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Outreach Frontiers of Microfinance Service Development in Rural Ethiopia: A Case of Shinile District in Somali National Regional State

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Abstract
Over the past one and half a decade, provision of adequate microfinance service has been persuaded as a promising pro-poor financing strategy in Ethiopia. Practical and timely steps were taken by the government to provide policies and legal framework services that promote rural financial intermediation in remote villages, where the majority of people face acute shortage of access to financial capital, being engaged in subsistence agriculture, which is little supported by modern technologies, thus, yield very low rate of return on investment. During this period, thirty-one microfinance institutions were initiated but due to the lack of equitable service allocation system, these were unevenly distributed among the regional states of the country. In Somali region where this study was selected as its setting, there has been no effective microfinance service regardless of the large unmet demand. Hence, the purpose of this study was to identify the main factors constraining the development of the service, using data collected from the Shinile district of the region. Results indicate that pastoralist specific socio-economic factors, failure of outreach policy of financial institutions and reluctance of state functionaries have lagged behind the development of microfinance service in the region. Therefore, consideration of these factors would immensely help in crafting policies aimed at promoting sustainable microfinance service development in the region.

Keywords: Microfinance, Pastoral economy, Outreach frontiers, Somali

1. Introduction

Ethiopia with a landmass of 1.14 million km^2 is subdivided into nine regional states and two city administrative councils, across which provision of social services is highly limited and differentiated. Public service distribution systems in general and the financial service delivery mechanisms in particular are characterized by the lack of equity and equitability among the states (World Bank, 2007). For instance, out of 526 branches of the country's dominant government-owned bank, the Commercial Bank of Ethiopia, only 28.2% are decentralized to regional remote rural areas while the rest 71.8% are concentrated in cities, and from this the majority are located in Addis Ababa, the capital city of the country (CBE, 2012). Relatively better developed states in the country like Amhara, Tigray and Oromia, being the historic seats of leaders and monarchies were better developed while states in the remote geographical peripheries like Somali, Afar, Gambela and Benishangul Gumuz had poor infrastructural development, thus, acquire limited services and lead the poorest living standard.

Regional economic literatures are replete with the controversies and critics of such unbalanced regional growth manifested by uneven distribution of services and allocation of resources over a national territory. While the concept of balanced regional growth has strong justification to maintain growth equity through simultaneous distribution of scarce resources among regions and sectors of an economy, the development strategies of unbalanced growth explained in 'growth pole' theories of Perroux (1955), Myrdal (1957) and Hirschman (1958) provide much weight for growth efficiency than equity. These theories argue that an efficient development process cannot be effected in all regions and across all sectors at a time. Rather, development is a dynamic process in the sense that repercussions can be replicated from developed to lagging regions through contiguous, 'trickle down', 'polarization', 'spread' or 'backwash' effects (Myrdal, 1957). Even though efficiency is a very important variable in measuring the success of development, the philosophy of the above development dynamism was practically less supported and the 'growth pole' theories have lost their credibility over time.

However, it is a general consensus that highly unbalanced service provision and inequitable resource allocation systems cause regional disparity and rural-urban divide. Recent studies in Ethiopia reveal that intensive investment on urban amenities, inequitable allocation of public services and the escalating cost of life in cities and urban slums have caused high interregional migration, rural-urban dichotomy and rampant resettlement practices of the poor (Tesfaye, 2010). Hence, inequity and inequitability in distribution of services and allocation of resources across the regional states of Ethiopia which were evidenced to be the result of the dysfunctional social development policies and plans during the earlier regimes and currently remained as the critical dimensions of poverty and important development agenda (Taye, 2011).

The overall level of poverty and ill-being in Ethiopia is very high. Ranking 171st out of 178 countries in Human Development Index (HDI) and 6th out of 94 developing countries in Human Poverty Index (HPI), Ethiopia represents one of the poorest countries in the world (UNDP, 2010). Agriculture is the dominant economic sector of the country, accounting for nearly 85% of labor force employment, 48.6% of GDP and 90% of foreign exchange earnings while the industry and service sectors contribute minimal, about 27.8% and 23.5% of GDP, respectively, (MoFED, 2006). As one of the basic social services, the Ethiopian financial sector is ill-suited to support the dominant agriculture sector in which the majority of the poor is engaged. The contribution of the financial sector to the overall economy is, thus, minimal.

To overcome these problems, the recent government of Ethiopia, which has taken power after the fall of the Dergue regime in 1991, has undertaken a series of economic reform programs by rationalizing the role of the government to ensure pro-poor finance and equitable growth. In the interest of the poor, the Agricultural Development Led Industrialization *(*ADLI*)* policy was adopted in 1993 to bring about a structural transformation in the productivity of the peasant agriculture, promote rural enterprises and streamline the industrial and service sectors so as to make them extensive use of the country's abundant natural and labor resources (MoPED, 1993). In this set up, rural financial services were articulated to deal with agricultural seasonality which was identified as the main obstacle for transformation of the smallholder agriculture. Customized agricultural micro-credit services were required to be intrinsically linked and support the transformation through i) liberalized rural financial markets and institutions like financial cooperatives and microfinance institutions ii) strong extension linkage and credit-led intensification of agricultural production, using credit to acquire modern inputs and technologies (MoPED, 1993).

However, even though revitalizing the role of rural financial intermediation in smallholder agriculture was given a great focus in global themes of Poverty Reduction and Millennium Development Goals (MDGs), the impact of public spending on the earlier agricultural credit system has yielded limited returns in terms of economic growth and poverty reduction (Moges *et al.,* 2007). Due to the inherently risky, subsistence and rain-fed agriculture, intervention through credit package has counted decades with a minimal success in achieving its objectives. The ADLI policy itself has succeeded little to provide even a self-sufficient level of agricultural production proportional to the increasing size of the population, further worsening the food security status of the nation, let alone transformation to industrialization (Workneh *et al.,* 2008).

Even then, pro-poor finance in Ethiopia was argued time and again for efficient inter-temporal transfer of resources and weather/seasonality risk coping mechanisms which in turn amplifies much prospects for sustainable increase in household productivity and living standard. Hence, effective rural financial intermediations were rejuvenated in the subsequent fine-tuned and nuanced strategic development programs and plans of Ethiopia including the Sustainable Development and Poverty Reduction Program–SDPRP (2002–2007), Plan for Accelerated and Sustainable Development to End Poverty–PASDEP (2005–2010) and the recent Growth and Transformation Plan–GTP (2011–2016). Microfinance services like credit, saving and insurance were underlined as effective antipoverty tools that help the unemployed become employed, increase household income, smooth consumption and reduce risks through easing liquidity constraints in production, which in turn contribute to the overall economic growth, poverty reduction and the creation of a more equitable society.

2. Microfinance: An Anti-poverty Tool

In using financial intermediations as the weapons of the poor to fight against poverty, one should note that fitting a feasible financial scheme in a particular socio-economic set-up is very crucial even though very challenging. Global lessons from the unsuccessful agricultural credit subsides in early 1900's and the subsequent paradigm shift in rural finance from the agricultural credit era (1950–1985) to donor microfinance era (1980–2000), commercialization of microfinance services (2000–present) and value chain finance (2005–present) indicate the gradual move of pro-poor finance towards the creation of inclusive financial systems that operate in accordance with the dynamics of the market (Akram *et al.,* 2008). The microfinance revolution is proved to be a successful pro-poor financing system with encouraging achievements and remarkable impact in Asia and the Caribbean like the Grameen Bank in Bangladesh and Bank Raykat in Indonesia (Remenyi *et al.,* 2000). Empirical evidences in these social experiments revealed that access to microfinance breaks the vicious circle of poverty and help in achieving the Millennium Development Goals (MDGs).

According to Hossian (1998), in Bangladesh, household income for Grameen members was 43% higher than non-members, and the former had increased their income and household expense by 112% and 28%, respectively, over their membership period. In Ghana, about 80% of the clients of the 'Freedom from Hunger' microfinance had secondary income sources as compared to only 50% of non-clients while in Vietnam, the clients of 'Save the Children' microfinance had decreased their food deficit from three months to one month (Barbara *et al.,* 1998). In achieving universal education, Grameen Bank in Bangladesh, Save the Children in Honduras and *Accion Communitaria Del Peru* were evidenced in increasing school enrollment rates in the ranges of 20-80% in varying localities. Addressing gender bias balancing roles of microfinance, Kabeer (1998) indicated that in Bangladesh, Indonesia and Nepal, female microfinance clients were observed more likely to make joint decisions with their husband on budgeting household earnings, children's education, using contraceptive method for family planning, participation on community events, sending daughters to school and arranging children's marriage than non-clients. Particularly in Bangladesh, evidences revealed that microfinance clients were more empowered than non-clients in terms of physical mobility, ownership and control of productive assets (including land), household decision making and awareness of legal as well as political issues (Hashemi *et al.,* 1996*)*.

Similarly, in reducing child mortality and maternal health, Grameen members were found 59% better than non-members, attributed to increased awareness on microfinance group meetings (Barbara *et al.,* 1998*)*. Similar studies in Bolovia, Ghana and Uganda showed that microfinance clients had better breast-feeding practice, more responsive rehabilitation therapy for children with diarrhea, improved weight-for-age and better children's nutritional status than non-members (MkNelly and Dunford, 1999). Even with regard to environmental sustainability, SEWA microfinance in India has engaged in building community infrastructure (tape water, toilets, drainage and paved roads) ensuring pure drinking water and sanitation for environmental sustainability (Chen *et al.,* 2001). Microfinance is, thus, globally proved as an exceptional banking system that succeeded with the poor who were perceived as '*unbankable*' from the perspectives of the traditional financial institutions.

In Ethiopia, formal microfinance was enacted by Proclamation No. 40/1996 in which Microfinance Institutions (MFIs) were encouraged to legally accept deposits from the general public, issue drafts and manage funds for promotion of micro-enterprises. Following this, thirty-one registered microfinance institutions were established with their considerable variation in geographical distribution, capital and customer size. According to Desalegn (2008), eleven of the 31 MFIs (about 41%) were located in Addis Ababa and 13 MFIs (about 48%) were in Oromia region, with 21.1% and 18.2% of the shares in total capital of all the MFIs, respectively. Moreover, about 81.3% of total capital of all MFIs in the country were owned by only four of them i.e Amhara (25.6%), Dedebit (24.3%), Addis (16.3%) and Oromia (14.7%). Within a region, the existing branches of MFIs have not fully covered all districts. The total amount of capital in MFIs in Ethiopia was amounted to $94.27 million (1.2% of GDP), of which $88.84 million (1.1% of GDP) was mobilized through saving and the rest from donors and shareholders, where as it extended a total credit of about $230.71 million to about 1.5 million borrowers throughout the country. Hence, as the above evidences clearly show, in Ethiopia, microfinance service provision is highly inequitably and the allocation of resources among the people and the regional states is uneven.

With regard to the factors that constrain the development of microfinance service, even though context-specific literatures were scant, the existing few indicated that socio-economic, institutional and regulatory factors often affect the development of microfinance services in rural areas (Knight *et al.,* 2008). In Somali national regional state of Ethiopia, huge unmet demand for microfinance service was revealed in various studies but there is no effective microfinance service since there was no any registered microfinance institution in the region until recently. Various studies have indicated the need for microfinance service as an antipoverty tool in the region. For instance, Wolday (2006) addresses the substantial benefits that herders can derive from financial services while Swift (2011) argues about the important role that microfinance services play in pastoral risk management system in Somali region.

Thus, given the level of poverty in the region and the promising evidence on microfinance as an anti-poverty tool overall the globe, the need for developing the service in the region is not debatable. However, even though financing the poor who were otherwise excluded from the formal financial systems were considered as the top development agenda of not only the regional and federal governments of Ethiopia but also that of the wider international development community, due attentions were not still given to timely initiate and develop the service in Somali region. Addressing this gap, Kejela *et al.* (2008) indicated that the few existing formal banks in Somali region serve only their business customers like hotels, retailers and petty business centers while the financial needs of the majority of the poor who were engaged in non-business activities were left unmet in the financial system of the region. In this regard, even though there are ample literatures on microfinance as an anti-poverty tool in Ethiopia, no studies have been endeavored so far to identify the factors which constrain the development of microfinance service in remote and context specific regions like the Somali region. Hence, this study was undertaken to identify the major frontiers which should be handled in policy decisions to promote sustainable service in the region.

3. Methodology

3.1. Description of the Somali region

This study was undertaken in Shinile district of the Somali region in Ethiopia. The Somali region represents the second largest region covering an area of 279,252 km^2 with a total population of 4,439,147 people, out of which more than 90% are residing in rural parts of the region (BoFED, 2011). Pastoralism is the dominant agricultural activity of the region. According to the Somali Bureau of Agriculture, during the year 2010/2011, this sector has supported about 92% of employment, 22.93% of national herd take-off, and 5.30% and 7.46% of national skin and hides market supply, respectively (SNRS, 2011). The topography of the region is dominated by low land plains and hilly middle altitudes with large vegetation cover. Large browse-rich bushes are available for camel and goats while shrub grass lands are being used for sheep and cattle grazing. But, production of staple food crops is highly limited due to moisture stressed nature of the climate and very limited access to irrigation facility. The livestock sector of the region's economy often suffers from mortality risk caused by climate change and recurrent drought. As a result, the region is one of the chronically food insecure regions in Ethiopia where persistent famine occurs at least three wise in a decade, claiming the lives of lots of people in the region.

As Deverex (2006) indicated, the overall economy of the Somali region of Ethiopia was intensely vulnerable to shocks emanating from drought, illegal cross border trade, high currency fluctuation, livestock import bans by the Gulf States, range land degradation and social conflict on access to range resources. These emerging threats are highly undermining the traditional livelihood strategies leading to persistent poverty traps among the households in the region. Hence, innovative adaptation mechanisms and effective livelihood diversification strategies towards on/off-farm income generating activities are of a priority. In line with this, Chantarat *et al.* (2007) indicated that all factors that seem to impede the economic capacity of the poor to surmount the critical threshold revolve around some combination of market imperfections that generate exclusionary mechanisms (e.g., credit and insurance rationing), resulting in the separation of subpopulations into distinct groups with different prospects. Hence, in the context of the northern Kenyan pastoralists where the above study was undertaken, provision of financial and livestock insurance services were recommended to be effective tools to fight against poverty, and this was implied for Ethiopian pastoralists due to their comparable socio-economic setups.

In Somali region of Ethiopia, almost all social services are limited. Limited access to road, communication network and other infrastructures make it difficult to access markets and financial services by the households. For the current study, the Shinile Zone which is one of the nine Zones of the Somali region was purposively selected. The zone borders with Djibouti in the North, Somalia (Somaliland) in the northeast, Oromia region in the south and Afar region in the West. According to the Bureau of Finance and Economic Development (BoFED, 2011), the Shinile zone has six districts including Mieso, Afdem, Erer, Shinile, Aysha and Dembel with a total population of 434,450. The six districts have varying geographical nature, livelihood composition and proximity to towns and district centers, thus, have varying access to different social services. The Shinile district has 13 *kebeles* (local administrative units) where pastoralism, agropastoralism and sedentary farming systems are the basic livelihood activities.

3.2. Data Sources, Methods of Collection and Analysis

Data for this study was collected from both primary and secondary sources. Primary data were collected through a formal household questionnaire survey, key informant interviews and focus group discussions. A multi-stage random sampling technique was employed to select the final observations. Firstly, Shinile zone was purposively chosen among the nine zones of the Somali region due to its geographical bordering with different regional states of Ethiopia where financial services were better developed. Secondly, the Shinile district which is at the center of the Shinile zone was selected as it holds the common socio-economic characteristics of all the districts in the zone. Thirdly, *kebeles* (local administrative units) were categorized as pastoral, agro-pastoral and sedentary farming areas in discussion with the district bureau of agriculture. Finally, proportionate random samples of 136 households were chosen from the three categories. A structured questionnaire was designed to elicit information on a wide variety of topics including household socio-economic and demographic characteristics that determine their demand for microfinance, saving and credit experience, household enterprises as well as the sources and uses of financial resources. In administering the questionnaire, enumerators who have experience in socioeconomic surveys were employed and were also introduced to the purpose of the study. The survey questionnaire was pre-tested and actual field survey was done from October 2010 to March 2011. Then, updated secondary data were collected from financial institutions, regulatory agencies and government development finance structures. Proclamations and directives of the National Bank of Ethiopia, Five Year Development plans, policies, strategies and programs of government were considered. As microfinance service development was evidenced to be largely determined by socio-cultural factors like religion in the study area, the collected data was critically analyzed using qualitative approaches and descriptive statistics.

4. Result and Discussions

4.1. Household Socio-economic Characteristics

Socio-economic and demographic factors largely determine the households' demand for microfinance services. In this study, pastoralist household specific characteristics were found to have important bearing in constraining the effective demand for microfinance service development as elucidated below.

Pastoral dominated livelihood: The majority of the households in the study area were engaged in pastoralism (67.2%), followed by agro-pastoralism (23.5%) and sedentary farming (7.8%) while the rest few of them were employed in petty business activities. This was due to the fact that culturally possession of as large number of livestock as possible determines the social status of a household among the Somali community. Those households whose livelihoods were based on petty business, micro-enterprises or artistic jobs were considered inferior if they have small number of cattle. This condition ultimately limits the entrepreneurial motive of the households to diversify their livelihood towards non-farm enterprises which in turn constrains their effective demand for microfinance services. However, households have happened to learn that the traditional nomadic style of livelihood cannot be sustainable in future due to the emerging adverse trends in climate change and recurrent drought that causes high livestock mortality risk. Hence, their response to microfinance demand elicitation for the purpose of livelihood diversification and micro-enterprise start-up was strongly positive. Indicating erratic nature of rainfall and limited access to irrigation facilities as the main obstacles of their livelihood, the agro-pastoral and sedentary farming groups opt to diversify their livelihood towards on/off-farm income generating activities like petty trade, micro- and small-scale enterprises. Thus, their need for financial support was highly justified.

Mobility with herds: Almost all pastoral and agro-pastoral households in the study area had family members, mainly household heads, who were moving from place to place with their herd in search for pasture. This has long been considered as the main challenge to provide basic social services in the pastoral areas. In microfinance service development, mobility poses a challenge because when household heads remain mobile, lending institutions lose their interest, confidence and trust to grant loans as they expect increase in loan default risk. In addition, serving mobile and segregated groups also increases transaction costs. Understanding this, the government of Ethiopia is currently advocating sedentarization programs which are mainly meant for fixing public services in the study area. But still, respondents argue that sedentarization and public service provision makes a trade-off against securing pasture for their livestock.

As a win-win strategy, one customized model that deals with pastoralists' mobility to render social services in the area is the 'satellite mode of service delivery' in which services remain mobile with the route of pastoralists from season to season. Adopting this model, animal health, children school and adult training services were experimented and found to be promising in different pastoral areas of Ethiopia. A team of Pastoral Community Development Program (PCDP) is currently providing such services in Somali region. Using advanced tools of geographic information system (GIS) that provides data on normalized differential vegetation index (NDVI), the team identifies areas with positive vegetation cover in the consequent seasons to which pastoralists probably migrate. This helps the team to predict and look after the pastoralists' mobility route to render early warning, risk and disaster prevention services in the region. As the respondents of this study were highly appreciating such service delivery, this can be scaled up to develop an innovative microfinance service in the study area.

Property rights: Among the Somali community, resources are perceived as the 'commons', mainly because of high interdependence in their communal life. Detailed focused group discussions with the clan heads, local leaders and community elders in the study area revealed that intrinsically there is no individualism. Access to the assets of relatives, friends and neighbors (particularly among those who belong to the same clan) is free. Hence, there is unclear property right for the assets that the households possess like land, pasture or livestock. From the perspective of financial service provision, the absence of property rights have remained as a threat since financial institutions perceive land and property less households as high risk clients with no collateral.

Religion: About 99.41% of the total populations in the study area were followers of Islamic religion. In this religion, charging interest on any financial services is prohibited. Thus, people in the study area perceive using bank or microfinance services as breaching the law of the religion. Therefore, religion restricts households not to seek formal saving and credit services which are linked with interest earning or payments. However, households have little awareness on the fact that microfinance services were much more succeeded among patriarchic Islam communities in Bangladesh and Indonesia. Similar to this areas, Islamic religious bond together with the traditional communal life of people in the current study area have created a sort of homogeneity in living standard and behavior of the people, leading them to develop high social cohesiveness. This is an indicator for the existence of high social capital and can be used for designing group loans and peer monitoring mechanisms in rendering the microfinance services. Therefore, even though religion fundamentally constrains the development of microfinance service in the study area, but still innovative microfinance service design can make use of the social capital being created from people's communal sprit for social collateral purpose.

Infrastructure: The Somali region is poorly developed in terms of infrastructural facilities. In this study area, it was observed that on average there was one first round elementary school, one public health center and one animal health center with an average distance of 15-20 kilometers. The only road outlet stretches from Dire Dawa to Djibouti with poor road conditions. Telecommunication and electricity services are very limited. This low development of the infrastructure base, thus, poses a great challenge for financial service development in the study area as it creates difficulties to process information, assess households' demand and willingness to pay for the services or expedite extended services from district centers and nearby towns. Such poor developments of infrastructure and communication systems also increase transaction costs.

Population density: The Somali region has a total population of 4,439,147 with an estimated area of 279,252 km^2, thus, the estimated population density of the region is 15.9 people per km^2. Such highly dispersed population density affects the efficiency and effectiveness of service delivery system. In the context of developing microfinance service, it remains as a threat because it increases transaction costs.

4.2. Rural Financial Architecture in the study area

The nature, characters and architecture of a rural financial sector affects the initiation and development of financial services in a given area. This section provides analysis of how the supply side of microfinance service development is constrained by the failure of outreach policy of the formal sector and the institutional limitations of the semiformal and informal sectors in the study area.

4.2.1. Formal Sector

In the context of Ethiopia, formal financial sector comprises of the services of those financial institutions which are legally authorized, regulated and supervised by the National Bank of Ethiopia (NBE), which is the central bank of the country. Under the formal sector category, there are four public banks (Commercial Bank of Ethiopia, Development Bank of Ethiopia, Construction and Business Bank and Cooperative Bank of Oromia) and many other private banks. Data on the services of these institutions generally show that these were not serving the rural poor due to the lack of reliable information on small groups of borrowers, inadequate legal frameworks for contract enforcement and inappropriate instruments for credit risk management. Prudential regulation, supervision and capital adequacy requirements were also evidenced to constrain the outreach services of formal banks since these conditions further penalize banks to lend to the poor. In Somali region, the main factors constraining the outreach of the formal financial sector to serve the poor were discussed below.

The 'poor is unbankable' view: It is a long held belief among the formal financial institutions that the poor is a clientele with high risk of default and no acceptable collateral. This mighty assumption widely prevails in Ethiopian financial sector. In the study area, households were perceived as absolutely nomadic and in spite of the fact that rural financial services were promoted to operate in all areas, formal banks undermine pastoralists as clients with no loan purpose, no security for collateralization, thus, unbankable.

Default Risk Aversion: One of the basic justifications which make the formal sector not to borrow to the poor is the risk of default. In the study area, default and loan repayment delinquency were expected to arise due to various reasons. First, failure of the borrowers' business due to different uncontrollable adverse conditions causes 'non-willful default', which is often considered as the problem of loan screening. Second, the unwillingness of borrowers to repay back the loan as they often consider it as a gift or political patronage causes 'willful default'. In the absence of institutional mechanisms to enforce repayment, willful default is, thus, a contract enforcement problem. Thirdly, the lack of adequate motivation of the borrowers causes loan delinquency and default as incentive problems. Default, be it willful or non-willful, makes credit transactions non-sustainable and highly costly because the credit will no more be self-liquidating and lenders would incur heavy loan administration, supervision and follow-up costs to assure repayment. However, willful and non-willful defaulters should be separately known because flexibility on the credit policy is required for the latter in order to make a sustainable credit system.

Inflexible Financial Policies: Banks in Ethiopian formal financial sector have 'rigid' financial policies that mandate collateral as always a requirement for an individual or enterprise to be considered credit-worthy. In the study area, the poor without collateral to borrow is excluded from the services of the formal financial sector since interest rates, due date and loan approval policies of banks in district centers and nearby towns were not conditionally flexible.

Limited and Inaccessible Financial Schemes: On top of the fact that the available financial institutions were very limited, they are also inaccessible even when farmers travel to district offices and nearby towns to get credit services. Households and banks have very divergent views with regard to the reasons why the available financial services were not accessible. Households perceive that public and private banks are not compassionate enough to serve the interest of the rural poor as they cannot logically identify the needy, the defaulter or both. On the other hand, banks justify limited branch net-work due to low capacity for expansion, poorly developed infrastructure that increases transaction costs, the geographic distance between the borrowers and bank branches, the time taken to process the loan applications, bureaucratic formalities of sanctioning loans as set by their head offices and the biased distributions of bank branches across the whole regions of the country as the main obstacles for the formal financial sector to serve the rural remote areas. As there were no intermediaries between credit users and formal institutions (non-agent operation), the formal financial services were not accessible by the poor.

Credit Discrimination and Bias: The operational by-laws of public and private banks in Ethiopia underscore securitization of loans, customer loyalty and credit worthiness as main criteria to grant credit. There is also strong government influence in credit targeting as result of which formal bank sources are managed only through the top-down bureaucratic system and they are directly instructed by government officials to give credit services to some targeted enterprises or groups irrespective of their credit worthiness. Thus, credit provision in the study area is observed discriminatory in nature.

4.2.2. Semi-formal Sector

Non-governmental Organizations (NGOs) and financial saving and Credit Cooperatives (SACCOs) that provide rural financial services were the two main elements of the semi-formal financial sector in the study area. These are termed as '*semi*' because they are not authorized and legally licensed by the NBE but their role in the rural financial system is significant. Historically, NGOs had played a significant role in building the foundation for pro-poor finance in Ethiopia. Before 1996, many NGOs were engaged in providing saving, credit and other non-financial services like family planning directly to the poor beneficiaries. However, the wave of microfinance interventions in the world and the urgent need of the service to the poor rural households in Ethiopia have necessitated regulation and standardization of pro-poor finance. In this set up, the financial services of NGOs were criticized as fragmented, hampered by a lack of specialized finance staff, weak loan recovery, and recorded no clear path towards sustainability. Thus, the government of Ethiopia enacted Microfinance Proclamation No 40/1996 that dictates only legally incorporated, licensed and regulated Microfinance Institutions (MFIs) to provide financial services to the poor. Hence, NGOs were prohibited to provide direct financial services to the poor in the country in favor of creating good market opportunities for MFIs.

As a result of this proclamation, regional governments in Ethiopia created a number of MFIs. To adapt to the system, many NGOs formed their own independent and regulated microfinance wings. Such strategy is used by NGOs like World Vision, CARE Ethiopia, Catholic Relief and Save the Children. In the study area, a remarkable pro-poor finance work was done by Save the Children-an international NGO-having long term experience in rural financial services through its wide range of interventions. This NGO followed a model known as Income Generating Group Financing (IGGF) model. The conceptual philosophy IGGF is forming Income Generating Groups (IGG), helping them to identify their business ideas, developing their business as a Group Income Generating Enterprise (GIGE) and covering the financial and technical requirements of the business. This model is found to be workable in the socio-economic context of the region and also shared among different NGOs. In addition, SACCOs were organized by NGOs in collaboration with the Ethiopian Cooperative Agency and

SACCOs groups were planned to provide rural saving and credit services.

4.2.3. Informal Sector

The Ethiopian informal financial sector is composed of moneylenders, *Iqquib, Iddir,* funeral mutual helps and exchange of money among friends and relatives. *Iqquib* is a rotating saving and credit traditional organization while *Iddir* is a means of pulling resources together through regular meetings. These are very common in Ethiopian rural and market places and their role is not only enabling their members to accumulate assets but also to deal with cases of financial stress and emergency needs of money, for instance, for health conditions and death compensations. Funds mobilized through *Iqquib* and *Iddir* are used as a precautionary strategy not just for managing ill health but also for managing a wide range of other financial crises and risks. In the study area, informal sector financing is the most dominant and sustainable way of pro-poor finance which meet the social, economic and religious financial needs of the community. One of the unique features of this sector in the current study area is the absence of moneylenders. Moneylenders who create dysfunctional markets in traditional institutions through charging exorbitant interest rate were prohibited in Somali community due to religious reasons. In general, the informal and semiformal sectors dominate the rural financial architecture of the study area. However, various factors were found even to constrain the advancement of these sectors to provide a sustainable pro-poor finance system. First of all, these sectors operate with a double standard for many of the basic financial variables. This is technically termed as 'financial dualism' and summarized in the context of the study area as follows.

Nature of Duality	**Semi-formal Sector**	**Informal Sector**
Accessibility	less accessible	Accessible
Transaction cost	involves transaction cost	involves no transaction cost
Default risk	involves certain degree of default risk	default risk is almost null
Adverse selection	high degree of adverse selection	low degree of adverse selection
Moral hazard	high degree of moral hazard	low degree of moral hazard
Flexibility	inflexible	flexible
Bureaucracy	bureaucratic and procedural	less bureaucratic and procedural
Conflict of interest	entails conflict of interest	coherent
Organization	better organized	disorganized

In addition, the semiformal and informal sectors in the study area were limited to satisfy the pastoral, agro-pastoral and sedentary farmers as separate groups demanding differentiated financial services. Due to limited resources, skill, knowledge, technology and manpower, the semi-formal and informal sectors operate in their traditional way and disregard the unique features of each of the activities. Due to their low financial literacy, these sectors do not have the necessary skill and expertise to give efficient credit service for the rural community. People having petty shops and micro-enterprises who often grant loans to the poor often collect loan dues in kind. Thus, non-monetary loan repayments are very common in the informal financial markets. There is also no integration among the informal lenders, thus, they follow different loan disbursement mechanisms for different loan clients, which hampers the efficiency of the credit market. The informal sector has a weak institutional setup to mobilize resources through individual saving. Financial services were generally undertaken as a secondary activity besides the normal day-to-day activities. There was also ethnic and clan affiliation in granting credit to different individuals.

4.3. Infant Development of Micro-enterprises in the study area

The government of Ethiopia has a great interest to promote MSEs in all regional states. In government development plans, new investment policy, new labor law, trade policy reforms, revised taxation rates and dissolution of highly centralized and bureaucratic corporations were made to promote private sector development. Industrialization has become a priority and various economic reforms were made in order to raise the productivity and competitiveness of private enterprises as the engine of growth. Hence, promotion of pro-poor financial services such as credit facilities, saving mobilizations, modernization of commercial banking, development of financial markets and policy-based lending were advocated to back up effective promotion of MSEs in all regional states of the country.

However, the Somali region is still characterized by the infant development of micro-enterprises in which few micro-entrepreneurs with low skill and business know-how were engaged in petty trade activities. This has constrained the demand of the microfinance service in the region because the ultimate objective of microfinance is to finance micro-enterprises. Thus, in the absence of micro-enterprises, microfinance institutions will not be established merely through the need of poor people. But they do function in the presence of feasible business activities and/or potentials that can be shaped. To serve the millions of entrepreneurs engaged in petty trade activities, the credit sector incurs undue costs of administering credit (the continuum from assessing credit worthiness up until credit collection). The unit transaction cost per loan agreement remains very high. In addition, information about potential borrowers is difficult to obtain since they are scattered and management of their their loans remain costly. The large number of scattered small size loan applications, the difficulty of conducting follow-up visits to each borrower, and the expected cost of loan administration impede lenders from reaching the rural community. In Somali region, micro-entrepreneurs and their enterprises operate more as social units, and less as business entities. Hence, this infant stage development of the micro-enterprise sector in the study area poses very significant obstacles for microfinance service development in the study area.

4.4. Financial Policy, Regulation and State Preparedness

Policy environment: At the macro-level, an enabling policy environment is very important to promote financial services. Understanding this, the government of Ethiopia has attempted series of reforms in the financial sector to create dynamic, vibrant and stable macro and fiscal environment. With regard to microfinance service development, one of the unique reforms made was the microfinance proclamation 40/1996 that prohibited NGOs and the government itself from direct involvement of delivering financial services in order to create a conductive market for the microfinance industry. But this proclamation imposed a threat on the development of microfinance service in remote areas where the hands of government cannot reach and where most of the social development works are undertaken by humanitarian agencies. For instance, NGOs have full-blown experience in initiating and developing micro- and other financial services in the country. But after this proclamation, these institutions were unable to provide their services in the peripheral areas including the Somali region.

Regulation and Supervision: Inadequate regulation and supervision system as well as inadequate contract enforcement mechanisms limit the provision of financial services in rural and urban areas. In Ethiopia, the Monetary and Banking Proclamation 1994 has laid the basic legal foundation of the financial sector. According to this proclamation, the task of licensing and supervising banks, insurances and other financial institutions was given to the National Bank of Ethiopia (NBE). Therefore, the NBE is the custodian of microfinance industry and it has taken the lead role in the regulation, supervision, coordination and development of MFIs in the country. Ethiopia is perhaps an exceptional country in this case. In authorizing the NBE, the Ethiopian government has followed a rather broad approach to banking supervision, which does not concentrate on deposit taking only, but instead explicitly includes lending of money as a banking activity. However, the supervision standards, risk assessment mechanisms, technical capacity and enforcement power of the NBE are far below the global best practices which limit the financial services of both microfinance and non-microfinance institutions.

Macro-economic Stability: Effective development of microfinance service requires stable macroeconomic conditions with relatively low inflation rate. But, alarming rate of inflation, unstable macroeconomic conditions, volatile fiscal, monetary and interest rate policies are the emerging trends in Ethiopian financial sector. Furthermore, microfinance provision is being politicized and there is a wide interference of government in financial service delivery and operational autonomy of institutions that grants them limited allowance for financial product differentiation. In addition, currency devaluation, rigidity in budgetary allocation, creating financial environment which is not competitive and unfair allocation of financial services among regions were some of the government decisions which constrain the development of the service. In general, it can be implied that both the policy environment and the financial system regulation in Ethiopia principally provide potential opportunities for microfinance service development in the study area. However, the existing policies and regulations were not flexible enough to meet the unique socio-economic and location specific characteristics of the Somali region to promote microfinance service.

*Regional inequity/Marginalization***:** Microfinance provision is equally persuaded and the existing policies and regulations do not make any discrimination among the regions in Ethiopia. In few regions, for instance, Amahra Credit and Saving Institute (ACSI) in Amahra region, Dedebit Credit and Saving Institute (DECSI) in Tigray and Oromia Credit and Saving Share Company (OCSSCO) in Oromia, have made a remarkable impact on poverty alleviation. But the initiation taken by the federal and regional governments to launch microfinance in Somali region was observed to be minimal. Lack of awareness and reluctance of the regional government can be one of the reasons for lagging behind. Since microfinance service were taken up as the engines for enterprise development plan of the regional governments in Ethiopia, the situation in Somali region evidences the prevailing inequity and marginalization of the region.

Socialization Gap: If the states bodies were conscious for microfinance service during the past sixteen years, it was possible to create interest and demand in the mind of a community about the microfinance service, its products and technology through social marketing. In the study area, both the government and non-government organizations appreciate the global importance of microfinance service but the efforts made by these organizations to create awareness and understanding in the mind of the Somali people who due to their socio-cultural and religious impediments, have a different mental disposition about banks and other financial services, was minimal. Thus, under the current situation, the majority of the Somali households relate microfinance service provision with interest-bearing financial service and in the absence of socialization efforts, demand driven service development cannot be effective.

Reluctance of the state Functionaries: Government officials in Somali region believe in microfinance as a nationally and globally accepted tool of poverty reduction. Even though, provision of microfinance is highly persuaded by the federal government in order to meet the demand, the reluctance of the regional government in giving high priority to launch a workable system and put the system in place has made matters to take time. Hence, despite the fact that the regional government of Somali has a great interest to start microfinance service, the efforts taken by the government to expedite the process is minimal.

5. Conclusion

It is evident from this study that provision of microfinance service has been promoted and remarkable achievements were made in some states of Ethiopia while the majority of the poor in remote rural areas and peripheral locations were left uncovered due to various reasons. In Somali region, socio-economic, institutional and policy/regulatory factors have constrained the development of microfinance service at micro-, meso- and macro-levels, respectively. The motive of the pastoral households to have large number of herds in order to have higher social status in the community which limits their entrepreneurial and livelihood diversification motive, religion, the absence of clear property right as well as mobility with herds, dispersed population density and poor infrastructure development which collectively increase transaction costs of service delivery were observed to constrain the effective demand for microfinance service. Similarly, institutional limitations including default risk aversion, inflexible policies, limited, inaccessible, differentiated and biased service provision as well as the mighty assumption of formal financial institutions that perceive the poor pastoralists as unbankable, were found as frontiers of their outreach service. The expansion and advancement of the semi-formal and informal financial sectors which were predominantly operating in the area were also constrained by the prevailing financial dualism, poor institutional set-up to mobilize resources and low financial literacy. In general, the overall rural financial architecture was found to constrain the supply of microfinance service while the financial policy/regulatory environment, regional inequity, marginalization and reluctance of state functionaries were found to be unfavorable environment for the development of microfinance service in Somali region.

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