is difficult to gauge how much net benefit the country will ultimately derive from them.

3.4 Financial and Business Education

Red status:

Commercial awareness is rare in Ethiopian society and if the country is to adopt a market-led economy, there is a need to develop a business culture and a strong understanding of the mechanisms of commerce. Addressing this issue is likely to be a long-term task.

After a long period of Communist rule, and an ethos of reliance on state provision that persists to this day, Ethiopia does not have a strong business culture. The title »businessman« does not command the same esteem as it does in other African countries and the term is often interpreted as »someone who makes a living through dishonest practices«, which speaks volumes about the business culture in Ethiopia.

Relating this to agricultural finance, producers often exhibit values and behaviours that are not sympathetic to the concerns of lenders, and their inability to understand deals from the perspective of the lender is a major factor in their exclusion from finance. As for larger producers, processors and buyers, this lack of a business culture appears to cause entrepreneurs to be reluctant to take risk. In lending relationships, this manifests as a reluctance to heavily commit their own risk capital – although the situation is mirrored on the lender's side, as banks seem equally reluctant to take on risk. Similarly, entrepreneurs also tend to be reluctant to make significant concessions in management control and ownership in return for outside capital.

Primary education is compulsory and free in Ethiopia, but the primary syllabus does not include business studies or any commercially-oriented teaching. There are disparate initiatives to foster enterprise and business among the adult population.

The Ethiopian Academy of Financial Studies, established by the NBE, exists to provide training for banking and insurance professionals. The organisation is undergoing a capacity-building programme, the ultimate aim of which is to run a diploma programme in financial studies. While this will help to build capacity and foster enterprise among financial institutions, it will benefit the country only if businesses in the real economy adopt a commercial approach to doing business.

3.5 Taxation

Amber/Green status:

The tax policy and administration framework is sound, but there are significant problems. Heavy reliance on customs duties as a source of revenue is a significant deterrent to investment. Firms find difficulties complying with taxes, especially Value Added Tax (VAT). Black markets resulting from weak enforcement of the Somali border reduce the competitiveness of the business environment in those areas.

Ethiopia has a reasonably well-developed tax system, administered by the Ethiopian Customs and Revenues Authority. Ethiopia's CPIA fiscal policy rating – the World Bank's Country Policy and Institutional Assessment measure of fiscal policy stability and sustainability – places Ethiopia equal eighth out of a list of 75 developing countries.

The tax environment includes some measures that are designed to encourage investment. These include exemptions from customs duty on capital goods, exemptions from income tax for income generated by certain new investments, research and development incentives, remittance of capital, and loss carry forwards.

Tax administration can be considered sound. The Revenue and Customs Authority has adopted a system of taxpayer identification numbers, which are considered essential for any modern customs administration, and are undertaking a programme of computerisation.

However, Ethiopia's tax system is not without its detractors. Almost 50 % of Ethiopia's tax revenues come from customs duties or other import levies. Even given the exemptions for capital goods, customs duties are clearly a constraint on the development of industries that rely on imported inputs.

One of the main complaints of businesses is that they lack information on tax laws and administrative practices, which makes it difficult for them to calculate their liabilities and comply with the tax authorities. This has especially been the case with VAT. Furthermore, there are considerable disparities in local tax law and administration between regions, and municipal taxes have been criticised for their lack of transparency.

Despite the best efforts of the Customs and Revenue Authority, tax and especially customs enforcement along the Somali border is a problem. Black markets operating in this relative tax enforcement void put firms that operate honestly at a competitive disadvantage.

3.6 Information Environment

Amber status:

There is room for improvement in the collection, aggregation and analysis of agricultural data. There are plans to improve the credit information environment.

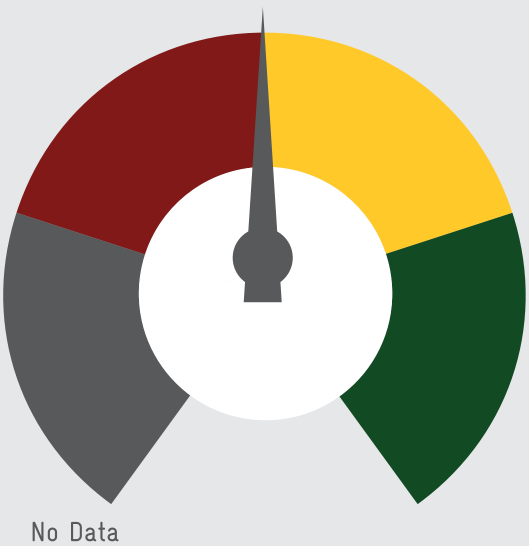
It became apparent during the assignment that the lack of reliable data was a source of frustration for all stakeholders. For instance, there has not been a survey of the coffee industry – Ethiopia's main agricultural export industry – for nearly 20 years. Not only does this hamper efforts to draft clear and coherent agricultural and industrial policies, it is also a disincentive to financing. To develop an effective credit portfolio, financial institutions need objective, accurate and timely data on the performance of the sector at sub-sector and regional level.

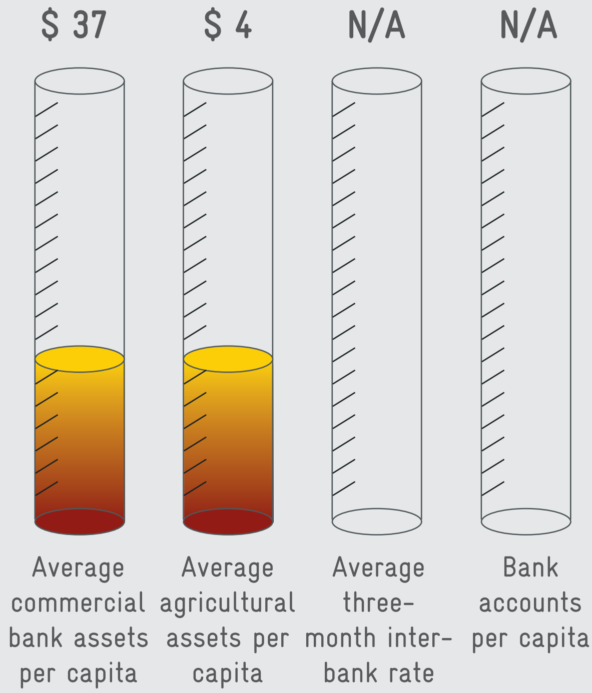
Relationships between players in many agricultural value chains are often very informal, with records of transactions between them seldom kept. This means that data on the cash flows of farmers, buyers and agribusiness is being lost. This data is potentially a hugely valuable record of financial activity, which could be used to help financial institutions identify bankable customers at both sub-sector and individual level. There is clearly a need to capture this information.

One way in which this information could be captured might be to promote the use of formal bank accounts and move away from the cash economy culture that prevails in rural regions. This way, over time, banks would amass information on their clients' incomes and expenditures and be much better placed to make credit decisions armed with this information.

The World Bank-funded Financial Sector Capacity Building Programme was due to include a project to establish a credit information bureau. We are aware that the International Finance Corporation (IFC) has also recently launched an initiative to increase the quality of credit reporting and improve credit information in Ethiopia, Tanzania and Mozambique.

4 Analysis of Financial Sector





Ethiopia´s financial system is currently not fit for purpose in supporting market-led development of any kind, but particularly agriculture. It is characterised by excessive state intervention which distorts markets and discourages competition. The exception is the Ethiopian´s Commodities Exchange, and also the government´s drive to encourage large-scale FDI in the sector.

Figure 4: Performance Dashboard for Financial Sector

Macro-Level

Market Liberalisataion	Ethiopia is a closed market dominated by stated-owned institutions and denied access to foreign capital or even credit lines.
Regulation and Supervision	NBE has significant deficiencies in its approach to financial sector policy, its human resources, and its organisational culture.

Meso-Level

Financial Sector Infrastructure	Major market deficiencies, though NBE is trying to address these (e.g. introduction of modern payments and settlements system).
Scope, Depth and Integration of Market	No real interbank wholesale market and very low levels of integration between institutions.
Product and Market Development	Product development currently sleepy but the implementation of the Ethiopia Commodities Exchange is a real innovation.
Interest Rates	Rates are feasible for borrowers but negative real interest rates mean that savings are low.
Financial Sector Expertise and Culture	Little tradition of commercial banking means skills and experience are very low.
Financial Sector Operating Model	A lack of coverage by financial institutions combined with a lack of integration means the required fundamentals are missing.
Technology	Adoption of technology is currently low, though technology could prove to be the key factor in driving the sector forward.

Micro-Level

Commercial Banks	The banking sector is dominated by state-owned institutions and current credit caps make the private sector uncompetitive.
SACCOs	The SACCO sector in Ethiopia is weak, with no real apex structure to promote development.
Development Bank of Ethiopia	A very weak institution characterised by poor performance.
MFIs	Ethiopia is home to some of the world´s largest MFIs, however, these are largely state-owned institutions.
Venture Capital and Private Equity	In a very nascent state but the Ethiopian government is encouraging direct investment, especially in export-led agriculture.
Insurance	The insurance sector is in an embryonic state, though shows great potential for future development.
Development Agencies	Aside from a major World Bank programme, there is not too much financial sector activity, and NBE restrictions are in place.

4.1 Overview

Red/Amber status:

Rapid growth in recent years has seen inflation soar. The government has tackled inflation with a number of blunt monetary policy instruments, including a cap on bank lending. Rising demand for and prices of imported goods have put strain on the central bank's foreign reserves, fears around which discourage investment. Ethiopia has a functional financial sector which is growing and evolving. However, there are some serious impediments to its growth. The sector is dominated by state-owned institutions and, despite having undergone liberalisation, the sector remains uncompetitive. Problems include state interference in the market, a lack of financial sector infrastructure, and soaring inflation.

Over the last decade, Ethiopia's economic growth has averaged around 10% per annum. The exceptions to this trend are 2002/03 and 2009/10, during which GDP declined due to periods of drought. Despite these setbacks, the overall growth over this period has been strong, although the general consensus is that the economy will grow at a more modest rate over the medium-long term.

Demand has increased at a rate higher than that at which the government has been able to expand economic capacity through its infrastructure development and poverty reduction programmes. As a result, inflation has been high – over 40% in 2009 – and there are fears that high inflation is becoming rooted in people's expectations.

The government appears limited in the monetary policy instruments it can effectively employ. Interest rates on government debt securities are very low and consequently the only participant in the markets for these securities is the state-owned commercial bank. This limits the extent to which the government can use open market operations to carry out monetary policy. One way the government has been conducting monetary policy is by increasing the reserve requirement on commercial bank deposits and raising minimum deposit rates. In addition, the government has imposed limits on the supply of credit in order to control the country's high rate of inflation.

Despite benefiting from the dramatic increase in commodity prices in recent years through its exports of agricultural commodities, Ethiopia has suffered from the rising price of oil and fertiliser. The rising cost of imports has put considerable pressure on the central bank's foreign reserves.

The NBE has therefore introduced a strict regime of credit caps and foreign exchange restrictions, which are crippling the development of the financial sector. This is combined with the commercial banking sector being dominated by state-owned banks, which receive preferential treatment, and has the effect of stifling competition.

4.2 Macro-Level

4.2.1 Market Liberalisation

Red status:

Ethiopia's financial sector is dominated by the state-owned commercial bank and is closed to foreign competition. Privately-owned banks are placed at a competitive disadvantage to the state-owned bank. The Government directs the state bank's lending and imposes restrictions on lending across the whole sector.

While the Ethiopian government has made attempts to liberalise the economy, the country's financial sector is far from liberalised. Arguably the most significant barrier to liberalisation is the dominance of the state-owned bank – the CBE – of the financial sector in terms of overall assets, deposited funds, loans outstanding, and number of branches.

There are privately-owned financial institutions in Ethiopia, but they compete on unfavourable terms with the CBE and the state-owned DBE. For instance, the CBE and the DBE are less constrained in their access to international funds than privately-owned financial institutions. Another example of how private financial institutions are placed at a disadvantage compared to state-owned institutions is that the CBE has the privilege of being the only bank in Ethiopia permitted to undertake export financing with China.

Foreign banks are not permitted to operate in Ethiopia. The government is extremely reluctant to open up the banking industry to foreign banks and it does not seem likely that this will change in the near future. The lack of foreign competition not only hinders innovation and product development among local banks, but also strengthens the government's domination of the banking industry.

Government-directed lending is common in Ethiopia. The government exerts its control of the financial sector through the CBE by directing its lending policies to priority sectors, regions, social groups and state-owned entities. Such interference is instigated by socio-political motives rather than on economic merit, and this clearly hinders the efficient allocation of capital by the financial sector.

In an attempt to curtail the excessive inflation described in the previous section, the central bank has imposed interest caps on lending. Allocation of credit is not market-oriented; lenders are simply allocated a fixed cap on their lending and there is no provision that allows lenders to trade allocations between each other. It is expected that the caps will be lifted sometime soon, however, the possible reinstatement of credit caps in the future as a response to inflation remains a concern both for lenders and for businesses that need to plan the future financing of their activities.

4.2.2 Regulation and Supervision

Red/Amber status:

The central bank of Ethiopia has critical issues in the capability of its staff, and its ability to make strong and timely decisions for the benefit of the financial sector without undue political interference. However, recent modifications have been made to financial regulations and efforts are underway to improve its ability to enforce those regulations in the banking sector. Parts of the financial sector remain unregulated and the central bank is burdened with a bureaucratic governance structure, which limits its ability to lead financial sector reform.

The NBE – the Ethiopian central bank – aims to maintain price and exchange rate stability, to foster a sound financial system, and to foster the economic growth of Ethiopia. The NBE is also responsible for regulation and supervision of Ethiopia's financial sector.

In 2008, a new banking proclamation was passed differing with previous legislation over improved corporate governance of banks; increased transparency and disclosure; measures aimed at promoting economic stability; increased liquidity and reserve ratios (largely in response to the soaring inflation at the time); and greater protection of stakeholders.

In 2009, a new microfinance proclamation was passed, broadening the range of services that microfinance institutions are permitted to offer, allowing banks to offer microfinance services and vice-versa, and tightening of the registration process for microfinance institutions.

Insurance companies are subject to regulations that specify minimum capital requirements and impose restriction on their financing activities.

As for supervision of financial institutions, the NBE is currently undertaking a project to strengthen banking supervision. The project is part of the World Bank's Financial Sector Development Programme and covers off-site surveillance, on-site inspections and the introduction of a deposit insurance scheme. It is less clear what capacity the NBE has in supervising MFIs.

One criticism of the NBE is that it lacks dynamism. Decision-making within the NBE appears to be fairly slow, as even relatively minor decisions are referred up numerous tiers of management. Some would suggest that this limits the NBE's effectiveness in leading financial sector reforms.

A number of financial sector-related activities are unregulated, notably the absence of a formal capital market. An informal market exists, whereby securities are exchanged on a black market. The lack of regulation of this market leaves participants unprotected.

4.3 Meso-Level

4.3.1 Financial Sector Infrastructure

Red/Amber status:

Development of Ethiopia's financial sector is severely hindered by the lack of a modern payment and settlement infrastructure. However, efforts are underway to introduce a modern electronic payment and settlement system. The NBE has established a credit reference bureau, however if reports of the bureau's deficiencies are accurate, some additional effort will be required to make it fully effective.

The Ethiopian financial sector lacks a modern payment and settlement infrastructure. This is one of the biggest impediments to financial sector development in Ethiopia and one the reasons why the country remains a primarily cash economy.

While a manual cheque clearing system is in operation, it is slow and vulnerable to fraud. There is no electronic system for transfer of funds. The lack of payment and settlement infrastructure causes banks to hold large portions of their deposits in cash (although this is also partly attributable to the lack of an interbank money market). Privately-owned banks are responding to the lack of a payment and settlement system by developing their own infrastructure and by employing alternative technologies, such as Point of Sale (POS) terminals, ATMs, mobile banking and the internet.

Microfinance institutions have traditionally employed lower levels of technology than banks, although in recent years many MFIs have adopted management information systems and are closing the gap in technological sophistication between MFIs and banks. As MFIs become increasingly similar to banks in their use of technology, the lack of a payment system is increasingly seen as a barrier to developing their service range. Furthermore, for MFIs servicing rural communities, the lack of basic transport and communications infrastructure is particularly problematic.

Fortunately, measures are being taken to remedy the absence of a payment and settlement system. The NBE is in the process of procuring and implementing a payments and settlement system, under the World Bank's Financial Sector Development programme. In fact, the World Bank has extended the length of this programme to allow the payment and settlement project to be completed.

Credit reference bureaus are a ubiquitous component of any discussion about improving access to finance. Although the Ethiopian financial sector lacks a modern payment and settlement system, the NBE has made progress in establishing a credit reference bureau. The bureau has, however, attracted some criticism, specifically about the accuracy of the information it provides and the timeliness with which it provides it.

4.3.2 Scope, Depth and Integration of Market

Red status:

The government's domination of the banking sector and the other restrictions it places on the financial sector significantly restrict the scope and depth of the market. The lack of an interbank money market limits integration of the market, as do geographical and cultural factors.

The scope of the market for financial services is restricted by the state's domination of, and influence on, the banking sector. The range of financial services offered by the financial sector is far from demand driven. With the government's powerful influence on determining which parts of the economy receive credit, there is little incentive for innovation and new product development.

The restriction on foreign capital entering the market limits the depth of the market for financial services. Although Ethiopian banks are generally fairly well-capitalised, there is significant potential to increase the depth of loanable funds by permitting inflows of foreign capital into financial institutions.

Other restrictions limit the scope of the market and the range of products and services on offer. One example is the ban on banks forming international trade finance relationships, which effectively eliminates any sort of international trade credit from the market.

The lack of an interbank money market is an obstacle to integrating the financial services market. So too are the country's geography and cultural diversity. Ethiopia is spread over a large area, with a range of terrains and consequently a diversity of cultures. By rights, this should lead to a mix of products and services on offer in the Ethiopian financial services market. In practice, however, this has led to segregation of the market along regional lines. It is as if there are different and completely separate financial sectors in different parts of the country.

4.3.3 Product and Market Development

Amber status:

In general, banks are keen to increase their lending to the agricultural sector, and the government has designated agriculture as a priority sector for lending by the state banks. The market will likely need to grow in order to meet the demand for agricultural lending without burdening any single lender with excessive risk. Product development would benefit from increased co-operation between co-operatives and banks. The success of the Ethiopian Commodities Exchange demonstrates what can be achieved in Ethiopia in terms of market development.

There is a big difference between the attitudes of the CBE and the private banks towards agricultural lending. The CBE's lending strategy is to a large extent dictated by the government in order to encourage investment in what it sees as priority sectors for the economy. The private banks take a more holistic view of their lending portfolios when formulating their lending strategy and try to diversify away as much risk as possible.

The government has directed the CBE to allocate a significant proportion of its loan portfolio to agriculture. Somewhat surprisingly, private banks seem keen to increase the size of their agricultural client base and have few reservations about agricultural lending. However, it should be noted that the private banks cited external constraints, such as the credit caps, as the reason they had only a small proportion of their loans to agriculture.

By far the biggest constraint that financial institutions face in offering services to agricultural clients is the huge amount of covariant risk inherent in the agricultural sector. This covariant risk – stemming from the fact that all agriculture is ultimately dependent on the weather – limits the proportion of any single well-diversified portfolio that can be allocated to agriculture. This is reflected in the opinions of the private banks: they were keen to increase their exposure to agriculture, but only as part of a wider lending portfolio.

With only 14 banks, mostly small in assets, it is unlikely that the banking sector in its present form can effectively diversify the risk arising from the quantity of agricultural lending currently demanded. There is clearly a need for the sector to grow, both in the numbers of institutions and in average size of assets, for it to begin to meet the agricultural sector's demand for funds.

Currently, finance is available to large commercial farms and agribusinesses through the commercial banking sector but the options for smaller farmers are limited. Some can access short-term trade credit through their relationships with agribusiness or co-operative buyers. Indeed, this may be the most effective route to improving access to working capital for small producers.

Many small producers obtain loans from MFIs. However, these loans are seldom tailored to the needs of small producers, are typically six months or 12 months in tenor, repayable monthly, and on high-interest terms. This makes them unsuitable for any sort of capital investment activity and, indeed, some ambitious farmers beggar themselves by seeking to use these instruments for unsuitable purposes.

From an agribusiness small and medium enterprise (SME) standpoint, the commercial banks feel that this segment is generally undercapitalised with weak management. They feel that these fundamental problems need to be addressed before they can develop a viable business model around them. This is quite aside from the sector-specific risks that they perceive in agriculture.

We see the opportunity to help both banks and co-operatives to develop a business model which can help make the agricultural sector more profitable. A range of services are required including deposit and savings accounts, cash management facilities, leasing and asset finance, insurance and retirement planning. In any market, profitable banking of small enterprise is underpinned by cross-sales of other products linked with a cost-effective distribution model and exceptional data management.

Despite the problems evident in the Ethiopian market, there is much to be encouraged by. The private sector has an apparent appetite for lending to the agricultural sector and the government has designated agriculture as a priority sector for the CBE to lend to. While underdeveloped in some aspects, the market is well developed in others. One aspect of the market that stands out as a beacon of excellence is the ECX, which is one of only three functional commodities exchanges that exist in Africa.

4.3.4 Interest Rates

Amber status:

Inflation has been higher than the rate of interest. The negative real interest rates have caused a mismatch between demand and supply of funds, and have prompted speculation in and consequent destabilisation of the markets for agricultural commodities. The problems have been made worse by interest rate caps which restrict market forces. As inflation subsides, so too are the problems.

As a result of the very high rates of inflation in recent years, Ethiopia has suffered from negative real interest rates. This has had numerous adverse effects on the financial sector.

First, negative real rates have discouraged saving, as savings rates do not compensate savers for purchasing power loss. This restricts the funds that banks have available to lend. By the same logic, negative real interest rates encourage borrowing, as the purchasing power value of borrowed funds reduces over time at a faster rate than the rate of interest on the loan. The mismatch in demand and supply of loanable funds is economically inefficient.

Second, under negative real interest rates, the tendency for speculation increases as savers and investors seek to offset their purchasing power loss. This has been evident in recent years in Ethiopia's agricultural commodity markets. A common complaint among agricultural producers is that rampant commodity speculation has caused huge price volatility and destabilised the markets for their produce.

Given the interest rate caps imposed by the government, there has been no market mechanism by which interest rates can reach market equilibrium rates at the prevailing rate of inflation. The lack of a feedback mechanism to correct interest rates has prolonged and to a certain extent exacerbated the problems.

However, it is possible, indeed probable, that now is the beginning of the end of negative real interest rates, at least for the time being. The rate of inflation has fallen in recent months and is rapidly approaching more sustainable levels. As this happens, real interest rates will become positive, reversing the problems associated with negative real interest rates.

4.3.5 Financial Sector Expertise and Culture

Red/Amber status:

Professionals within Ethiopia's financial institutions are more often than not poorly trained with weak expertise. There is no culture of financial services in Ethiopia. The NBE runs the only provider of financial sector professional education.

Given the country's communist past and its legacy of state-owned banks, there is no strong financial services culture. Likewise, the expertise among staff, managers and directors of financial institutions is generally weak.

While financial skills can be taught, the business culture associated with agricultural finance is very different from that associated with corporate or retail banking. Frontline staff need to have both empathy and understanding of their customers, and also the commercial awareness to make sure the bank gets viable business from them. They need to be prepared to engage with farmers and small business on their terms, travelling and visiting premises and farms to see the enterprise first hand. In essence, they need to have an entrepreneurial spirit themselves, and often the best recruits come from an agricultural mercantile or trading background, and are then taught the banking skills they need on the job.

The main provider of professional education for the financial sector in Ethiopia is the Ethiopian Academy of Financial Studies, which is run by the NBE, and is undergoing a capacity-building project under the World Bank's Financial Sector Capacity Building Programme.

4.3.6 Financial Sector Operating Model

Red/Amber status:

Coverage by private sector financial institutions is extremely limited. The state-owned MFI network has much wider distribution but not the financial model to address producer level finance in a proper way. It would be tempting to suggest facilitating relationships between the two, but the mobilisation of private sector finance to underpin ostensibly state-owned institutions is complicated and fraught with political risk.

Broadly, the commercial banks are not currently well set-up to address mass-market agricultural finance. It has not been their strategy to bank this market so it is understandable that they have not invested in the operating model required. This needs the heavy application of data and technology to reduce costs and improve the consistency and predictability of lending, as well as a widely distributed network of highly-trained frontline staff who can engage with customers face to face. This is expensive and difficult to implement, and requires a long-term approach to the market.

The outreach of MFIs is better, especially some of the large, regional state-owned institutions. However, they are essentially MFIs, best oriented towards short-term, high-turnover lending business for low-income urban and rural customers. The situation is unclear, but some sources suggest that major problems with some MFI portfolios may yet emerge.

4.3.7 Technology

Red/Amber status:

Privately-owned banks have begun to adopt new technology to circumvent the lack of payment and settlement infrastructure, although there has been little incentive for banks to adopt technology on a large scale. The internet is tipped to be at the centre of technological development in the financial sector.

As already noted, some of the privately- owned banks have started to employ alternative technologies, such as POS terminals, ATMs, mobile phones and the internet, in response to the country's weak financial sector infrastructure. Such initiatives are relatively recent, occur on an ad hoc basis and vary widely between different institutions. New technology has been adopted on only a very small scale within the financial sector, as institutions have had little incentive to do so, given the credit caps and other constraints to lending. It is therefore too early to spot trends in technological developments within the financial sector.

If the investments announced by the Ethiopian Telecommunications Corporation come to fruition, it seems likely that services that use internet-based technologies will become commonplace in the financial services market. Alternatively, the introduction of a payment and settlement system could be the catalyst for technological innovation in the financial sector.

4.4 Micro-Level

4.4.1 Commercial Banks

Amber status:

Ethiopia's commercial banking sector is dominated by the state-owned commercial bank. The number of privately-owned banks is growing slowly but steadily, however the operational and managerial capabilities of some of these banks is questionable. Foreign banks are prohibited from operating in Ethiopia.

Prior to the military revolution in 1974, Ethiopia's banking sector had evolved slowly and organically, in response to the country's needs. The military dictatorship, however, transformed the banking sector from a small but competitive market into a state-controlled monopoly, consisting of the CBE as the sole commercial bank. Following the end of communism, policies were implemented to liberalise the economy, including the financial sector. A market-oriented economy began to emerge and the country's banking sector opened up to domestic competition.

The CBE is Ethiopia's largest commercial bank in terms of deposits, loans and branch network. It controls over 50 % of banking deposits, makes around 35 % of loans and has a network of over 200 branches. CBE offers some credit services to individuals, but the majority of its lending is to traders, largely in the service sector. The bank's lending policy is heavily influenced by the government and the bank is encouraged to channel funds into industries that the government believes are priorities for the country's socioeconomic development. The government has designated agriculture as a priority sector and has tasked the CBE to lend to the sector accordingly. The CBE's management are keen to respond to this mandate, but have reservations as to their knowledge of agricultural sector risks and how to manage them.

Construction and Business Bank is a state-owned bank that provides loans for construction, housing finance, real estate development and community facilities.

There are 12 privately-owned banks in Ethiopia, the two major ones being Dashen Bank and Awash International Bank. Other (privately-owned) players include Bank of Abyssynia, NIB International Bank, United Bank, Wegagen Bank, Zemen Bank, Cooperative Bank of Oromia, Oromia International Bank, Lion Bank, Bunna Bank, and Birhan Bank. The private banks vary in size, range of services on offer, and management capacity. For instance, Dashen Bank is one of Ethiopia's longest established private banks, with a diverse product range, an extensive network of ATMs, and strong managerial capacity. In contrast, some of the more recently established banks lack the managerial capacity to offer services of the same quality and quantity as Dashen Bank.

Foreign banks are not permitted to operate in Ethiopia. This limits competitive pressure on the sector to improve its product range and quality of service delivery.

4.4.2 SACCOs

Red/Amber status:

Though the SACCO movement in Ethiopia is relatively small, the number of institutions has been growing rapidly. However, the rapid growth in the sector appears to be artificial, as the result of a government-led drive to promote membership of SACCOs. Increase in SACCO membership has been much more modest than the increase in the number of SACCOs.

There has been a rapid increase in the number of Savings and Credit co-operatives (SACCOs) in Ethiopia over the last decade. This has largely been a government-led response to the absence of bank credit in rural areas and to the huge success that the SACCO movements in other countries have had in improving access to finance.

However, the initiative has not been as successful as some have hoped and the Ethiopian SACCO sector has not had the same impact on access to rural finance as in other countries. While SACCOs have proliferated, the growth in SACCO membership has not matched the growth in numbers of SACCOs. One of the reasons frequently cited for the low membership is that the SACCOs have been forced into existence by the government and are not valued by their would-be members. The formation of a SACCO is an organic process, driven by the coming together of people with common interests who share the belief in the mutual benefits that can be gained through co-operation. Critics of the government's promotion of SACCOs in Ethiopia argue that the SACCOs have simply been funded and legislated into existence and do not exist in spirit. In short, the formation of these institutions has bypassed the most fundamental aspect of the co-operative movement: realisation of the benefits of mutual co-operation.

4.4.3 Development Bank of Ethiopia

Red status:

The DBE is a very weak institution with a history of problems. It is difficult to understand why it continues to receive support from the state. Even if it were transformed overnight, it is unclear what advantages it would have over other banks in the sector.

The DBE was established to provide long-term loans on a project finance basis to develop industry, agriculture and infrastructure.

The DBE has a history of poor performance. Most notably is the huge amount of non-performing loans on its books. Despite issues with non-performing loans, the bank has continued to make ill-advised loans, and its bad debts have ballooned.

The DBE has been bailed out repeatedly by the NBE. In addition to its financial problems, the bank has a high turnover of senior management and it has been restructured a number of times. Adding to the DBE's problems are allegations that the institution has been used for political and ethno-centric leverage, and that much of its funds have been misappropriated.

4.4.4 Microfinance Institutions (MFIs)

Amber/Green status:

The microfinance sector is characterised by seemingly well-capitalised institutions. However, there are some concerns surrounding the state's involvement in the sector and the governance of MFIs. Encouragingly, MFIs seem to be becoming more market oriented and the range of products and services on offer is expanding, however microfinance products designed to meet the needs of specific value chains are the exception to the norm.

Ethiopia has a large, vibrant microfinance sector, which has its roots in the financial interventions of NGOs. During the early history of the country's microfinance sector, various NGOs offered loans, the purposes of which were varied, but they were all alike in that very little interest was charged. During the mid-to-early 1990s, the government took action to formalise and regulate the sector.

Ethiopia's MFIs seem to be generally well-capitalised, liquid and run by competent management. Some of the country's MFIs regularly appear in the top rankings of global microfinance composite measures published by investment research organisations. Ever since the sector was formalised, there has been a transition towards commercially-oriented provision of services, and the range of products and services on offer has slowly grown over time.

However, as with the banking sector, the microfinance sector is dominated by the state. The five largest MFIs have a combined market share of over 80 % and are all state-affiliated to varying degrees. Many MFIs are owned by regional governments and/or backed by NGOs. Very few MFIs are owned by private investors. Consequently, governance is generally not commercially focused and, while there has been steady progress towards a commercially-oriented microfinance sector, the transition is likely to have been much faster if the sector were predominantly owned by private investors.

MFIs in Ethiopia are regionally oriented and are focused on serving the needs of communities in the regions where they are based. Some MFIs offer agriculturally-focused lending products, although these are often generic and targeted at a wide range of agricultural borrowers. Very few MFIs offer products tailored to meets the needs of specific players in specific value chains.

4.4.5 Venture Capital and Private Equity

Red/Amber status:

Private equity is just starting to take off in Ethiopia, mostly in the form of venture capital (VC). One possible impediment to venture capital is the weak business culture and lack of willingness among entrepreneurs to give up a share of their business.

Venture capital and private equity funds are scarce in Ethiopia, though a number of venture capital firms seem to be taking hold. A number of large international venture capital firms are looking at Ethiopia as a potential new market into which they can diversify their portfolios. There are a number of local venture capital firms starting to appear on the Ethiopian private equity landscape. A notable success story is Access Capital, which within three years of establishment has become a key player on the Ethiopian private equity scene.

We are particularly interested in funds focused on the SME sector, and especially agribusiness. Elsewhere in Africa, firms such as African Agricultural Capital, Citadel Capital, AfricInvest, Kestrel Capital and Root Capital seem to be pioneering this niche, albeit in a small way. The future role of sovereign wealth funds in agricultural investment may be vital, as countries attempt to embed food security within their investment strategy.

One possible impediment to the development of private equity and venture capital in Ethiopia is the weak business culture prevalent in the country. Owners of SMEs seem reluctant to relinquish any control or ownership in their business and this is clearly an obstacle to private equity financing.

4.4.6 Insurance

Red/Amber status:

Insurance is a relatively new industry in Ethiopia. The government is supportive of it, but in a fairly passive way. There is a market for agricultural insurance, but it is very unstable and there are serious issues surrounding its sustainability.

Ethiopia has a fledgling insurance industry, which is led by the state-owned Ethiopian Insurance Corporation (EIC). Many of the privately-owned banks offer insurance services and there are a number of smaller, dedicated insurance firms.

In general, government policy has supported the growing insurance sector, but policies have often taken a long time to implement. One common complaint is that it has taken too long to introduce compulsory auto and health insurance.

Over the last five years, EIC and Nyala Insurance Corporation have offered various forms of agricultural insurance. This has included weather index insurance and multi-peril crop insurance, livestock insurance and horticultural plantation insurance. The crop insurance they provide has not only smoothed farmers' incomes, but also improved their access to financial institutions, as they have been able to use their insured crops as collateral to access loans.

However, the market for these types of insurance has not been entirely stable – and there are fears that it could disappear. At the time of writing, Nyala is not advertising its agricultural insurance products. It is unclear whether there are institutional or management issues concerning the provision of agricultural insurance; however, as with other forms of agricultural finance, a large number of institutions are necessary to spread the covariant risk around the sector. Two institutions is clearly insufficient to share the huge amount of risk involved in providing agricultural insurance, even when one of them is by far the dominant firm in the market in terms of assets.

4.4.7 Development Agencies

Amber status:

Much of the technical assistance the financial sector receives is in relation to wider programmes, for which financial sector issues are only a minor concern, which raises questions as to how well financial sector technical assistance is co-ordinated among development agencies. The credit caps imposed in recent years have restricted the funds that donor agencies have been able to disperse.

There is a fair amount of activity by donors and development agencies around financial sector development. These are either targeted directly at the financial sector or involve the financial sector as part of cross-cutting initiatives, such as those centred on rural development. Financial sector development is often treated as a secondary concern on cross-cutting programmes and financial sector development is often left at the periphery. This ad hoc attention to financial sector development raises the question of how well financial sector technical assistance (TA) is co-ordinated among development agencies. Another pressing issue for development agencies is that they have been severely limited in their ability to disburse funds in recent years because of the credit caps imposed by the NBE.

The International Fund for Agricultural Development and the African Development Bank is currently implementing the Rural Finance Intermediation Programme (RUFIP). RUFIP is a large programme providing TA, loans and legal support to MFIs and SACCOs. The African Development Bank has recently secured funding for a separate financial sector development programme in Ethiopia.

World Bank is just completing its Financial Sector Capacity Building Programme at the NBE. Two projects are underway under this programme: a project to implement a payment and settlement system and another project to strengthen supervision of the banking sector and introduce a deposit insurance scheme. These will be the last components of the current phase of the programme. The World Bank is currently deciding whether or not to extend the financing and duration of the programme.

KfW has established a MFI apex guarantee fund, which supports commercial lending to the MFI sector. Terrafina Microfinance has also supported Ethiopia's microfinance sector by providing seed capital contributions and technical support to three MFIs, which have subsequently grown out of the start-up phase and are well on their way to financial sustainability.

5 Value Chain Analysis

5.1 Coffee

Ethiopia is generally regarded as the birthplace of coffee. The word coffee comes from »Kaffa«, the name of one of Ethiopia's main coffee-producing regions, and more genetically diverse strains of coffee exist in Ethiopia than anywhere else in the world. The practice of drinking coffee spread to neighbouring countries, the Middle East and to the rest of the world. Today, Ethiopia is the largest producer of coffee in Africa.

The Ethiopian coffee industry is the country's biggest export earner and is therefore an extremely important part of the economy. This is reflected in the priority that the government has placed on the industry in formulating its socioeconomic policies. In recent years, coffee has accounted for over a third of export earnings. The various taxes imposed along the coffee value chain are an important source of government revenue and, since coffee production is a labour-intensive process, the coffee industry is a key source of rural employment, It has been estimated that more than 20 million families rely on coffee for their livelihood in some form or other and most of them are small-scale farmers with limited financial resources and land to diversify their crop production.

There are many different species of coffee but the most commercially-traded coffee comes from two: Coffea Arabica (Arabica coffee) and Coffea Canephora (Robusta coffee). Ethiopia produces around 70 % of the global supply of Arabica, as the crop is suited to the temperate climate of Ethiopia's tropical highlands, at altitudes of over 1 000 meters. It is regarded as the premium variety of coffee on account of its fine aroma and rich taste. Robusta is grown in lower-lying lands, gives higher yields and is an easier crop to cultivate than Arabica. Its taste, however, is not as highly prized as that of Arabica, so it is used for blending and to increase the caffeine content in espresso and instant coffee.

The Ethiopian coffee industry has been quick to respond to the rise in the popularity of specialised coffee. These are coffees that are unique in some way and can therefore command premium prices over more common types of coffee. Specialised coffees can be categorised into four types: socially responsible coffee, organic coffee, eco-friendly coffee, and coffees of origin.
Socially responsible coffees are sold to the end consumer with the guarantee that the producers of that coffee have received a fair price for their labour and crop, and that they have not been subject to poor working conditions. The Fairtrade Foundation is one of the best known brands of socially responsible products. Socially responsible coffee is produce in many countries around the world, including Ethiopia.

Organic coffee is coffee that is grown with minimal use of pesticides and with no artificial chemical fertilisers or genetic modification of the crop. The Soil Association is a well-known organisation that certifies the organic credentials of various types of food. The use of manure as the main source of fertiliser means that most of the coffee produced in Ethiopia is eligible for the organic designation and can therefore command a premium price in the international coffee market.

Eco-friendly coffees are coffees that are guaranteed not to have caused any environmental degradation in their production. The Rainforest Alliance is a well-known organisation that certifies certain foods as being eco-friendly.

Coffees of origin are specialised coffees that have unique characteristics owing to the location and conditions in which the crop was cultivated. The many different varieties of coffee bean cultivated in the different coffee growing areas of Ethiopia all have distinctive tastes, sizes, shapes and colours, depending on growing conditions such as altitude, temperature, amount of rainfall and soil type. The unique tastes and aromas of high-quality Ethiopian coffees of origin such as Harar, Sidamo or Yirgacheffe distinguish these varieties as premium coffees. Wild Arabica coffee from the forests of Ethiopia has also found a place in the specialty market. These types of coffee are found only in Ethiopia. The importance of the Ethiopian brand was highlighted in 2005 during an intellectual property dispute in the US between the Ethiopian government and some large US coffee retailers objecting to Ethiopia's attempt to establish a trademark over some of these coffees of origin.

Clearly, there is much potential overlap between organic and eco-friendly coffee. The fundamental characteristic that links all of these types of speciality coffee, however, is that care must be taken at each stage of production to ensure that their special characteristics are not compromised. For this reason, value-chain analysis is a particularly valuable technique to employ when analysing speciality coffee.

5.1.1 Production

There are numerous ways in which coffee is cultivated in Ethiopia. First, there is forest coffee, which grows freely in the forest. Semi-forest coffee is harvested from wild coffee plants that grow on private land and receive little or no cultivation. Garden coffee is cultivated by smallholders on small plots. Finally, plantation coffee is grown on large plantations, almost all of which were formerly state-owned farms.

Traditionally, coffee is grown in the shade of trees, and coffee grown in this manner is referred to as »shade-grown« coffee. An increasing number of farmers are choosing to use sun cultivation, a method in which coffee is grown in rows, fully exposed to the sun with little or no protection from forest canopy. This causes berries to ripen more rapidly, which produces higher yields. However, this method necessitates the clearing of trees and use of fertiliser and pesticides, thereby forfeiting the eligibility of the crop for organic or eco-friendly speciality status. Deforestation, pesticide pollution, habitat destruction, and soil and water degradation are cited as undesirable side effects of sun-cultivated coffee. Sun-cultivated coffee is also widely regarded to be of inferior quality compared to shade-grown coffee.

Cultivation of coffee in Ethiopia is primarily performed by smallholders, either running garden farms or picking wild and semi-wild coffee. Approximately two thirds of the land cropped with coffee is under smallholder cultivation, whereas just under a third produces wild or semi-wild coffee. Large plantations account for a very small proportion of coffee producing land.

As most of Ethiopia's coffee is either cultivated by smallholders or grows wild, it is a labour-intensive industry and therefore does not require large quantities of capital. Land is provided to farmers by the government, so this does not constitute a financial hurdle for most producers.

One significant cost that should be highlighted, however, is the opportunity cost of cultivating coffee. Once planted, coffee plants take four years to mature to the point where they start producing a harvestable crop. The loss in revenue that could be earned by using the land to grow alternative crops during the maturing period is therefore the most significant fixed costs for most coffee farmers. That said, garden coffee can be successfully intercropped to diversify income streams.

Smallholders require very little working capital, as the input supplies are limited to small quantities of fertiliser and perhaps the occasional replacement of tools. Farmers are generally not obliged to remedy environmental degradation arising from their production and so do not incur costs of environmental renovation.

Owners of larger farms and plantations do require working capital, mostly to hire labour, as coffee production is labour intensive.

In terms of input supply, the private sector is weak. Opportunities lie in promoting nurseries that develop and distribute newer disease resistant strains cost-effectively.

➔ Financing

For smaller producers, replantation is the major capital cost, incurring both the expense (ideally) of purchasing new disease-resistant strains and the lost income while the coffee trees mature. There are virtually no avenues for financing this, though the MFI sector does provide some short-term working capital for those who need to cover costs (largely labour) during the harvesting period. It is difficult to see the market expanding into longer-term finance for this purpose in the foreseeable future.

The situation may be markedly different for larger growers, especially if the credit environment eases. Ethiopia still has large tracts of land available for expansion, and commercial banks could target successful growers with a view to funding expansion. The ideal product here would be a longer-term (e.g. three-to-five years) capital investment loan, underpinned by a partial guarantee from a development agency or bank. Growers with plans to implement outgrower schemes could be prioritised with a view to benefiting smaller growers.

Alternatively, given the current credit environment, equity investments in larger farms could be considered.

Other ancillary avenues could include promoting access to finance for input suppliers. In this case, the nursery sector could be a viable market. Similarly, start-ups or expansion plans would need longer-term capital loan or equity investment.

Products easier for the banks to swallow could include short-term loans, particularly seasonal credit (e.g. less than one year) for producers who face cash-flow problems, particularly during the harvest period.

5.1.2 Trading, Transport and Storage

Most coffee is dried on the farm before sale to their co-operatives or private traders. The trading system is multi-layered with several levels of storage and aggregation before it reaches processors or exporters. Predictably, there are major ongoing issues with the quality and consistency of supply.

Co-operatives sometimes also play a role in providing some inputs, perhaps on a credit or discounted basis. They have been badly hit by the coffee crisis of several years ago, however, and many have major financial problems. Therefore they find it very difficult to prefinance production in any capacity.

That said, there are a few examples of larger co-operative unions forming an apex structure for regional co-operatives. They seem to be having some success in structuring supply lines, particularly with a view to obtaining certification for higher value specialist coffees. Better governance and professionalism in these institutions make them more viable partners than primary co-operatives.

By law, most coffee must now be traded through the EXC, and it seems that even local trade is now gravitating towards this market. The ECX has a network of warehouses and testing centres, which facilitate trade and give comfort to buyers. The ECX is also trialling a system of warehouse receipts which may ease short-term finance for traders, though it is not clear to what extent this facility is being used.

In general, however, transport and storage supply is weak, and opportunities may exist in supporting private sector growth.

The bulk of the coffee is destined for export, and only licensed exporters are allowed to engage in this trade. There are accusations that preferential treatment is given to locally-owned firms with strong connections to government.

➔ Financing

There are many levels where improved access to short-term trade finance could have an impact in improving trade flows and incomes for all players in the value chain. Clearly both private traders and co-operatives are short of working capital, particularly during the buying season.

Commercial banks could be encouraged to develop these markets, given suitable incentives through some sort of risk enhancement. Again, this dependent on the loosening of credit caps.

Ethiopia's co-operative movement is badly hampered by the lack of a well-organised co-operative banking system. It should be a long-term objective of the movement to encourage co-operative financial sector development. If other countries are any guide, co-operatives will always be more difficult for commercial banks to finance, and the sooner a dedicated financial system for the co-operative movement is in place, the better.

Capital investment is really missing in transport supply and storage infrastructure. Logistics companies could represent a much more appealing avenue for the banks. Co-operatives also need capital investment for such facilities but their financial structure and management is weak.

The ECX has developed a warehouse receipts scheme for coffee, but this appears to be in its infancy. Technical assistance and risk enhancement for this scheme could be a welcome addition.

Finally, exporters are in dire need of international trade finance lines. These are currently limited to documentary credits and the market is strictly controlled by the NBE. Liberalisation could mean a real opportunity for banks to develop international exposure and also serve their customers better.

5.1.3 Processing

Shortly after harvesting, coffee must be processed. There are two types of coffee processing; wet processing and dry processing. Both types are used in Ethiopia.

The dry method is the simplest and cheapest method of processing coffee, and one that produces a natural tasting coffee. The wet method of coffee processing involves more capital outlay, more water, and more care than the dry method. The main difference between the wet and dry methods is that the wet method removes the pulp from the bean soon after harvesting instead of allowing the berries to dry in the sun. The wet method produces a green coffee that is more homogeneous with fewer defective beans than the dry method. The coffee is characteristically mild in taste and is generally regarded as being of better quality. It therefore commands a higher price.

Arguably the most important stage of coffee processing is roasting, a process that transforms the chemical and physical properties of green coffee beans and ultimately produces the characteristic flavour and aroma of coffee. Grinding and packaging is the final stage of coffee processing.

Almost all of the coffee that is roasted in Ethiopia is destined for the domestic market, and overall Ethiopia is a net importer of roasted coffee. Almost all coffee exported is shipped as unroasted green beans, largely because roasted coffee has a limited shelf life. However, a small number of Ethiopian roasters are trying to break into the international market for roasted coffee. They face seemingly large competitive issues from large internationally recognised brands of roasted coffee, logistical issues surrounding the time it takes to ship their product, and the consequent shelf-life limitations. Crucially for this study, importers of roasted coffee often stipulate large minimum order quantities. Small roasters often struggle to finance the raw coffee required to meet these large order sizes and would therefore benefit from some financing.

Most coffee processing in Ethiopia is undertaken by co-operatives. Typically, coffee co-operatives are focused on a particular geographic area, and have a network of collection centres, which are accessible to farmers. Farmers deliver their crop to these centres in exchange for payment and the coffee is then taken from the collection centres to a warehouse run by the commodities exchange, where payment is made. The proceeds of the sale are then disbursed to the farmers.

Most co-operatives are undercapitalised, and lack the professional management and skills needed to manage a growth strategy. They are keen to expand services (including financial services) to members but lack the financial and business wherewithal to be more successful. An approach to simultaneously providing both financial and management support would benefit the sector.

Some locations are not as well served by co-operatives and in these cases middlemen collect the coffee from producers and then sell on their collections directly to the commodities exchange. Technically this is illegal, as the ECX is the only legally authorised purchaser of coffee, however, the practice is common. A common complaint among farmers is that the middlemen do not pay them a fair price for their crop.

➔ Financing

The major financing gap is for the expensive roasting, grinding and packaging machines, which are required to be competitive. These tend to range from a few tens of thousands of dollars up towards the million dollar mark. Neither debt nor equity capital for this purpose is feasible in Ethiopia at present. Payment terms for debt would need to be at least three years and commercial banks currently have little appetite.

Should the credit environment improve, a credit guarantee product could then perhaps be developed to support lending by the banks. Again, equity investment might prove a more direct route, with a number of coffee processors we spoke to actively soliciting investor interest.

Working capital facilities are also required, though again these are in short supply. Access to trade finance to support export operations is extremely limited, as well as for importing machinery and indeed the packaging materials they require for their business.

Figure 5: Diagram of Typical Coffee Value Chain

Case Study: Eliana Coffee

Eliana Coffee is a small local roaster with an annual turnover of perhaps US$ 20 000 and an operating profit margin of around 50 %. It has a good franchise with a local coffee chain, some supermarkets and other local stores.

Working capital is a struggle for a small operator. The lots he is required to buy from the ECX are typically large and a lot of money is tied up in stock. A lot is typically 1 800kg and costs about US$ 5 000.

Major capital costs required for expansion are machinery such as roasters and grinders. These units are imported from Europe and can typically cost upwards of US$ 20 000. He has tried to obtain a loan from every bank but been declined every time, despite offering his car as collateral. Added to this is the difficulty in obtaining the necessary permissions for the required foreign exchange.

The entrepreneur is lucky to have access to some land owned by a relative, on which he built a small factory from his own financial resources. He stated high land prices would have been an insurmountable barrier had he not had a family connection to help.

Other running costs include casual labour required to sort the beans, and utilities as well. Power outages in Addis Ababa are a major cost to his business and cause constant disruption.

Figure 6: Profile of Small Coffee Processor

Case Study: Robera Coffee

Robera Coffee is a substantially larger firm engaged primarily in green coffee processing for export. Its turnover is approximately US$ 10m with profits of around US$ 400 000. The firm does some roasting with a small roaster (see below), but would like to move much further into value addition. Its strategy is to export roasted coffee to the Middle East and Scandinavia but it needs a new large 500kg capacity roaster to achieve the volumes and competitiveness required. It is estimated that this roaster would cost around € 2m. The banks are unwilling to finance this investment so Robera is seeking an equity investment partner. It has prepared a brief prospectus and hopes to solicit proposals soon.

Other plans include establishing a factory plantation, along with an eco-tourism facility for coffe-lovers. The firm finds diversification essential as margins in coffee exporting are very low. Currently it cannot even use the full capacity of the factory due to short-term credit restrictions, despite being a large multi-banked enterprise.

Figure 7: Profile of Large Coffee Processor

5.2 Sesame

After coffee, oilseeds are Ethiopia's second biggest export earner. Their importance as a source of foreign exchange has made them a priority for government. Sesame seed is the main oilseed export product (over 90 %) for both export quantity and value, and Ethiopia has high-quality sesame seed varieties that are suitable for a wide range of applications. These include:

- Edible sesame oil, which is especially important in the cuisine of East Asia, and Japan and China in particular;
- Confectionary, biscuits and baking where the hulled clear white sesame seed adds flavour;
- Tahini, which is a traditional Middle Eastern paste used in cuisine;
- Halva, a sweet made from tahini, boiled sugar and other ingredients;
- Sesame flour and sesame seed sprouts; and
- Pharmaceuticals and cosmetics (e. g. soap).

Sesame production is well-suited to large parts of Ethiopia. It is adaptable to many soil types and thrives in warm climates. Production is dominated by more than 750 000 small-scale farmers, cultivating nearly 200 000 ha. Total production by Ethiopia has risen rapidly, up from 19 000 tons in 2000/2001 to 216 741 tons in 2008/2009. More than 70 % of the sesame is exported, with Ethiopia beginning to increase its global market share – up from 1.9 % by value in 1997 to 8.3 % in 2004. This ranks it fourth in the market share behind Sudan, India and China. Major importers include countries in Asia and the Middle East, with demand growing steadily. The current average yield in Ethiopia is estimated to be 780kg per ha compared to China with the highest average yield of 1 000kg per ha. Research indicates that yields of around 1 500kg per ha are possible adopting best practice in all areas.

It is notable that over the same period, relative value has decreased against export volumes. There has been a gradual deterioration in the quality, and therefore price, of Ethiopian sesame. This is attributed to the very long value chain, intermediated by several levels of local, regional and national trading structures. Traders are not supported by good logistics or a transport network, which necessarily leads to problems. In addition, the environment is plagued by sharp practices from many parties, exemplified in the corruption and spoiling of produce by weighting it with detritus such stones, sticks and water to increase the apparent volume and mass.

Exporters in Ethiopia are therefore burdened with the increased labour costs required to clean the product for export and processing. However, even in this industry, Ethiopia is eclipsed by other developed nations (e. g. UK, Netherlands, Israel) which buy the produce at low value and make returns by cleaning it and selling it on at a higher price. This is a capital intensive and technologically advanced process.

5.2.1 Production

Most sesame is grown as a cash crop by small-scale farmers, and less than 2 % is produced by large commercial farms. Production is currently labour intensive, rain-fed and uses low levels of inputs. There is significant capacity to produce yield by increasing input use and enhancing irrigation in particular. Another input which deserves consideration is the use of new, improved seed varieties. Otherwise, sesame is relatively hardy and can flourish with zero or very low levels of pesticides and herbicides.

Sesame rotates well with a number of other crops including cotton, corn, peanut and sorghum, and is also a good soil builder. That said, many farmers do not diversify and focus solely on sesame.

Sesame production is a pretty simple process. Immediately after the previous season, the land is cleared and ploughed. Most use oxen for this purpose but some hire the services of a tractor. After planting, weeding is required at certain intervals, a labour intensive process where farmers may have to recruit casual labour. Harvesting has a very short window and also requires casual labour, at which point local wages spike due to demand.

Following the harvest, the cash poor farmers are approached by local traders to sell on to their local co-operative. During the harvest period, farm-gate prices are typically 30 % lower than during the rest of the season, but farmers need to realise cash quickly. There is little competition for their produce and farmers are not generally well informed about prices elsewhere. As far as it goes, price is influenced by the uniformity of product in terms of taste, colour, dryness, and purity.

For small-scale farmers, the input costs are largely made up of:

- Labour for weeding and harvesting;
- Seed stock; and
- Fertiliser.

Local MFIs and credit unions offer small loans on strict terms, and many farmers turn to moneylenders instead. The labour costs are generally essential so, more often than not, farmers use seed from the previous crop (rather than buy improved varieties) and go without fertiliser.

At the other end of the spectrum, we are beginning to see the formation of large commercial farms. Despite over-population in some areas, Ethiopia still has vast tracts of arable land owned by the government, which are extended on long-term leases to commercial farmers and enterprises. Commercial farmers are able to obtain some limited finance from the commercial banks (e. g. Commercial Bank of Ethiopia, Wegagen Bank and United Bank) if they are able to provide collateral. This could be a piece of urban real estate for example as, like small-scale farmers, commercial farmers are also prevented from pledging their land as collateral.

➔ Financing

The opportunities for obtaining larger and longer-term finance for small-scale farmers directly from the financial sector seem limited. A partial guarantee scheme could help expand the amounts loaned but probably would not have a great impact in increasing the term of the loan. Farmers really need seasonal credit, rather than the very short-term harvest period facilities they receive at present. On top of this, the financial sector is currently subject to strict credit caps which prevent overall expansion in lending.

Supplier credit is perhaps an option. This has been attempted in the past in Ethiopia with poor results, however, Firstly, the private sector operators are weak and starved of credit themselves and, secondly, side-selling and non-repayment has proved to be a serious problem. More opportunities probably exist further up the value chain, which would have a trickle-down effect for small-scale farmers. Ethiopia is really missing some strong private sector input suppliers, particularly for seed stock and fertiliser. Helping establish these is a necessary first step to developing supplier credit.

With commercial farmers, if we assume that credit caps are eventually lifted, co-operation with the commercial banks to leverage finance should be considered. Perhaps a partial guarantee scheme for seasonal (short-term, one year) lending for pre-financing production could be considered. It would have to be accompanied by extensive capacity building in the banks to help them undertake unsecured lending to the sector. Maybe larger farmers with outgrower schemes could be prioritised, with a view to developing supplier finance lines for their community of small-scale producers.

5.2.2 Processing

There is very little processing of raw sesame in Ethiopia, though there have been some recent examples of market entry by some small to medium-sized companies producing tahini, sesame oil and hulled seeds. The process is quite capital intensive, using large and expensive machinery, which demands skilled operation and maintenance. Even the process of cleaning the raw sesame up to international standards is highly mechanised. Indeed, developed world companies actually specialise in this business currently, making profits (even considering the additional burden of international logistics) from importing cheap Ethiopian sesames to countries like the UK and the Netherlands, cleaning it and exporting the export grade product.

Over half of the companies concerned have been primarily financed by foreign investors, often those that have ready access to a market in their home country (e.g. Israel, Turkey). Investments are typically less than US$2m, so these are still small enterprises.

They buy their produce on the open market, preferring not to deal directly with farmers with whom some have had difficulty in the past. One has established its own factory farm (with an outgrower scheme) and others are considering this route.

Unfortunately the nascent industry is not particularly competitive for reasons which are not entirely clear. Lack of foreign exchange is certainly a problem, and it also creates absurd situations whereby the sesame production business essentially operates at a loss to generate access to foreign exchange. Naturally some of this is vital in enabling the import of vital inputs like packaging and machinery, but some of it is directed towards consumer goods which are sold on to prop up the profit and loss account.

➔ Financing

The commercial banks provide some short-term financing for these businesses for working capital purposes, however, in the longer term more capital finance is needed. If credit caps are relaxed, then initiatives to help the banks understand longer-term balance sheet lending are vital. Undoubtedly this will need to be supported by risk incentives from the development community, probably in the form of a guarantee scheme. For example, perhaps we could envisage a three-to-five year loan product for capital investment purposes (e.g. machinery, facilities), supported by a partial risk guarantee for appropriate customers.

A more immediate and direct approach would be to consider equity investment opportunities. While there are all sorts of problems with the business environment in Ethiopia, the government is actually making practical steps to encourage FDI. The development or facilitation of venture capital and private equity is considered in more detail in Section 6.

Finally, a strange feature of the Ethiopian financial sector is the absence of international trade finance lines for the private sector commercial banks. Clearly this is part of NBE's effort to limit credit expansion but it is extremely demoralising. Trade finance lines are one of the long-term routes for banks to build international credibility and interest. Not that this is hugely relevant in an environment in which foreign participation in the banking sector is not permitted.

Documentary letters of credit seem to exist, but apparently these are badly administered and payment takes a long time. It is not clear whether the delay is in the presentation of documents or the processing, but this is clearly unacceptable for a simple product designed to guarantee swift payment for exporters who can deliver the required produce at the required standards. If the credit situation eases, however, we anticipate a major effort to help banks build their international trade finance lines, perhaps supported by a guarantee scheme like the IFC operates, which would be valuable for both the banks and their trading customers.

5.2.3 Domestic Trading

The supply chain from producer to processor/exporter is typically chaotic and unprofessional. It is characterised by several different levels of traders who are generally in the business to exploit market imperfections. They rarely have long-term relationships with particular suppliers and buyers, and take little care in the handling of produce. Indeed, in the sesame value chain, many even deliberately corrupt the product to obtain higher prices. This is not to malign the activity of trading itself as it is a vital activity. However, traders simply respond to market incentives and disincentives when adopting their value and behaviours.

Co-operatives also play a role in buying and bulking sesame and coffee. Despite their mutual nature, they do not currently seem to offer farmers greater benefits either in price or input credit. Typically they are institutionally weak and sorely underfinanced (some are quite crippled by bad debt themselves).

However, the failure of traders and co-operatives operating at the base of the value chain to adequately grade and bulk the produce is a major source of lost earnings. For example, in the international market, the level of sesame cleanness is expected to be 99.5 % pure seed, whereas in Ethiopia it stands at about 97 %.

Perhaps the ECX Exchange will begin to enforce some discipline on the market. Part of the trading regime is the rigorous quality testing of produce. Through this approach, those traders with good supply lines will quickly be identified and rewarded for their professional approach.

➔ Financing

Assuming the credit environment improves, assistance should be given to commercial banks to develop credit portfolios for those more professional and higher performing traders and co-operatives. Again, this could consist of short-term credit lines for trading, underpinned by a partial guarantee scheme. Initially, traders and co-operatives will need to build their own balance sheets and credit history. Short-term credit of this type will allow them to bulk and store produce which, even over the short term, can yield real benefits as the seasonal price fluctuations run their course.

In the longer term, priority could be given to those traders and co-operatives with an appetite for supplier credit. Those with the wherewithal to be trading members of the ECX could represent a good starting point. Care is needed, however, as farmers have a poor reputation for honouring contracts and avoiding repayment. Traders and co-operatives will need to develop a good system of incentives and, indeed, repercussions to encourage the right behaviour. The government is unable or unwilling to assist in this process at present so they will have to develop them independently, acting at all times within the law and the ethical standards of good business.

An ancillary opportunity which may be easier for the commercial banks to swallow is in transport and storage. Lending opportunities should be identified within the haulage industry, and appropriate products developed. Similarly, business plans for establishing warehousing facilities (for example by commercial farmers, hauliers and co-operatives) should be viewed positively, and perhaps specific risk mitigation products can be developed to encourage lending.

The ECX is keen to expand warehouse financing along with the commercial banking sector. It appears that there have been very few transactions so far but this may be partly or largely due to the current credit caps. This initiative should be supported as a positive development.

5.2.4 International Trade

There are limited trade finance facilities available to exporters, as result of a ban by the NBE on private sector banks obtaining foreign currency credit lines from overseas banks. This is partly a result of the central bank's wish to impose exchange controls, but also symptomatic of a wariness of foreign finance that is embedded in the institution. There is an export credit guarantee scheme operated by DBE, however.

Other incentives to support exports in general are available (e. g. export duty exemptions and an import duty drawback scheme) but agriculture is effectively excluded from access to these as it is not a value-addition industry. Exporters, however, are prioritised for foreign exchange allocation. This can lead to some interesting business models such as agric-exporters which are essentially fronts for the subsequent import of consumer goods.

Coffee is already traded and sesame is the next commodity to be integrated into the ECX. This could have a major impact on improving the structure of the value chain, and improving the quantity and quality of the sesame which reaches export markets.
Brokers on both the buy and sell side of the market complain about access to working capital. Financing lines need to be in place for the main buying season, and delays have been reported which cause major problems for traders.

➔ Financing

Trade finance is a relatively straightforward product line, which should be attractive to banks in normal circumstances. In the event that restrictions on international trade finance lines are lifted, a programme of capacity building in international trade finance should be considered. This could be combined with a guarantee scheme (along the lines of the IFC's Global Trade Finance programme) to generate appetite among international banks.

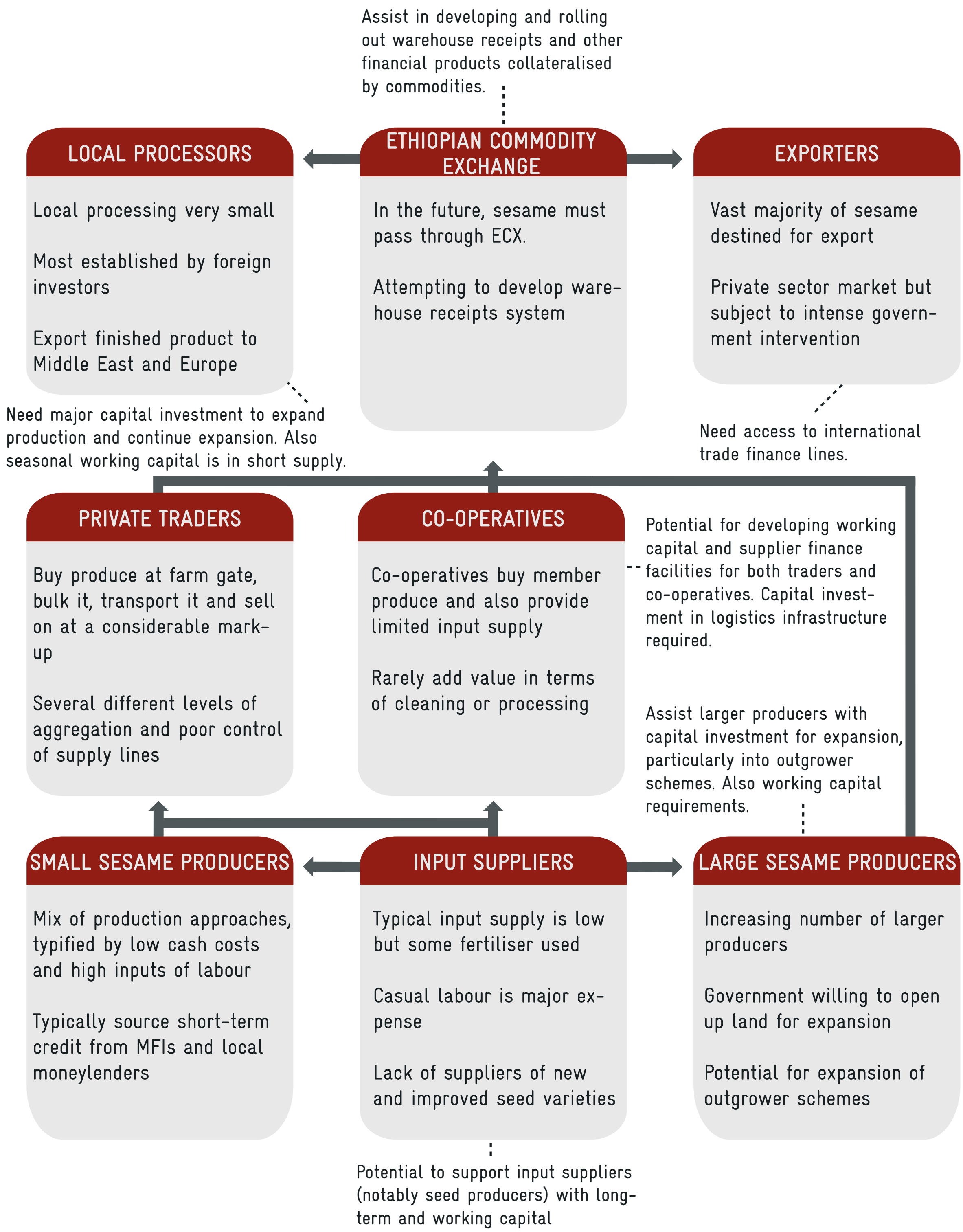


Figure 8: Diagram of a Typical Sesame Value Chain

Case Study: Ethiopian Commodity Exchange

The Ethiopian Commodity Exchange (ECX) is an initiative sponsored by the Ethiopian government to better regulate and more efficiently trade major agricultural commodities. The exchange is currently trading a number of commodities (of which coffee is only the most important) and hopes to move into sesame in due course. The government has mandated that all trade in certain commodities must be directed through the exchange so it is effectively a monopoly. Buying and selling members buy a seat on the exchange, and the exchange also takes a margin on all trade, which underpins operating costs. The ECX has a network of warehouses throughout the country where produce can be stored securely, and correctly measured and graded. On the basis of a receipt from the issuing warehouse, a seller can then instruct his agent to make a deal in the open outcry market. The buyer can then collect the specific produce from the warehouse on production of the required paperwork. The ECX is one of the few functioning commodity markets in Africa.

Figure 9: Profile of Commodity Exchange

6 Critical Success Factors and Recommendations

This section of the report is a suite of broad recommendations which we feel will assist the value-chain approach to financing the agricultural sector. They therefore tend to concentrate on aspects of value-chain development and financial sector reform which directly impact on the topic. It is not our intention to reflect all the well understood elements of successful value-chain development which indirectly impact the financial feasibility of value chains and their participants.

The study is oriented towards the promotion of private sector capital towards endeavours which are mutually rewarding, and it does not reflect deeply on the poverty alleviation aspects of agricultural finance. Ethiopia is markedly different from other environments we have studied and has the following features:

- Finance is largely in government hands and allocation of credit is underpinned by political considerations;

- There are considerable barriers to the free flow of capital, and development agencies will need to liaise closely with government to agree on objectives;

- The financial sector in Ethiopia is very underdeveloped, and needs considerable capacity building to be able to handle large-scale credit expansion; and

- The overwhelming fiduciary duty of financial institutions is to shareholders, depositors and members; and

- Financial support must be sustainable as market exit and/or default events can create unnecessary hardship and ruin markets for others.

Many of the recommendations are mutually supportive and, to some extent, interdependent. It is difficult to separate them clearly but we have done so for the sake of readability. However, they should be viewed as a suite of proposals rather than a set of mutually exclusive options.

6.1 Macro-Level

6.1.1 Continue Policy Dialogue around Financial Sector Liberalisation

The options for engagement with pro-growth agricultural finance by the development sector are limited given the closed financial sector. Credit growth is currently frozen, and product and market development has halted. Competition between the banks is extremely low, and banks are largely recycling their portfolios in the hope that the situation will improve in the future.

It is likely that credit caps will be removed at some stage, at which point the banks hope to spring into action. The reality is that the focus of lending will be on Ethiopia's fast-growing construction, manufacturing, retail and service sectors. Agribusiness will also receive some attention but it is unlikely to be transformative.

If private banks are to achieve the scale required to play a leading role in the economy they must be opened to foreign capital and competition. At the moment, there is not even a domestic stock market where banks can raise capital locally.

To attract capital, private investors will also need to be convinced that the environment is fair. At the moment, the financial sector is a political space where the CBE, DBE and NBE are able to dictate the agenda (this is not to say that there is not a role for state-owned development banks or that financial stability be cast aside).

No doubt these arguments have been put before the Ethiopian government time and time again, yet it is difficult to see how bank-led agricultural finance can really flourish until significant change is implemented.

6.1.2 Assist National Bank of Ethiopia Continue Financial Sector Development

The financial sector in Ethiopia is dysfunctional and structurally weak. The NBE is tasked with developing the sector but is challenged by:

- Continual political interference in the pursuit of its objectives;
- A limited range of instruments for influencing inflation;
- Limited experience in terms of human resources;
- A bureaucratic decision-making process;
- Entrenched prejudices and a distrust of new ideas; and
- A lack of confidence in its abilities to manage change.

If the central bank is to become a more progressive, innovative institution, we will need to work with it to help influence the outcomes. A major World Bank capacity-building programme is now coming to a close, hopefully culminating in the successful introduction of a new payments and settlements system.

We understand that a subsequent World Bank mission will be working with the NBE to lay out a supplementary programme, and to provide additional funding. There is almost no area in which this input would be wasted, however, some of the priorities would include:

- Assisting NBE to implement a government bond market, not least to give it further options in the area of monetary policy aside from credit caps; and
- Continue with the development of a local stock market, to formalise and regulate the current raising of capital.

6.1.3 Strengthen Co-operative Movement

The ability of small farmers to organise themselves into progressively more close-knit and larger groups is such a vital quality that it is difficult to over-emphasise. In Ethiopia, this is particularly weak. This is not only important in mobilising finance, but also in facilitating access to all the other inputs needed to improve productivity and to strengthen bargaining power.

There is a nascent co-operative movement, nominally spearheaded by the Co-operative Agency. This institution, while well-meaning, does not appear to have the strength and vision to lead the movement by itself.

Similar to agricultural co-operatives, the weakness of financial services co-operatives is also evident. There is some development of local credit unions, often around workplaces or neighbourhoods, but there is no leadership in the sector to spearhead its development. The formation of SACCOs in rural areas could be a vital development, providing a genuine community-based alternative to the MFI sector.

6.2 Meso-Level

6.2.1 Strengthening Agribusiness through Equity Investments

Particularly in Ethiopia, we feel that the most direct route to strengthening the agribusiness sector (including both input suppliers as well as produce buyers) is through direct equity investment rather than credit, particularly for SMEs. Credit is in extremely short supply and the government is actively encouraging FDI. Working on the assumption that high-potential opportunities can be found, and current ownership can be induced to accept the necessary concessions in return for additional capital, this can simultaneously reduce the financial risk profile of the business while also introducing improved governance and better management.

International Financial Institutions (IFIs) and private investors could combine to create an agricultural VC fund, especially focused on value-addition agriprocessing in attractive value chains. The aim of the fund would be to make a return for investors through the assumption of equity risk and the adoption of an active management approach. Investments could also be synergised with Enterprise (or Business) Development Services to strengthen management and technical capacity. This indirectly addresses access to credit by strengthening balance sheets and enhancing growth prospects.

This could be combined with developing a national agriculture investment pipeline. Private capital, both local and international, could be assisted to make their investment decisions in Ethiopia through establishing a register of high-potential opportunities. These could be selected through criteria, including quality of management, appetite for investment and openness to negotiation, business prospects, and alignment to the national agricultural strategy.

Successful applicants would have priority access to EDS, and the administrators would undertake regular, brief financial and management reviews of the business. These should be collated in a database, which would allow potential investors to easily analyse and identify targets that meet their desired profile. This would also serve well for the development community for identifying strong private sector counterparts with whom to co-ordinate initiatives of mutual benefit.

Karuturi Global, Ethiopia

Karuturi Global is an Indian company and the world's largest producers of cut roses with floriculture operations in Kenya, Ethiopia and India. It is looking to move into becoming a major agroproducer and has leased over 300 000 ha of land in the Gambella to produce maize, rice and some other produce. Much of the produce will be directed towards regional markets as well as some for export. To support the drive, Karuturi is importing over 1 000 tractors to mechanise the operations. It will also require a substantial local labour force, and the firm will benefit from a cheap local labour supply. It is also working closely with USAID to co-ordinate the development of a network of grain silos across the country to help improve transport and logistics.

6.2.2 Deepening Value Chain Relationships through Contract Farming and Outgrower Schemes

The most important factor in any agricultural finance intervention is to make sure that there is a reliable, robust and hopefully growing market for the specific produce or commodity in question. Two approaches which help support the comfort that lenders can find in loans to producers are contract farming and outgrower schemes. Contract farming is when the producers undertake to supply a certain quantity and quality of produce at some time in the future, and the buyer undertakes to buy it at a certain price. This helps ensure stability of supply for the processor while providing market security for the producer.

Outgrower schemes are generally underpinned by a large commercial farm, which often comes with the benefit of modern and professional farming techniques and technology, good infrastructure and equipment, and well-served by suppliers of inputs and logistics for example. Furthermore it usually has access to a strong market, for example, a major international buyer. As with the contract arrangements with a processor, nucleus farms can work with small producers in the surrounding area, making contractual arrangements to buy a certain quality and quantity of produce at a later date.

In both examples, but particularly with outgrower schemes, it is possible to support the small producers with technical and practical assistance to improve productivity. The produce also benefits from the professional post-harvest handling, storage, transport and marketing that comes with the economies of scale generated by larger agribusiness. In addition, some producers and nucleus farms facilitate access to inputs for their small producers, sometimes with a discount generated from bulk purchases and sometimes with some trade credit. Development agencies should be encouraging the formation of these relationships generally, but specifically by promoting the use of supplier finance lines to deepen access to finance for producers.

Unfortunately, as discussed in previous sections of this report, the business culture and legal environment surrounding agriculture is not generally supportive of these arrangements. Too often, promising relationships are undermined by lack of trust between stakeholders, a belief rooted in the widespread disregard for contractual norms and business ethics.

Outgrower Scheme, Ghana

The Integrated Tamale Fruit Company (IFTC) is a 155ha nucleus mango farm established in 1999. The farm cultivates certified mangos from harvested from trees grown from high-yield, exotic grafted varieties. It also directly supports around 75 small farmers on the surrounding 50ha through an outgrower scheme. ITFC facilitates access for the farmers to high-quality inputs and advice, and provides a ready off-take market equipped with a modern packhouse and transport arrangements. The cost of the inputs is paid back when they begin to produce an economic crop in about five years. In turn, the ITFC benefits from an increasing sales volume and the capacity to meet larger orders.

6.3 Micro-Level

6.3.1 Enterprise Development for both Producers and Processors

There are some emerging signs of domestic commercial farming and agribusinesses. However, there are major deficiencies in management and financial planning skills. Naturally this detracts significantly from their creditworthiness and attractiveness for investment.

There appear to be very few strategic initiatives to improve the business skills of the agricultural sector, and we feel that this is a major deficiency. Entrepreneurial and commercial skills are in particularly short supply in Ethiopia, though a returning diaspora are bringing some of these with them. Indeed, targeting the diaspora with a range of initiatives, both technical and financial, may provide the best returns.

Effective EDS require a sophisticated approach and intensive effort, and the involvement of highly intelligent and persuasive agents. They need to be concentrated on those with the potential and attitude to absorb the benefit, and to be customised to the local circumstances and environment. In our experience, enterprises in the small-medium range tend to have greater growth potential than those towards the micro end. With producers and very small processors, efforts should be directed towards improving basic financial literacy, rather than attempting to be too ambitious.

6.3.2 Support for Ethiopian Commodity Exchange

The development of the ECX is an example of how a centrally planned economy can move quickly and effectively under the right circumstances. In this case it took an exceptionally motivated, brilliant and well-connected individual to accomplish this. Without detracting from this achievement at all, it is also exceptional to have the government pass a law requiring certain types of commodity trading to pass through the exchange. While we are very uncomfortable with yet another government monopoly intruding into business, undoubtedly this has brought some immediate benefits in better structuring the value chains for certain commodities. It would be ideal to see the entity privatised in due course, in line with the government's promise, and the exchange opened up to competition.

In the interim, however, the exchange is having a honeymoon period. It also appears to have the energy and vision to implement change. The key to success in any country is having good partners, and the ECX has a particular interest in efforts to improve the financing of agricultural value chains. Currently it is busy attempting to integrate sesame trading into the exchange, and also to develop a functioning system of warehouse receipt financing, though no doubt it has many other ideas for the future.

Commodity Exchange, Ethiopia

The ECX is a government-sponsored initiative to establish a modern and transparent trading environment for key commodities. A network of warehouses has been established across the country, where produce can be bulked and stored. Trading takes place in an open outcry exchange based in Addis Ababa, where buying and selling agents strike deals. Control of the goods, deals and settlement is all underpinned by an integrated, real-time, software system developed specifically for the purpose. Current trade is dominated by coffee but the ECX is moving into other key commodities such as sesame.

6.3.3 Strengthening the Commercial Financial Sector

The commercial financial sector includes the commercial banks (both state- and privately-owned), insurance, leasing and commodity markets. With few exceptions, skills and experience across a wide range of areas is particularly weak. In Ethiopia, institutions, particularly banks, will need ongoing technical assistance from the development community for some time if they are to effectively address the agricultural sector. While we generally advocate working with private sector counterparts, Ethiopia is exceptional in this case. The unique status of CBE as the pre-eminent commercial bank necessitates a programme of development. Some of the areas of most value in our view are:

- Credit strategy for agriculture: helping financial institutions develop a portfolio for the agricultural sector aligned to their balance sheet strategy, to determine attractive sub-sectors and set suitable limits, to develop products fitting both the needs of customers and the balance sheet, and articulate a clear credit policy towards the sector;

- Marketing strategy for agriculture: working with financial institutions to develop a cost-effective operating model and distribution strategy, to set appropriate sales targets and to train and incentivise sales staff;

- Risk management approaches: including portfolio management strategies, developing risk rating models and credit scoring methodologies, and effective bad debt management and collection;

- Training: in all of the above, making sure that the training is customised for the local environment, applies detailed local case studies and involves participants in intensive problem-solving group work.

Annex: Glossary of Financial Terms

This brief guide prepared by the authors explains some basic financial terminology used in the reports. The definitions given are to aid interpretation, and not to be relied on in preference to a good financial text book. Some of the terms may seem like jargon but they are not, and some financial terminology is imbued with quite subtle and nuanced meaning which can require some explanation.

Capital – money or assets used to generate income (e.g. in a business)

Capital Market – the mechanism by which long-term capital finance is allocated. An example is a stock market, though any kind of competition between financiers to provide capital finance to borrowers or investees is a capital market

Equity Capital – is money contributed by the owners of the business. Therefore equity investment is taking an ownership stake with a share of the profits (or losses)

Debt Capital – is longer-term loans which can be used to invest in fixed assets in particular

Guarantee Fund – a fund which underwrites some or all of the credit risk assumed by private sector lending, usually in order to encourage great participation

International Financial Institutions (IFIs) – development banks such as the World Bank or African Development Bank

Liquidity – the cash or cash equivalents on hand for a business to meet day-to-day operational requirements

Long-term Credit – typically loans of more than five years in duration, often used for investment in capital items

Microfinance Institutions (MFIs) – financial institutions which specialise in small, short-term loans

Public-Private Partnership (PPP) – a deal structure whereby public good or services are provided by the private sector, while the public sector retains some project risk to incentivise interest

Savings and Credit Co-operative (SACCO)/Credit Union – member-based financial services organisations run along the co-operative model

Short-term Credit – typically loans of less than one year in duration, typically used for funding working capital

Under-capitalised – a business (which can include a bank) which is overly reliant on short-term borrowing to cover its day-to-day liquidity needs

Wholesale Credit – lending to other financial institutions (who will then presumably further intermediate the credit)

Working Capital – is the net position of the short-term assets of a business (e.g. debts owed to it, inventory, cash etc) less short-term liabilities (e.g. debts owed by it, loans etc)

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