

Sectoral Credit Policy Framework: Challenges and credit flow to micro and small enterprises in Kenya.

Patrick L. Onsando.

Presentation at

Growing Inclusive Markets 2008 Conference
Dalhousie University, Halifax ,Nova Scotia
Canada

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This paper supports the claims on the positive relationship of competitive micro and small enterprise sector to economic growth and poverty reduction. Economic growth is closely linked to the intricacies of the financial system. It is widely believed that Micro and small enterprises tend to be discriminated against in terms of credit allocation by formal financial institutions. This is as a result of highly skewed information asymmetry, moral hazards problems and high transactions costs attributed to this sector. A well developed and efficient system helps in allocating financial resources to the best uses in the real sector. As the real sector grows, the demand for financing increases and in this way the financial sector grows in tandem with the economy, signifying a two way causal relationship between finance and growth.

An examination of the financial sector and policy initiatives by the Kenyan government in support of Micro and small enterprise financing and development is also attempted. A conclusion is derived that, the policy environment should create a "level playing field" for all enterprises, and not discriminate small enterprises relative to larger ones. Therefore credit policies must ensure priority sectors receive an increasing share of domestic credit. Priority sectors of interest are the Micro and small enterprises that contributes to the real sector of the economy.

Introduction

The Grameen Approach of lending to the poor has attracted international interest and made the micro credit approach a new paradigm for thinking about economic development (Murdoch 1997). There is almost a global consensus that micro credit and sustainable gain is the key element for the 21st century's economic and social development. Currently most bilateral and multilateral development agencies incorporate micro credit into their development projects and are keen to push other multi-sectoral development oriented NGO's and private voluntary organizations into the function of credit to Enabling MSEs to have access to finance as they grow provides one viable alternative for increased funds. The transition, however, is not usually a smooth one, as usually an entirely new set of procedures and requirements, such as strict collateral for obtaining loans must be mastered. Moreover, commercial banks and other formal financial sources are frequently reluctant to deal with unfamiliar small enterprises, because of higher transaction costs and greater perceived risks of lending to them. However Several approaches have been proposed for facilitating this

credit delivery (Wood, and Sharif 1997). Increased attention needs to be focused on how even these 'successful' schemes can be scaled up to reach large numbers of MSEs.

One promising path is a financial system that aims at financial viability of the lending institution and stresses the importance of saving (Rhyme, and Otero 1991). Among the institutional variants of such an approach are options that would link MSEs Programmes into specialized financial institutions capable of providing both credit and saving services. transition. One approach is to provide technical assistance to the MSEs themselves to teach them how to obtain loans from formal financial system (Meyer, 1988). A second approach is to provide technical assistance to the commercial banks and similar financial institutions on how they could lend more effectively to MSEs (Kilby et al., 1984). While a third approach would be to graduate or convert an entire micro enterprise lending programme or scheme into a financially self-sufficient institution providing a

complete array of financial services to a large and broader group of MSEs (Meyer, 1988; Rhyme, and Otero 1991).

Definition: There is no clear and universally acceptable definition of Micro and Small Enterprises (MSEs). The number of employees engaged by the enterprises is the more commonly used unit of measurement of the size of a business than the turnover, the degree of formality, or legitimacy of the enterprise; capital investment; and degree of skills per worker. The Kenya 1999 National Micro and Small Enterprise Baseline survey however defined MSEs as enterprise in both formal and informal sectors employing 1-50 workers.

Providing credit to the poor serves a dual purpose. As borrowed capital is invested in small enterprises, it often results in significant short-term increases in household expenditure and welfare. A second goal of micro enterprise credit programmes is to support economic growth in the informal sector through fostering increased capitalization of businesses, employment creation, and long-term income growth. Therefore, targeting micro enterprises credit in certain circumstances does appear to embody a trade-off of economic growth in favour of poverty reduction (Kevin, and Bruce 2001 pp.1225-1235). On the other hand, an increase in income is likely to have great positive effect on the welfare of the children (Pitt, and Khandar 1998).

Developing economies can never expect to achieve sustained economic growth without developing and nurturing vibrant micro financial markets in which small entrepreneurs of all income levels with appropriate projects will find loans. Credit market plays a positive role in the finance of micro and small enterprises as it provide efficient and effective credit to the productive sector not generally catered for in the formal financial market. (Manna, 1993).

On delivering financial assistance to the MSEs in developing countries, Levisky (1993) suggests that it is time to explore ways of involving the private and non-formal financial institutions a priori in the long-run. He further suggests that such organizations are more likely to be accepted by the MSEs they are trying to help. He argues that for development of MSEs, a central national body should be set up, composed of representatives of the government and the public and private sectors involving participants from financial,

technical and research institutions who are engaged in one form or another in programmes or activities in support of the MSEs sector. Such a national council would act as a central supervisory body for the MSEs sector.

The magnitude and composition of the MSEs' effective demand for finance will typically vary as they evolve. In particular, the relative importance of fixed and working capital as well as the overall magnitude of each will change as the firm ages and grows. Once the micro enterprise begins to produce and eventually expand production, the demand for working capital typically increases both absolutely as well as relative to fixed capital. Proprietors themselves typically perceive lack of capital to be their most pressing initial constraint in establishing a small enterprise. (Carl, 1993).

Credit or finance therefore enables a producer to bridge the gap between the production and sales of goods. It provide people and businesses with the capacity to exploit economic opportunities whenever and wherever they occur. Access to credit removes the pressure imposed by sudden and unexpected demand for cash on the enterprise, and provides an opportunity to an investor to acquire more than it is possible from the current resources against the expected future income. This shows how important micro credit/financing in assisting MSEs.

Micro and small enterprise Development: Policy Initiatives

The genesis of government policy towards the informal business sector is traceable to a report by the International Labour Organization in 1972 on Kenya's employment situation. Prior to this; the government was, in theory at least, committed to small enterprise and the modern small firm of early government policy was a relatively rare phenomenon (McCormick, 1999). Informal sector activities were perceived as falling without the system of modern commerce, technology and entrepreneurship. Policy therefore ignored and excluded these activities. This exclusion was costly to the poor entrepreneurs in terms of bribes they had to pay, lack of security (of tenure and property), and support infrastructure and so on. Thus, it can be argued that Kenya's industrial policy in the first decade after independence favored large, formal

enterprises. Institutions such as the Kenya Industrial Estates and the Small Industry Research and Training Center were established to nurture “modern” small industry as well as to kenyanise economic activity. An industrial estate was conceptualized as an agglomeration of enterprises linked to common infrastructural, commercial and technical services. These warped policies created a polarized industrial structure often referred to in the literature as the “missing middle phenomenon”. This phenomenon is characterized by large and formal enterprises (mainly multinational corporations, parastatals and foreign-owned enterprises), on one hand, and small enterprises dominated by indigenous businesspersons, on the other hand.

Kenya’s 1983-1989 Development Plan launched the District Focus for Rural Development strategy. The main thrust of this strategy was to achieve balanced growth through decentralization of industrial activity from urban to rural areas. As part of the strategy workshops, commonly referred to as “Nyayo Jua Kali sheds”, were constructed to support MSE entrepreneurs in the country (ICEG,1998).However, congestion was rife in the work sites-a reflection of the failure of the authorities to harmonize the demand for and supply of the available sheds.

The Sessional Paper of 1986 and the Development Plan of 1989-1993 marked a turning point for small enterprise policy in Kenya (McCormick, 1999; ICEG, 1998).These documents were significant for two reasons.First, this was the first time explicit reference was given to informal sector manufacturing as a critical feature of Kenya’s industrial structure; and second, a comprehensive framework, upon which future initiatives were to be based, was developed. Such initiatives included a supportive policy environment, strengthening vocational training, improving access to credit and export markets. Other measures included investment allowances, exemptions from taxes and duties on imported equipment, and the establishment in 1987, of the District Development Fund to provide conducive infrastructure through the development of Rural Trade and Production Centers. In addition, the Rural Enterprise Fund was established in 1989 to finance Jua Kali enterprises (Kimuyu, 1999a).

The Sessional Paper No.2 of 1992 in line with the spirit of liberalization and privatization was explicit that the government’s role was to be facilitative, leaving the small enterprise to meet their own needs. A conducive working environment was

to be promoted through infrastructure development, research and development, linkages between small and large enterprises, and export orientation. Unlike other earlier government policy documents, the Sessional Paper No.2 of 1992 was more refined and elaborate. This explains why this paper has served as the basis of all other programmes for the development of the sector (Mullei and Bokea, 1999)

During the 1994-1996 Development Plan period, the Government initiated an evaluation programme to review and assess programmes and policies as outlined in the Sessional Paper No. of 1992 in order to strengthen the implementation of programs (ICEG, 1998). This was to be achieved through an Action Plan on policy and strategy for Small Scale and Jua Kali Enterprises in Kenya.

The Action Plan gave priority to the following factors (a) the improvement of mechanisms for policy and strategic implementation (b) coordination and monitoring of MSE’s and jua kali activities (c) assessing the impact of such policies and programmes on target beneficiaries (d) improving the legal and regulatory environment (e) developing physical and institutional infrastructure (f) developing the market for MSE and jua kali products (g) improving, designing and developing other support services vital to the sector (h) promoting the development of the MSE and jua kali sector; and (i) facilitating the gathering and dissemination of information(Kimuyu,1999a).Despite the above policy pronouncements,the achievement of the objective to date remains below expectations(see Mulei and Bokea,1999).

At the conclusion of the assessment, it was clear that weak co-ordination mechanisms kept the actors involved apart, leading to resource wastage through duplicative efforts or overlapping functions. It was also evident that, while the policy environment had improved considerably, the regulatory environment remained repressive. This was not expected since a review of the repressive laws and regulations had been carried out in 1988.The problem was that of poor dissemination. The institutions that were to implement these amendments were not informed of their roles in the changed environment. It was with these loopholes in mind that the MSE unit in the Ministry of Planning and National Development was upgraded to a division with two

distinct sections: the Policy Section and the Deregulation Unit (Mullei and Bokea, 1999). The functions of policy formulation, coordination, implementation, appraisal and dissemination fell under the Policy Section while the Deregulation Unit was mandated to identify and propose amendments to laws and regulations that stifled the growth and development of the MSE sector.

The Ministry of Planning and National Development was equally concerned about the extent to which the policy proposals spelt out in the Sessional Paper No.2 of 1992 had been implemented. To this end, the Ministry engaged the International Center for Economic Growth to undertake a review and give proposals that were to form the basis of a more elaborate sessional paper for the MSE sector. The review exercise covered several aspects of the sector including the legal and regulatory environment, credit and finance, physical infrastructure, entrepreneurship and business development, marketing and technological policies, and gender and environmental concerns.

At the end of the review, it was evident that very little progress had been made in almost all the preceding aspects. For example, regarding licensing and land reforms. Karingithi (1999) observed that little progress had been made in the actual review of specific laws through law review task forces. The results of the task forces had not been disseminated in any way and no regulatory change had resulted. On the positive side, however, the single business permit system had been affected in January 1999. For a start, the system remained optional for Local Authorities before January 2000 but became mandatory thereafter. In the area of credit and finance, the access of MSEs to credit was still severely constrained even though there had been substantial deregulation of the Kenyan financial markets.

Financial Sector

Kenya has a diversified financial system, comprising a Central Bank, 56 commercial banks, 24 non bank financial institutions 4 building societies, more than 36 insurance companies, 80 insurance brokers, the Nairobi stock exchange and several stock brokerage firms. The number of commercial banks increased significantly in the 1980s, from 16 in 1981 to 26 in 1990 and 48 in 1997. The NBFIs also experienced rapid growth over the same period, more than doubling from 23 in 1981 to 54 in 1988. The number declined sharply after that, to 24 in 1997 (CBK, 1998). The rapid growth in the banks and NBFIs was attributed to a

regulatory framework in which entry requirements were relaxed as a deliberate government effort to promote the growth of locally-owned financial institutions.

The rapid growth of NBFIs was due to the lower entry requirements for NBFIs, which also faced no interest rate restrictions and were therefore able to attract more deposits by charging higher interest rates. In the 1990s, the realization that regulatory differences had resulted in the mushrooming of NBFIs led to harmonization of capital requirements and interest rate regulation for both banks and NBFIs led to harmonization of capital requirements and interest rate regulation for both banks and NBFIs. This led to the decline in the number of NBFIs as many converted to commercial banks.

As an increase in the minimum paid-up capital of a financial institution restricts entry into the industry and also leads to greater concentration. This concentration leads to a quasi-monopoly situation. When small financial institutions were allowed, MSEs benefited because they could deal with firms of their size. Now they have to deal with very large financial firms and they face the danger of being marginalized.

Expectations for the formal financial sector

Well-developed financial systems and markets foster economic development by improving the allocation of society's scarce resources and possibly by facilitating faster capital accumulation or increased savings (Beck, Levin and Loayza, 2000). For a financial intermediary to be pro-poor, it is necessary for the financial development not only to exert a positive impact on income distribution, but also to raise everyone's income equally-or to increase the incomes of the poor disproportionately more than the non-poor

The process of financial development entails a deepening of markets and services that channel savings to productive investment and allow risk diversification. These positive aspects of financial development lead to higher growth in the long run. As economies mature, however, the same process can present weakness evidenced by systematic banking crises, cycles of booms and busts, and overall financial volatility. Whether inherent to the process of development or induced by policy inadequacies, these

elements of financial fragility can hurt economic growth and will do so until maturity is reached. However, whereas financial depth (indicated by private domestic credit/GDP) leads to higher growth, financial fragility (represented in financial volatility and banking crises) has negative growth consequences (Loayza and Ranciere, 2004).

Under the endogenous growth model, financial deepening leads to more efficient allocations of savings to productive investment projects (Greenwood and Jovanovic, 1990; Bencivenga and Smith, 1991)

A well-developed financial system widens access to external finance and channels resources to the sectors that need them most (Rajan and Zingales, 1991; Demirgüç-Kunt and Maksimovic, 1998; Wurgler, 2002).

Private Sector Credit

The period under review saw private credit increased from 26 percent of GDP in

1991 to 43 percent of GDP in 1995 before declining to 31 percent of GDP in 2006. The ratio of private sector credit to deposits was impressive averaging at 80 percent. This could be attributed to sluggish financial system. The clearest indicator of the absence of competition in the financial market was the continued spread in the interest rates.

Interest rates remained high and the spreads were not getting any narrower, despite the reforms that sought to bring them down. What is even more worrying about the still-high interest rates is that they make it difficult for small borrowers to access credit. Sluggish financial system can also be seen in the ratios M_2/GDP , liquidity ratios, whereby there has been excess reserves indicating that commercial banks were capable of lending more to the private sector. (See tables 1, 2 And 3)

Table 1
Commercial Bank Sectoral Credit

End of	Central Govt (Net)	Other Public Sector		Private sector								Total Credit.
		Local Government	Parastatals	Agriculture	Mining & Quarrying	Manufacturing	Building And Construction	Transport, Storage And Comm.	Trade	Finance Institution	Other Business	
1991	1372.20 (2.7)	80.6 (0.16)	3,958.20 (7.7)	6801.80 (13.8)	471.60 (0.9)	11,276 (22)	2855.4 (5.6)	2182.40 (4.3)	8785.2 (17.2)	2171 (4.2)	11,255.4 (21.98)	51,209.8 (100)
1992	1424.20 (2.27)	148.0 (0.24)	3513.80 (5.6)	8,243.80 (13)	363 (0.58)	11,620.60 (18.56)	4248.40 (6.8)	2306.80 (3.7)	9823.20 (15.7)	1274.0 (2.0)	19,645.20 (31.4)	62,611 (100)
1993	789.40 (1.2)	219.40 (0.34)	3,630.60 (5.6)	9575.80 (14.8)	243.60 (0.38)	15,509.40 (24)	3557.80 (5.5)	2725 (4.2)	9,235 (14.2)	1896.60 (3)	17,478 (27)	64860.60 (100)
1994	1,128.60 (1.3)	249.20 (0.29)	5120.00 (5.86)	11,890.40 (13.6)	1,010.40 (4.2)	19,218.20 (22)	4,217.20 (4.8)	4113.40 (4.7)	13,080.60 (15)	1577.80 (1.8)	257730.40 (29)	87,379.20 (100)
1995	1,270.60 (1)	304.20 (0.24)	4926.60 (3.9)	14,478.20 (11.47)	1,529.80 (1.2)	32,216.36 (25.5)	6091.60 (4.8)	6594.20 (5.2)	21,797 (17.3)	3242 (2.57)	33,830.20 (27.8)	126,281.56 (100)
1996	1454.20 (0.94)	357.40 (0.23)	5237.00 (3.4)	14730.40 (9.5)	1582.20 (24.7)	38,380 (1.0)	8469.00 (5.4)	7319.80 (4.7)	25,918.40 (16.7)	3157.20 (31.40)	48,708.60 (31.40)	155,314.00 (100)
1997	2177.20 (1.1)	572.20 (0.3)	7572.20 (3.84)	17,918.80 (9.1)	2419.20 (1.23)	42,875.20 (21.74)	11,507.80 (5.8)	10,972.20 (5.56)	32,865.00 (16.70)	5164.80 (2.62)	63,182.40 (29)	197,227.00 (100)
1998	2778.80 (1.22)	595.00 (0.26)	6906.80 (3.04)	21,932.60 (9.60)	2,617.00 (1.15)	4934.60 (21.82)	14962.00 (6.54)	10,309.00 (4.54)	36,751.00 (16.18)	6471.60 (2.85)	58498.00 (25.9)	227,199.40 (100)
1999	2899.80 (1.3)	894.80 (10.4)	6454.80 (2.96)	23,426.0 (10.40)	2974.80 (1.32)	49634.60 (21.82)	11,507.80 (5.8)	9722.80 (4.3)	39,413.60 (17.48)	6876.40 (3.05)	55,291.00 (23.50)	225,514.80 (100)
2000	2432.00 (1.0)	1,143.00 (0.49)	6959.00 (2.96)	24,399.00 (10.37)	2810.00 (1.2)	54936.40 (24.40)	14962.00 (6.59)	9608.00 (4.1)	51,138.00 (21.73)	5324.00 (2.3)	53,218.00 (24.5)	235,380.00 (100)
2001	2431.00 (1.1)	659.00 (0.3)	6601.00 (3)	23,795.00 (11)	2169.00 (1)	59,426.00 (25)	18363.00 (8.14)	9901.00 (14.56)	45,989.00 (21.2)	5,391.00 (2.5)	50,405.00 (22.77)	217,040.00 (100)
2002	3122.00 (1.4)	687.00 (0.3)	7824.00 (3.5)	25,304.00 (11.43)	1982.00 (0.9)	49,597.00 (22.99)	16,850.00 (7.16)	16705.00 (7.5)	40,837.00 (18.44)	6788.00 (3.06)	50,482 (22)	221,412.00 (100)
2003	2805.00 (1.2)	658.00 (0.29)	6282.00 (2.7)	28,117.00 (12.28)	1493.00 (0.65)	52476.00 (22.7)	17288.00 (8.0)	16750.00 (7.3)	46,619.00 (20)	6372.00 (2.78)	60,184.00 (22.8)	229,048.00 (100)
2004	3007.00 (1.1)	338.00 (0.13)	11,468.00 (4.2)	30,807.00 (11.70)	1934.00 (0.73)	63104.08 (24)	17615.00 (7.4)	20194.00 (7.7)	47,498.00 (18)	7641.00 (2.9)	83827.00 (27)	263,391.00 (100)
2005	2068.00 (0.67)	630.00 (0.20)	10830.00 (3.5)	32,984.00 (10.7)	2399.00 (0.78)	62701.00 (20)	21,421.00 (6.9)	27092.00 (8.78)	51275.00 (16.6)	13292.00 (4.3)	93,579.00 (26.21)	357,200.00 (100)
2006	2502.00 (0.7)	1089.00 (10.30)	16,951.00 (7.7)	32,068.00 (8.96)	3034.00 (0.85)	70,462.00 (19.7)	30,227.00 (8.46)	39,051.00 (11)	53,153.00 (15)	15,185.00 (4.3)	93,579.00 (26.2)	351,200.00 (100)

Source: Central Bank of Kenya, Various Annual Reports, Author's estimates.

Table 2
Selected Monetary Indicators 1991-2006

End of	Domestic Credit				Gross Domestic Product (GDP) (KShs.Million)	Money Supply (M ₂) (KShs.Million)	Ratios		
	Government (KShs.Million)	Other Public Bodies(KShs.Million)	Private sector (KShs.Million)	Total (KShs.Million)			M ₂ /GDP	PSC/GDP	Liquidity Ratio (Percentage)
1991	32,547.20	4072.20	49983.20	86,602.60	190806.60	74,326.20	0.39	0.26	22
1992	32,310.60	3,998	63,548.60	99,857.40	219,719.80	99,291.80	0.45	0.29	31
1993	30,625.20	4,011.40	65,591.20	100,227.80	270,240.00	124,828.40	0.46	0.24	50
1994	522,256.60	5,678.400	85,388.40	146,323.40	326,079.80	163,257.80	0.50	0.26	53
1995	77,422.40	5,029.00	166,281.20	248,732.60	389,110.20	232,787.40	0.60	0.43	41
1996	73,761.20	5,354.80	192,866.60	271,982.60	458,370.00	2388,366.00	0.52	0.42	42
1997	82,665.20	7,812.40	224,196.40	314,674.00	539,959.86	277,810.60	0.51	0.42	37
1998	90,234.80	6,260.80	254,301.60	350,797.20	596,539.30	284,510.20	0.477	0.43	38
1999	86,656.00	7,304.00	277,407.00	371,367.00	639,056.20	295,513.40	0.46	0.43	40
2000	83,789.00	8,058.00	289,478.00	381,325.00	685,436.20	297,872.00	0.43	0.42	43
2001	100,383.00	8,027.00	271,800.00	380,210.00	770,027.80	308,734.00	0.40	0.35	46
2002	113,384.00	8,016.00	288,831.00	410,231.00	907,092.75	338,243.00	0.37	0.32	44
2003	134,278.00	5,992.00	302,888.00	443,158.00	1,012,342.00	381,016.00	0.38	0.30	49.2
2004	121,543.00	10,934.00	368,683.00	501,160.00	1,140,048.00	419,838.00	0.37	0.31	42.3
2005	118,879.00	119,60.00	398,517.00	529,356.00	1,276,969.00	462,524.00	0.36	0.31	41.8
2006	134,728.00	118,465.00	446,824.00	600,017.00	1456391.00	542741.00	0.37	0.31	46.6

Source: Central Bank of Kenya, Various annual Reports. Economic Surveys

M₂ = Includes Currency outside banks plus all other deposits except those of Central Government, Local Government, Commercial Banks, on Residents and foreign currency denominated deposits.

Table 3
Real interest rates for selected principal interest in Kenya 1993-2006

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Discount rate for Treasury Bills	-6.7	-10.9	19	16.1	15.1	6.0	17.0	3.5	5.0	6.4	-8.4	-3.3	-2.2	-8.7
Advances against Treasury Bills	-1.5	-8.3	21.6	21.4	20.1	10.5	22.0	6.5	8.0	9.3	-	-	-	-
Commercial Bank Deposit Rate	-23.5	-16.7	14	18	17	18	10	8	7	18	-8.4	-10.6	-8.9	-13.1
Commercial Bank Lending Rate	26.0	2.1	29	34	30	29	22	22	20	5	3.7	0.7	2.9	-0.8
Inflation	46.0	28.8	1.6	7.1	11.2	6.6	3.5	10.0	5.8	2.0	-11.69	13.37	13.28	-

Source: Various Economic Surveys including Author's estimates

Micro and Small enterprise Credit

The demand for credit by the Micro and small enterprise in Kenya is the least studied aspect. To estimate the effective demand for Micro and small enterprise Credit, one needs to survey all sources of credit for this sector and establish all the loans they have been able to make and those they have rejected due to the inability of the entrepreneur to comply with their requirements other than for reasons of

inability of the business to absorb and repay the loans.

A number of institutions provide credit to the Micro enterprise and small sector in Kenya. These include commercial banks, non-bank financial institutions, Non-governmental organizations, multilateral organizations, business associations, and rotating savings and credit associations. In addition, financial transactions also take place between traders, friends, relatives and landlords, as well as commercial moneylenders. The

main commercial banks involved in Micro and small enterprise lending and savings mobilization are the Kenya Commercial Bank and Barclays Bank.

Rotating savings and credit associations (ROSCAs) are also an important source of credit in the country. They are found in both rural and urban areas as either registered welfare groups or unregistered groups. They mainly provide credit to those who would likely be ineligible to borrow from other sources. These associations have developed mostly in response to lack of access to credit by Small enterprises, forcing them to rely on their own savings and informal credit sources for their financing. It has been found that rural firms rely on this source of funds more than urban ones. They mostly integrate savings into their credit schemes, thus mobilizing savings from their members. However, even for members of these associations, not all their credit needs can be satisfied. This implies that there is some proportion of borrowing and lending that is catered for by personal savings as well as borrowing between entrepreneurs and other forms of informal transactions.

Credit Challenges facing Micro and Small enterprises.

As the financial sector grows, institutional diversity is expected. However; this has not been the case, as reflected in the limited growth of other competing institutions like post bank, insurance and the stock exchange. The Kenyan banking sector is dominated by a few large firms, which focus mainly on short-term lending. The short-term nature of their lending and their policies of concentrating on a small corporate clientele has implied indifference to small savers and borrowers. This has meant that they exclude a large number of potential borrowers and investors from their services.

The growth and relative sophistication in the Kenyan financial system have not been matched by efficiency gains in the quality of services offered to the customers and the economy in general. It has been argued that the large differential between deposit and lending rates is an indication of the lack of sufficient competition for savings among Kenyan banks. Despite the liberalization of interest rates in 1991, nominal interest rates have shown minimal increase, resulting in negative real interest rates, and a widening of interest rate spread, indicating inefficiency in the system. Bank charges for services rendered

also make the cost of banking prohibitive to a majority of the population. The high profitability in the banking sector has not triggered entry by new competitors as would be expected. There is need to introduce regulatory measures to check oligopolistic tendencies, which restrict entry and efficiency in the banking sector

As in many other countries in sub-Saharan Africa, the performance of formal financial institutions and credit programmes in Kenya in terms of alleviating the financial constraints of the smallholder sector has met a lot of criticism. The criterion of creditworthiness, delays in loan processing and disbursement, and the government approach to preferential interest rates, resulting in non price credit rationing, have limited the amount of credit available to smallholders and the efficiency with which the available funds are used (Atieno, 1994). This can be seen as an indication of the general inadequacy of the formal credit institutions in meeting the existing credit demand in the country. This is compounded by making collateral lending the only legal form of lending to Micro and small enterprise which adversely affects many of them.

Many financial institutions, especially commercial banks, rarely lend to small and micro enterprises since they emphasize collateral and which most them lack. Few enterprises are able to provide the marketable collateral and guarantee requirements of commercial banks, with the result that small enterprises lacking such requirements have not been able to obtain credit from banks. Most of them therefore rely on their own savings and informal credit (Oketch et al., 1995).

The advantage of commercial banks is that they have a wide branch network that can reach most microenterprises. They also operate accounts, which makes it possible to monitor their clients closely. Most of them are located in urban areas, however, making it difficult to provide services to those enterprises located in rural areas. Given that up to 78 percent of the Micro enterprises are located in rural areas; this is a major limitation on the extent to which commercial banks can serve them. Other limitations of commercial bank lending to the Small enterprise sector in Kenya are the lack of appropriate savings instruments to mobilize savings to this sector and the restrictions on withdrawals, which discourages savers who would like

frequent access to their savings. Their location away from many enterprises also implies high transaction costs, which discourage most enterprises from using their savings and other services.

In the recent past, a number of non-governmental organizations have been involved in financing of microenterprises. Most of these organizations have not had positive performance, however. Their inexperience in financial intermediation and limited financial resources has constrained their potential. There is little coordination among the Non-governmental organizations, resulting in duplication of resources and activities. Most of them have high credit costs, are donor based and sponsored, lack adequate funding, and are limited in their geographical coverage. They also discriminate against small-scale enterprises who get rationed out by lenders since cheap credit creates excess demand for loan able funds, forcing lenders to lend to large enterprises that have collateral and are perceived to be less risky.

Suggested Policy Interventions

- Ensure Macroeconomic Stability; Symptoms of macro-economic instability, such as inflation, currency depreciation, sluggish economic growth and high State indebtedness, have a negative impact on the private sector. In the financial sector's case it usually translates into lower demand for financial services. Moreover, high inflation produces quick erosion of the financial institution's capital base and reduces the value of savings and loan funds when interest rates are adjusted. It makes credit activity very difficult except with very short maturities. State indebtedness may also lead to an increase in taxation, making it more difficult for institutions to become sustainable and often pushing them to informal sector (where it becomes harder to raise capital and other financing). Policy intervention must therefore ensure macroeconomic stability.
- Given the relatively abundant financial resources of the formal institutions compared with informal credit sources, there is need for policy measures to increase access of small enterprise to formal credit. This can be achieved through the establishment of credit insurance schemes protecting the financial institutions against default risks, which result in credit rationing. The formal financial institutions should also be encouraged to diversify their loan portfolios so as to be able to cater for the different financial needs of this sector.
- A market-oriented strategy for improving Micro and small enterprise access to financing that focuses on reducing the risks and transactions costs associated with this segment of the market, strengthening the capacity of financial institutions to serve smaller clients, and increasing competitive pressure in financial markets. The aim is to increase the number of financial institutions that find lending to Small business to be profitable, and therefore sustainable. Elements of this strategy would include:
 - To cope with the absence of collateral for those who have potential and prospective businesses, but lack collateral, there is need to initiate the establishment of loan guarantee fund;
 - Reducing barriers to entry, e.g, by reconsidering capital adequacy requirements and prudential regulations that may be inappropriate for financial institutions serving smaller clients;
 - Reducing the risks associated with lending to small businesses, focusing on laws governing the enforcement of contract, forfeiture and collection of collateral, and the use of movable assets as collateral;
 - Developing the policy, legal, and regulatory frameworks that are essential to the development of innovative financial institutions and instruments, including venture capital, small equity investments, and leasing;
 - Promoting innovation in specialized lending technologies that reduce the administrative costs associated with credit application, monitoring, and payment;
 - Strengthening the capacity of financial institutions to evaluate MSE creditworthiness in accost-effective manner, for example

- through the use of credit scoring techniques; and
- Improving information on the creditworthiness of potential borrowers, by promoting the establishment of credit bureaus and ways to help Microenterprises prepare business plans and financial projections.
 - Eliminate cheap credit but improve access for small enterprises
 - Eliminate income tax for enterprises with low incomes, and substitute this with, more comprehensive indirect taxes. The development of micro and small enterprises is a policy goal of monetary authorities, however the resulting distribution of credit signifies considerable difficulty in policy implementation and also exhibits the difficulty with which established formal financial institutions can address the credit needs of micro and small enterprises, even under an interventionist approach.

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Notes

Financial institutions serving small and micro enterprises in Kenya

- **Barclays Bank:** offers loans for women entrepreneurs both as individuals and in groups. Credit is advanced to small businesses by Barclays Bank, operating within the traditional banking system, with the institutional systems in place to achieve a high level of loan recovery. The loan guarantee fund is used to guarantee part of the loan. The client provides 25% of the security for the loan while the guarantee fund provides the remaining 75%, thus helping to distribute the risk of lending.
- **Care International:** focuses on pre-existing organized rural groups. Its credit programme emphasizes women owners of microenterprises. Clients are required to raise equity cash of 25% of the total loan required. The loan security is the group members who guarantee each other and are collectively guaranteed by the group. Credit is advanced to the group, which lends to its members individually
- **Industrial and Commercial Development Corporation (ICDC):** operates credit schemes including one that caters for retail and wholesale traders for working capital.
- **The Anglican Church of Kenya:** Provides financial and nonfinancial services to farm and non-farm rural enterprises.
- **Kenya Industrial Estates:** directs loans to small-scale enterprises. The main security is land and buildings.
- **Kenya Small Traders and Entrepreneurs Society:** Brings together entrepreneurs whose share contributions determine the amount of credit they receive. Members act as the guarantors for the loan.